

Criteria for rating of Asset/ Mortgage Backed Securitisation Transactions

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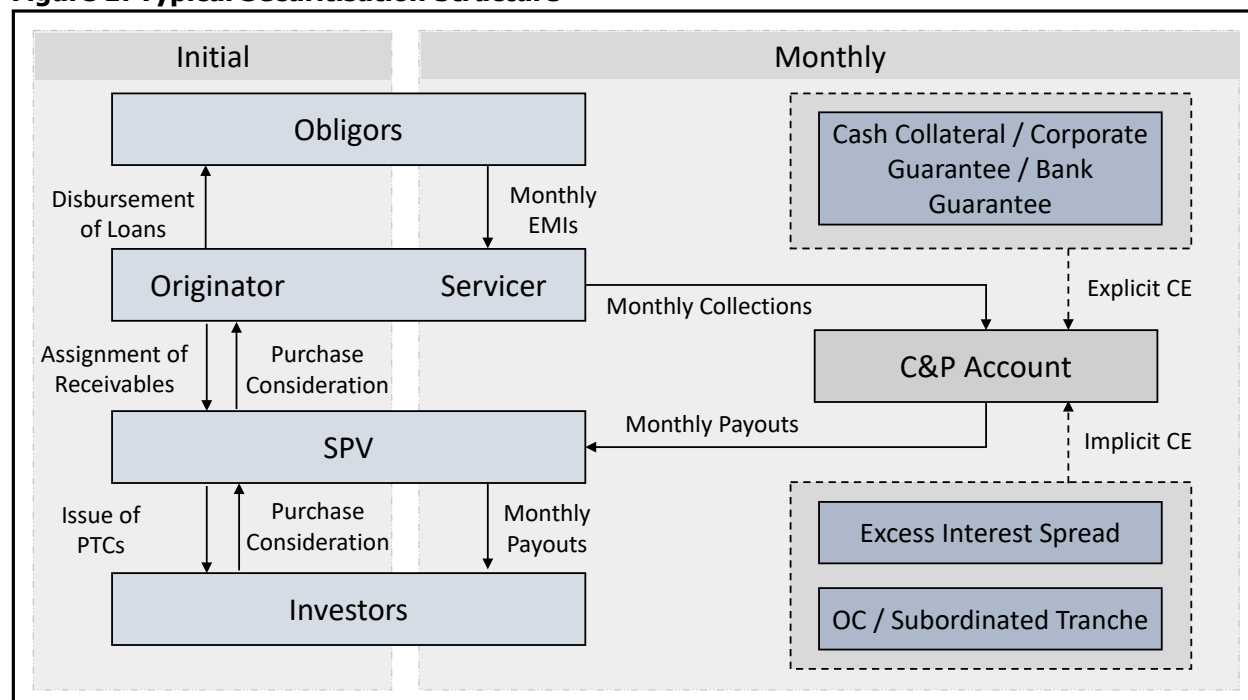
Introduction

This document summarises the methodology followed by CARE Ratings Limited (CareEdge Ratings) to assign ratings and credit opinion to securitisation transactions - Asset Backed Securities (ABS) and Mortgage Backed Securities (MBS). This methodology is also applicable to direct assignment of pools of loans where CareEdge Ratings provides lifetime principal loss estimation for pool backed by retail loans.

Overview of Securitisation

Securitisation involves selling a pool of assets as financial instruments to investors through a special purpose vehicle (SPV). In India, banks, non-banking finance companies (NBFCs), and housing finance companies (HFCs) typically act as originators. The assets include secured loans (such as housing, auto, commercial vehicle loans) and unsecured loans (such as personal and consumer durable loans). The SPV, usually a trust managed by a trustee, buys the asset pool and issues pass-through certificates (PTCs) or securitisation notes (SNs) to investors. The originator, acting as the servicer, collects payments from borrowers and passes them to the SPV, which then pays the investors. The external credit enhancement may be divided into First Loss Facility (FLF) and Second Loss Facility (SLF), protects against asset losses. FLF is the initial financial support, while SLF provides additional protection if FLF is exhausted. Liquidity Facility (LF), if provided, meets the temporary cash flow mismatches and does not provide loss protection to the investor. Securitisation transactions are generally carried out under Reserve Bank of India (RBI) Regulations and / or Securities and Exchange Board of India (SEBI) Regulations.

