The Pakistan Credit Rating Agency Limited

# Methodology
# Structured Finance Rating

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## Summary


This methodology describes PACRA's approach to rating structured finance, a relatively complex form of debt, resulting from securitization transactions. PACRA's assessment begins with the profile and background of the originator – the entity that requires financing. This is followed by studying the legal structure of the transaction, to ensure isolation, or "de-linking," of the pool of assets underlying the transaction, from the credit risk of the originator. PACRA then analyzes the nature of the underlying assets along with their associated cash flows using a data heavy approach to assess asset quality and payment risk. Herein, a key factor is incorporating the impact of entity specific, industry wide, or economic changes likely to impact future cash flows. Upon completion of analysis, usually, a "preliminary rating" is assigned. Subsequently, when the transaction is legally formalized, the legal documentation is reviewed to incorporate the credit and legal implications of the transaction structure to arrive at the "final rating".



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# 0. Introduction

- Typically issued to carve out risk and/or improve marketability of underlying assets
- De-linking of credit risk of originator from risk of instrument
- Governed under SECP's Asset Backed Securitization Rules, 1999

**0.1** Structured finance instruments are a relatively complex form of debt, involving the pooling of assets and the subsequent sale to investors of tranched claims on the cash flows backed by these pools. Such instruments are usually issued to transfer or carve out risk and/or improve marketability of a pool of underlying asset(s), by separating the performance of the assets from the entity originating them. These assets are created through a process known as "securitization". Securitization allows the entity in need of funds to separate assets from the credit, performance, and other risks associated with the entity itself. Moreover, this process helps convert illiquid assets that cannot be easily sold to third party investors into liquid, marketable securities.

**0.2** Securitization involves creating, combining, and recombining categories of assets, including loans and receivables, into new forms. Assets from a customer or a group of customers are pooled and repackaged, underwritten and sold in the form of asset-backed debt instruments. The instruments or 'asset-backed securities' are collateralized or 'backed' by a pool of assets and are not considered general obligations of the entity that is in actual need of funds. This is typically achieved by the sale of an identifiable and specific pool of the originator's assets, either directly or indirectly, to a special purpose vehicle (SPV). This is a crucial step in the process. The aim here is to "de-link" the credit risk of the originator from that of the underlying pool of assets, so that neither the assets nor their proceeds will be consolidated as part of the bankruptcy estate of the originator/seller in the event of its insolvency. The investor in an asset-backed security is entitled to receive a pass through of the timely payment of profit and principal on the pooled assets. The rating agency, therefore, evaluates the risks associated with the cash flows emanating from the purchased assets for repayment.

**0.3** Although all structured finance instruments are asset-backed, the nature of assets may vary. Following are prominent types of such instruments:

| Type of Asset backed (Structured finance) Instruments | |
|---|---|
| **Collateralized debt obligations** | Pools of commercial loans to corporates or small and medium-sized enterprises and pools of corporate bonds |
| **Mortgage-backed securities** | Pools of residential/commercial mortgages that may consist of a single property or a group of properties financed by a single borrower, or a pool that combines numerous loans from different borrowers secured by diverse properties |
| **Future flow Securitization** | The future cash flows from pools of assets such as export receivables, telephone net settlements and airline receivables or flows from financial assets such as credit card voucher processing receivables, trade payments rights or worker remittances |

**0.4 Regulatory Regime:** Structured finance transactions, wherein Special Purpose Vehicle (SPV) is created, are governed under The Companies (Asset backed Securitization) Rules, 1999, issued by Securities and Exchange Commission of Pakistan. These rules require SPVs to be registered with SECP, meet the conditions and abide by respective obligations.