Figure 1: Typical Securitisation Structure



The key risks in a securitisation transaction can be summarised as follows:

1) Credit Risk

It refers to the risk of non-payment by underlying obligors. CareEdge Ratings analyses the originator's sourcing and credit appraisal system, historical portfolio performance (including static and dynamic portfolio performance data), and actual pool to assess the credit risk. The general risk perception of the asset, introduction of new models/substitutes or new technology may also have an impact on the pool performance. CareEdge Ratings considers the historical performance of the asset class and the factors that may impact the future performance of the asset-class to assess this risk.

2) Prepayment Risk

The prevailing and expected market interest rates and expected income levels influence the prepayment rates. Prepayment impacts maturity of the pool, total income of the investor, excess interest spread (EIS), and principal losses (in case of premium structures). CareEdge Ratings assesses the historical prepayment rates observed for that asset-class for the originator and the industry. Based on historical data and expected interest rates and income levels, CareEdge Ratings adopts suitable assumptions.

3) Basis Risk

The interest rate mismatch may arise where collections from underlying borrowers are based on fixed interest rate and payouts to investors are based on floating rate or vice versa. The basis risk also arises when interest rate of pool and PTCs are linked to different benchmarks. CareEdge Ratings adequately factors this while sizing credit enhancement levels. This risk is more prominent in MBS transactions.

4) Counterparty Risk

- a. Servicer Risk** – In securitisation transactions, the servicer plays a critical role in managing the underlying pool of assets throughout the transaction's life. In India, third-party service providers are limited and the originator acts as the servicer. The investors are exposed to disruption in collections in case of servicer bankruptcy or non-performance of servicer. As a result, the ability of the servicer to continue in business and maintain consistent performance is important. Provisions for an alternate servicer may partially mitigate potential disruptions.

To assess servicer risk, the following factors are considered:

- Experience and management quality of the servicer
- Size, market position, and reach of the servicer
- Collection processes, strategies, and organisational structure
- Quality of management information systems (MIS) for efficient monitoring
- Credit risk profile of the servicer

- b. Commingling Risk** - There is a time lag between the collection of instalments and their deposit into the collection and payout account (CPA), in which the funds may be used by the servicer. The Servicer is required to maintain separate records of pool collection and these amounts are held in trust by the servicer. The risk of partial or total loss, or delayed recovery increases if the servicer faces bankruptcy or legal proceedings.

- c. Trustee / Assignee Representative** - CareEdge Ratings considers the trustee / assignee representative's experience and capability to perform its duties and responsibilities. Generally, the trustee can be replaced by investors holding majority interest and may not have material impact on the transaction.
- d. Credit Enhancement Facility Provider** - The risk varies based on the type of credit enhancement facility, for example, cash collateral in the form of fixed deposit is considered low risk compared to a guarantee by the originator. Investors are exposed to the credit risk associated with nature of credit enhancement. The transaction may have mechanism to minimise the impact of changes in risk profile of credit enhancement.
- e. Other Counterparty Risk** - As per the transaction structure, there could be more counterparties involved, CareEdge Ratings will assess the credit quality of such counterparties to evaluate this risk and factor the same in the analysis.

5) Legal Risk

Any sell down involves transfer of receivables which must be a 'true sale' as per law. This effectively means that the originator does not have any right on assigned receivables. The sale should not contradict any of the terms of underlying loan agreements. The trust / assignee should have unrestricted access to receivables.

The SPV should be bankruptcy remote from the originator, meaning that the bankruptcy of creditors of the originator should not have claim on the securitised assets and its cashflows, which belong to the SPV. CareEdge Ratings relies on an independent legal opinion confirming the above.

In addition to the above, CareEdge Ratings places utmost importance on the accuracy and integrity of the data provided by the Originator.

Risk Analysis in an ABS/MBS Transaction

Analysing the originator's business process

The Securitisation process de-links the underlying pool of assets from the originator. The analysis of underlying asset pool involves evaluating the originator's sourcing process, credit appraisal system / underwriting standards, and collection and monitoring mechanism. This analysis is a key input to assess the pool quality as it is expected to reflect the sourcing, underwriting norms, and credit appraisal system of the Originator. As the Originator typically also acts as the servicer in India, the collection and monitoring methods used by Originator becomes equally important. The Originator analysis involves evaluating the management quality and experience, business growth, credit policies, underwriting standards, and financial strength, among others.

Analysing the portfolio data and the collateral (Securitised pool)

The underlying pool of loans which are sold down are typically selected based upon certain eligibility criteria. Although loans are cherry picked, analysing the originator's historical data plays a critical role in understanding the behaviour of underlying assets. The pool is analysed based on pool characteristics, with some factors considered favourable while some considered adverse. Based on historical data analysis, actual pool characteristics, prevalent and expected economic environment, the base case shortfall is derived for the pool. For securitisation transactions, the adequacy of the credit enhancement to cover the stress case shortfall is assessed to ensure it is commensurate with the rating assigned to PTCs.

A. Portfolio Data Analysis

CareEdge Ratings also studies trends in disbursement, collection efficiency, portfolio ageing (bucket movement), and prepayments, among others. This quantitative analysis supplements the qualitative analysis of the Originator, as mentioned above.

i. Disbursements

The disbursements show a trend of business with respect to the asset class. It can indicate if the business is stagnant, growing or in a declining trend.

ii. Collection Efficiency

The collection efficiencies are calculated to analyse the effectiveness of the collection mechanism employed by the Servicer. The collection efficiency can be further divided into two components – collection efficiency from current billings and collection efficiency from overdues.

iii. Dynamic Delinquency Analysis

The asset class-wise portfolio days past due (DPD) – is an important performance indicator. The principal outstanding as on a particular date is classified into buckets based on payment status of loans in the portfolio. CareEdge Ratings studies the bucket movement as on different dates over a period of time, for example, as on quarter ends for last two years. CareEdge Ratings analyses the delinquency numbers, such as 30+ DPD, 90+ DPD, 180+ DPD, over time. The lagged delinquency levels may also be calculated to account for possible understatement of delinquency levels in a growing portfolio scenario. Write-offs are also factored in while analysing portfolio delinquencies, as the portfolio of an originator with an aggressive write-off policy will typically exhibit lower delinquencies.

iv. Prepayments

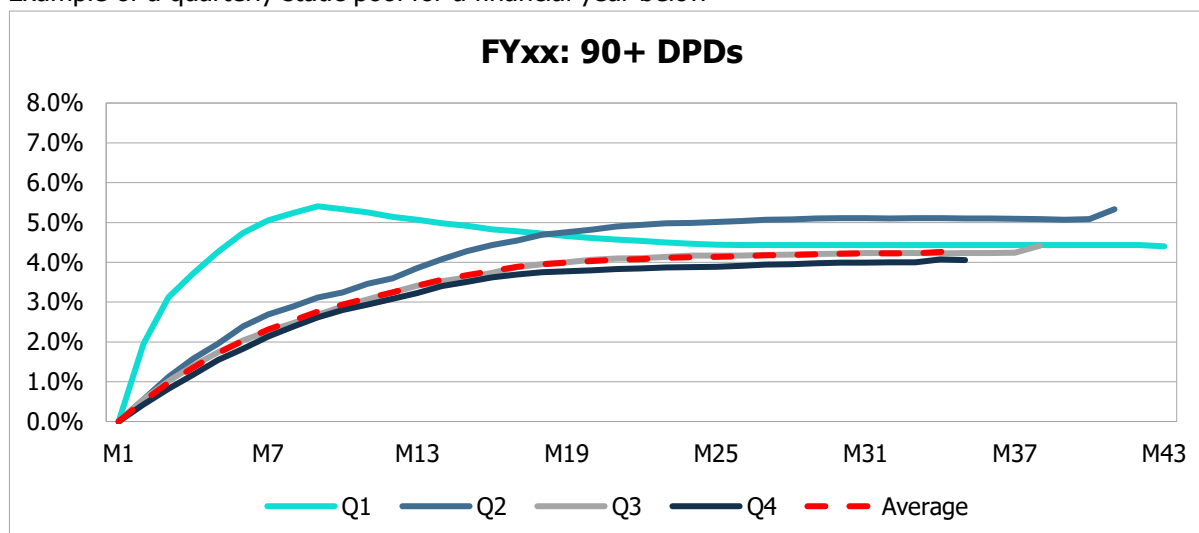
Prepayments in the underlying pool can affect the pool cashflows, which in turn can affect the cashflows to the trust. CareEdge Ratings studies prepayment data on the originator's portfolio and prepayment rates in the specific asset class across originators. In a high prepayment scenario, the transaction's EIS could reduce if borrowers with higher interest rates prepay. CareEdge Ratings analyses prepayments in conjunction with EIS compression for the transaction.