| Terms related to Structured Finance Instruments as defined by law | |
|---|---|
| **Structured Finance Products** | Structured Finance Products are the instruments resulting from the securitization transactions *[Credit Rating Companies Regulations, 2016]* |
| **Investor** | "investor" means a person holding any asset backed securities issued by a Special Purpose Vehicle under *[The Companies (Asset-backed Securitization) Rules, 1999]* |

| | |
|---|---|
| **Originator** | "Originator" means a person who transfers to a Special Purpose Vehicle any assets in the form of present or future receivables as a consequence of Securitization *[The Companies (Asset-backed Securitization) Rules, 1999]* |
| **Securitization** | "Securitization" means a process whereby any Special Purpose Vehicle raises funds by issue of Term Finance Certificates or any other instruments with the approval of the Commission, for such purpose and uses such funds by making payment to the Originator and through such process acquires the title, property or "future receivables" (defined below) right in the receivables or other assets in the form of actionable claims *[The Companies (Asset-backed Securitization) Rules, 1999]* |
| **Special Purpose Vehicle** | "Special Purpose Vehicle" means a special purpose vehicle registered by the Commission for the purpose of Securitization *[The Companies (Asset-backed Securitization) Rules, 1999]* |
| **Future receivables** | "future receivables" includes all such receivables against which income may accrue or arise at a future date *[The Companies (Asset-backed Securitization) Rules, 1999]* |

# 1. Flow of Structured Finance Transaction

- **Participants**: Originator, issuer, investor and trustee / investment agent
- **Process**: Creation of SPV → true sale of assets → issuance of instrument

**1.1 Participants:** A typical structured finance transaction involves the following participants:

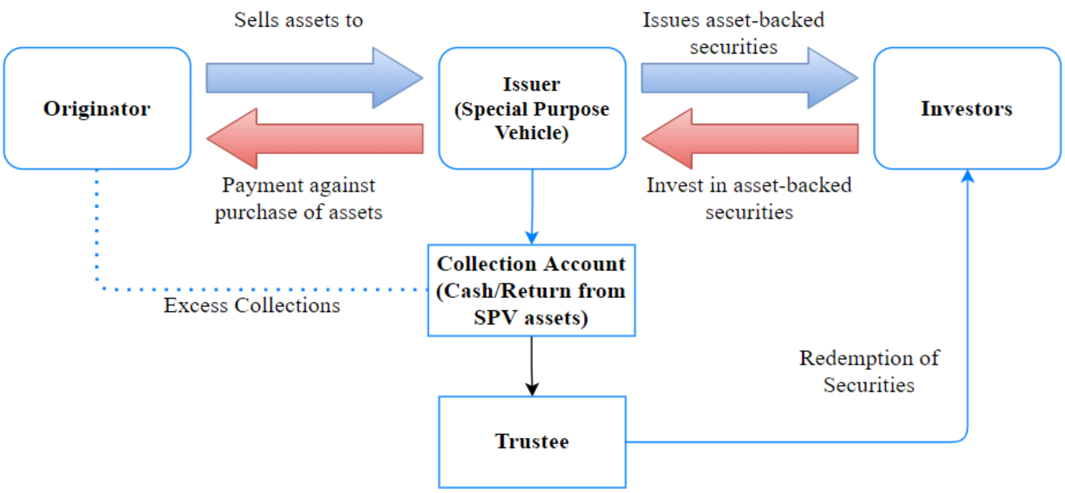
i) Originator – the entity that actually requires financing

ii) Issuer, which is a Special Purpose Vehicle – a bankruptcy remote legal entity that issues debt securities

iii) Investor – who is the financier to the structured finance instrument

iv) Trustee/Investment agent – who plays a key role in monitoring of the instrument, and ensuring all agreed terms and conditions are adhered to

**1.2 Process:** Issuance of a typical structured finance instrument takes the following steps: i) originator creates an SPV, ii) a true sale transaction takes place whereby the originator sells the underlying assets (either to carve out specific assets or entrap cash flows) to the SPV, iii) the SPV issues structured finance instruments to investors, using the proceeds to acquire the cash-generating assets. This process is illustrated below. Throughout the life of the instrument, it is trustee/investment agent's responsibility to ensure all terms and conditions including the covenants are complied with, in accordance with the trust deed.



# 2. Rating Structured Finance Instruments

- **Originator**: Financing needs and long-term financial strategy of
- **Legal Structure**: Asset isolation and "bankruptcy remoteness" of SPV as per documentation
- **Asset Risk**: Nature and characteristics of asset pool and its historical performance
- **Repayment Risk**: Timing of cash flows and level of coverage against repayment
- **Challenges**: Availability of adequate data pertaining to the asset pool, and in certain cases the originator itself

**2.1** Structured finance instruments have three key attributes that define the risk: i) pooling of assets (that directly or synthetically generate cash flows), ii) delinking of credit risk of the originator (no recourse), and iii) tranching of liabilities. The risk analysis of any structured finance instrument focuses on three broad areas: i) Legal structure, ii) Asset risk, and iii) Repayment risk.