v. Static Pool Analysis

It is noteworthy that portfolio analysis is based on dynamic data in the sense that newly disbursed loans get added to the portfolio. The dynamic delinquency data is also impacted by portfolio write-offs. Therefore, the delinquency levels as observed in the portfolio analysis are not the best estimate of the expected delinquency levels for the pool to be securitised. The Static pool analysis overcomes this limitation of Portfolio analysis.

A static pool refers to fixed cohorts (set of loans) in which no new loans are added. Typically, the static pools are formed based on period of origination, and their performance is measured over a period. The performance measures are overdue curves and DPD curves, and recovery rate, among others.

Example of a quarterly static pool for a financial year below-



Note: The above static pool graph is for 90+ DPD for disbursements made in the quarters Q1 to Q4 of a particular Financial Year FYxx. The peak 90+ DPD is 5.41% in Q1, while the average 90+ DPD is 4.80%.

Based on above analysis, CareEdge Ratings observes the average values, volatility, and trend in the delinquency curves and recovery rates to derive base case assumptions.

In case the static pool data is not available, CareEdge Ratings uses portfolio delinquencies of originator and also relies on delinquency data (dynamic and/or static portfolio) of other players in the same industry as proxies for arriving at shortfall assumption.

vi. Past Pool Performance

CareEdge Ratings analyses the past securitised pool performance of the originator. This analysis suggests how the securitised pools perform. Analysing the past pool performance reveals whether the cherry-picked pools have exhibited lower delinquencies compared to the overall portfolio of the originator for that specific asset class.

The past pool performance also reflects on servicer's capability. A significant history of past pool performance is favourable for the servicer in this regard.

B. Collateral Analysis (Securitised Pool)

The collateral analysis or the actual pool analysis involves the following factors:

i. Pool selection criteria

The pool selection criteria play an important role in estimating the expected future performance of the pool. The pool selection criteria typically set boundary conditions on certain pool characteristics such as minimum seasoning, upper limit on LTV, tenor, months overdue, geographical concentration and obligor concentration, among others.

ii. Pool characteristics

Pool characteristics are key inputs to determine the pool quality and potential future performance.

Few key pool characteristics which are generally evaluated are mentioned below. Please note this is not an exhaustive list.