**2.2 Originator:** PACRA's risk assessment starts with basic understanding of the originator. PACRA reviews the policies and procedures by which the assets to be securitized are originated. Most of the times originators would be the ones servicing the flow of funds so that normal business transactions with customers remain less disruptive. Although the originator's credit profile is delinked from actual securitization, the rating agency needs to understand the background of the originator and the industry in which it operates and will be looking for the company to demonstrate at a minimum the following: i) a clear strategy for meeting financing needs and ii) an understandable and realistic motivation for securitization.

**2.3 Legal Structure:** PACRA then assesses the transaction's legal structure and documentation to assess the credit and legal implications. As part of this review, issues considered include transferability of assets, bankruptcy remoteness of SPV, taxation issues including transfer tax, stamp duty and withholding tax and regulatory concerns. The legal structure of a securitization transaction is expected to provide assurance that the pool of assets underlying the transaction cannot, under any circumstances, be recovered by the originator or become a part of the originator's assets in the event of bankruptcy. PACRA has found that the legal ability to transfer assets and attached security to a third party can often be constrained to securitization. Most securitizations rely on a "true sale" of assets to an SPV where ownership cannot be challenged in the event of the originator's bankruptcy. Meanwhile, there are several legal restrictions imposed on the activities of SPVs under the Companies (Asset-backed Securitization) Rules, 1999, and compliance with these regulations is an important consideration. When rating a securitization transaction, particularly in an industry with no previous securitization transactions or examples in the proposed asset class, an understanding of the legal environment is vital.

**2.4 Asset Risk**: The second step is understanding the nature of underlying assets or pool of assets for each structured finance instrument. These are unique and so are the cash flows. PACRA believes a securitization is impacted by the performance of asset portfolio more directly than a company would be when the assets remain on its balance sheet. Quality of past cash flows is assessed to ascertain expected cash flows. Likely changes in cash flow pattern in response to entity specific, industry wide, or economic changes is given key importance and incorporated in cash flow analysis. This is a data heavy analytical approach since it requires analysis of past trends and future projections of cash flows. PACRA looks for a set of data that provides understanding of underlying pool of assets. The dataset varies depending on the asset class to be securitized, but generally provides information on characteristics of the asset pool.

**2.4.1** PACRA solicits data to better understand an asset pool and its historical performance. Among other things, PACRA's asset risk assessment takes into account the asset class, tenure, borrowers' profile, level of diversification at borrower level. For many types of assets, the most easily securitizable portfolio consists of a homogeneous pool, ideally with a diversified customer base that generates a stable and predictable cash flow while concentrated asset pools are deemed higher risk. When looking at historical performance of an asset pool, delinquencies, defaults, recoveries, and prepayments are among important considerations, all of which may hinder the scheduled payout to the investor.

**Future Flow Securitization:** Assessment of asset risk in a future flow securitization differs from other types of securitization structures. This is because instruments issued under such structures are backed by assets (receivables) which do not currently exist. The receivables are usually to be generated over years, through the normal course of the originator's operations. Thus, repayments depend upon the ability of the originator to deliver certain goods/services, allowing for the creation of receivables which are then securitized. Thus, in this particular form of securitization, it is not entirely possible to de-link the risk of the transaction from that of the originator and the originator's credit profile and business continuity become a central consideration when rating the instrument. PACRA analyzes the risk associated with the originator's ability to continue to generate the receivables, and hence, cash flows, volatility of the future receivables and concentration of exposure to one or a limited number of parties.

**2.5 Repayment Risk**: Once quality of cash flows is ascertained, adequacy of cash flows is analyzed. This is also data heavy. It focuses on actual coverages against redemption schedule of structured finance instrument. PACRA assesses timing of cash flows vis-à-vis repayment terms. PACRA develops a base-case portfolio performance expectation, which represents the anticipated performance of a portfolio under a non- stressed economic scenario. This base case is run through stress scenarios at each desired rating category. The stressed scenarios would represent minimum cushion available. To assess the cushion appropriately, PACRA should be able to accurately project what percentage of cash flows from a pool of assets may not be available due to extended nonpayment to meet repayment obligations to investors. Some securitization transactions are impacted by the potential that customers make prepayments, repaying their obligations ahead of schedule. The analysis incorporates an understanding of which customers are most likely to prepay and for what reasons. In case of financial institution, repayments received on a loan portfolio are generally used to cover floating, short- term liquidity needs, funding additional loans or paying short-term liabilities. Liquidity managers typically have access to a range of cash inflows and are therefore able to cover liquidity needs even if expected loan payments are not received. In contrast, when this same loan pool is securitized, the cash flows from the loans are the only monies available to meet fixed repayment obligations. Delinquencies and defaults increase the cost of securitization to originators, as credit enhancement and liquidity facilities are put into place to cover potential cash shortfalls when expected payments from the assets are not received. For this reason, clearly understood trends in delinquencies and loss exposures are important to managing the securitization. The level of rating would be dependent on quantum (asset risk) and sustainability of coverages (repayment risk) against the commitments during life of instrument.

**2.6 Preliminary and Final Rating**: Most of the time, the originators will approach PACRA with proposed structure of the transaction. PACRA assesses all the draft documents and proposed structure and assigns a "preliminary rating". Once the transaction is legally formalized, the rating team is obligated to review the legal documentation. In case of material variation form the original proposed structure, the Rating Committee may decide for a lower or higher "final" rating.

For rating of structured finance instruments, the Credit Rating Companies Regulations 2016 require the following disclosures:

❖ ***[SECP] Credit Rating Companies Regulations'16:*** *"information about the originator like its name, its principal business, its brief financial and operating position for the last five years, nature of defaults and delay, if any, in repayment of any financial obligation during the last five years, nature and value of assets backing the instrument, detail of guarantee, if any, or any other additional security arrangement, transaction structure, collection mechanism etc."*

**2.7 Challenges faced while Rating Structured Finance Instruments**: Availability of reliable and standardized data in the rating process of structured finance instruments is of paramount importance. The availability of data is typically the major impediment in the rating process. This is because the data required for the on-going management of an asset pool is frequently different to that evaluated in the standard entity/instrument rating process. Securitization may call for data in formats not previously captured by a company's systems. Recreating historical data for existing assets using new parameters is time-consuming and can be a major cause of delay. However, companies that bring their information systems in line with the data requirements of such transactions find that the process can be completed efficiently.

# 3. Surveillance

**3.1** Once an instrument is issued, PACRA undertakes a formal review once in every six months. Surveillance frequency may be higher depending on repayment terms, frequency of repayments and other unique characteristics of a particular instrument. PACRA also establishes relationship with the trustee/investment agent of the instrument to remain updated on all instrument related information.

# 4. Rating Scale

**4.1** To differentiate between rating scale of plain vanilla debt instruments and structured finance instruments, the letters "sf" (Structured Finance) is being added as suffix to PACRA's standard rating scale.

| Structured Finance Rating |
|---|
| Structured Finance rating reflects forward-looking opinion on credit worthiness of underlying instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default. |

To distinguish the rating of structured finance instruments from plain vanilla debt instruments, the letters "sf" (Structured Finance) are added as suffix to PACRA's standard rating scale.

| Scale | Definition |
|---|---|
| **AAA (sf)** | **Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments |
| **AA+ (sf)**<br>**AA (sf)**<br>**AA- (sf)** | **Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events. |
| **A+ (sf)**<br>**A (sf)**<br>**A- (sf)** | **High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions. |
| **BBB+ (sf)**<br>**BBB (sf)**<br>**BBB- (sf)** | **Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity. |
| **BB+ (sf)**<br>**BB (sf)**<br>**BB- (sf)** | **Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met. |
| **B+ (sf)**<br>**B (sf)**<br>**B- (sf)** | **High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment. |
| **CCC (sf)**<br>**CC (sf)**<br>**C (sf)** | **Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default. |
| **D** | Obligations are currently in default. |

**Outlook (Stable, Positive, Negative, Developing)** Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

**Rating Watch** Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

**Suspension** It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

**Withdrawn** A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

**Harmonization** A change in rating due to revision in applicable methodology or underlying scale.

**Surveillance.** Surveillance on a publicly disseminated rating opinion on structured finance is carried out on an ongoing basis till the maturity of the instrument or cessation of contract. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.