Key pool Characteristics	Remarks
Asset type	Proportion of used / refinanced assets. Generally, used / refinanced assets show comparatively higher delinquency levels.
Asset Classification	In the case of commercial vehicles, some manufacturer or models may have high resale value compared to others. Some classes like Light Commercial Vehicles (LCV) have shown comparatively higher delinquency levels than Medium or Heavy CV (MCV / HCV). In the case of mortgage, residential properties have shown better performance as opposed to commercial properties. Secured business loans are viewed better as opposed to unsecured business loans.
Borrower Profile	Certain borrower profiles like First Time Buyers (FTB) or First Time Users (FTU) and Self-employed category have shown comparatively higher delinquency levels.
Geographical Distribution	Concentration in geography poses an additional risk since disruption or operational risk, natural disaster, political risk, arising in geography can lead to higher magnitude of losses.
Obligor Distribution	If few borrowers account for large proportion of the pool, it is an additional risk since a default of few borrowers can drive the losses exponentially high.
Seasoning & Amortisation	Typically, high seasoning leads to higher build-up of equity, lowering the credit risk. Seasoning is typically seen alongside amortisation. A significant level of amortisation in the underlying pool gives comfort regarding the quality of the pool
Loan To Value Ratio (LTV)	Measures the initial equity participation of the borrower; higher the LTV, higher the credit risk.
Installment to Income ratio (IIR)	Indicates the obligor's ability to pay. Higher the IIR higher the credit risk.
Original Tenure	Typically, higher the tenor, higher the credit risk.
Credit Bureau Score	Higher the credit bureau score, the better is the expectation of the borrower to repay on time.
Property Occupancy	In case of MBS pools, self-occupied property is considered better than others such as rented, vacant, under construction, and others.
Property Type	In case of MBS pools, Residential Property is considered safer compared to Commercial, Industrial, among others.
Payment Status (Overdue composition)	Higher the composition of loans in overdue category, higher the credit risk.

iii. Portfolio Vs Actual pool comparison

CareEdge Ratings analyses the characteristics of actual pool in comparison to originator's portfolio wide characteristics for that asset class. The comparison typically is with respect to characteristics such as asset type, asset classification, borrower profile, geographical distribution, obligor distribution, LTV, IIR, and original tenure, among others. The proportion of the pool in each characteristic type is benchmarked against the delinquency levels observed for that characteristic in the originator's portfolio. An example for one such characteristic (Geography) is shown below:

Geography	Proportion of Portfolio as on 31st March, 20XX	Portfolio 90+ DPD as on 31st March, 20XX	Proportion of actual Pool
State 1	20.0%	1.8%	20.00%
State 2	15.0%	2.5%	5.00%
State 3	15.0%	1.5%	40.00%
State 4	20.0%	1.3%	15.00%
State 5	25.0%	1.3%	15.00%
Others	5.0%	3.0%	5.00%
Total	100.0%	1.7%	100.0%
Weighted Average 90+ DPD in Actual pool (assuming the Actual pool behave in the same way as Portfolio of the Originator)			1.6%
Extent of Negative Deviation			1.60% / 1.70% = 0.96

The transaction structure

CareEdge Ratings reviews the broad terms of the transaction to understand the transaction structure. The transaction structure is analysed to assess its impact on the cash flows. CareEdge Ratings also considers the effect of the credit enhancement available in the transaction (both internal and external), the counterparty's experience, and credit worthiness and legal soundness of the transaction.

i. Legal soundness of the transaction

The legal soundness of a securitisation transaction structure is an important pre-requisite to assign final ratings. The transaction should comply the prevailing laws, guidelines and / or regulations. The transfer of pool assets (pool of loan receivables) to SPV / Assignee should be recognised as a true sale. The transaction structure should be such that it creates bankruptcy remoteness of pool assets from originator / seller. For the legal risk analysis of the transaction, CareEdge Ratings relies on a legal opinion from an independent legal counsel certifying the above.

ii. Par or premium

The structure of the transaction - whether par or premium, will impact the requirement of credit enhancement. In case of premium structure, prepayment of higher interest rate loans in the pool will lead to loss on prepayment to be made good by the credit enhancement. On the other hand, in case of par structure prepayment of higher interest rate loans in the pool will reduce the EIS if available in the form of credit enhancement. CareEdge Ratings applies stressed prepayment rates and EIS compression to account for this risk.

iii. Available Credit and Liquidity Enhancement

CareEdge Ratings also assesses the available credit enhancements in the transaction structure. The credit enhancement could either be internal (in the form of EIS, Over Collateral, and/or Subordinated Tranches) or external (in the form of a cash/credit collateral, typically fixed deposit and/or a corporate/bank guarantee). There can also be a liquidity enhancement in the form of liquidity facility in the transaction. Liquidity facility does not provide loss protection to the investor. The credit enhancements discussed above are detailed below in the criteria paper.

iv. Payment structures

There are multiple payment structures prevalent in the market. CareEdge Ratings ascertains the impact of these payment structures on the transaction. The transaction could either have a Timely Interest Ultimate Principal (TIUP) structure or a Timely Interest Timely Principal Structure (TITP) or an Ultimate Interest Ultimate Principal (UIUP) structure. There are other ways a transaction could be structured. CareEdge Ratings evaluates the impact of the structure in its cashflow model. Payment structures play an important role as the impact of each structure given other things being equal can be different. There is a mechanism for accelerated amortisation as well, where the EIS is used to prepay the principal on the PTCs. It can be conditional or unconditional and accordingly the impact of the same is evaluated.

v. The waterfall mechanism and cashflow analysis

The waterfall mechanism of the transaction is incorporated into the proprietary cashflow model. Basis the base case and stress case shortfall, the cashflow analysis determines whether the future cashflows from the pool are sufficient to pay PTC investors as per the transaction structure, the waterfall mechanism, and the available credit enhancement.

a. Waterfall mechanism

The waterfall mechanism refers to the hierarchy of payments of the receivables from underlying pool assets. CareEdge Ratings incorporates the waterfall mechanism in its cash flow model. It determines how the future cashflows from the pool will be allocated to investors.

b. Cashflow analysis

The actual pool to be securitised is static in nature. The base case assumptions for estimating the expected cash inflows from the actual pool should therefore be based primarily on the static pool analysis. However, it is noteworthy that the static pool analysis provides the historical performance of the originator for that asset-class. To some extent, this limitation is mitigated by incorporating the recent trend observed in portfolio analysis in the assumptions. These assumptions are adjusted to account for deviation of actual pool from static pool features and expected economic environment.

For stress case scenario, assumptions in base case scenario are stressed according to the rating level and thereupon cash inflows from underlying asset pool are estimated.

i. Stressed pool cashflows

Cashflow model incorporates the stress case shortfall and applies the same on the securitised pool's future cashflows.

ii. Investor payouts

The stressed cashflows from the pool, commensurate with rating, are modelled to ensure payouts to the PTC investors based on the waterfall mechanism as per the payment structure.

Forms of Credit Enhancement

In the Indian securitisation market, typically the credit enhancement is provided by the originator. The credit enhancement can be split into two types:

- A. Internal Credit Enhancement
- B. External Credit Enhancement

A. Internal Credit Enhancement

Internal Credit Enhancement comes from the given pool and the transaction structure. There is no counterparty associated with internal credit enhancement.

i. Subordination and Over Collateral/Equity Tranche

In a multiple tranche structure, there could be a senior tranche and subordinate tranche. It means that the senior tranche has the first right over the pool cashflows before the subordinate tranche. Any losses in the pool will be allocated to the subordinate tranche before allocation to the senior tranche thus providing credit support to the senior tranche. Over collateral is the excess of pool principal over the PTC principal which provides cushion to the PTC investors if there are any losses.

Equity Tranche (ET) is generally a subordinate tranche, similar in character to the OC, in that the ET shall typically receive repayments only after payouts are made in full to the senior tranche.

ii. Excess Interest Spread

EIS is the difference between the interest on the pool of assets and the interest payable to the PTC investors. EIS cushions monthly payout to investors and after making investor payouts remaining EIS if any, may either flow back to the originator, be trapped, or used to accelerate the amortisation of the PTCs.

B. External Credit Enhancement

External Credit Enhancements are provided by a counterparty to support the transaction in case of any losses.

i. Cash Collateral

Credit enhancement can be provided through cash or its equivalents, such as cash held in a dedicated cash collateral account or fixed deposits. The SPV is authorised to operate the cash collateral account.

In the event of a shortfall in investor payouts, the SPV can utilise the funds from this account to meet obligations. When the collateral is in the form of fixed deposits, the credit rating of the bank holding the deposit is also considered.

ii. Corporate or Bank Guarantee

Originators sometimes provide a guarantee or undertaking towards stipulated credit enhancement. In case of a shortfall, the SPV typically sends a notice, to the originator / bank invoking the guarantee. There could be instances where a third party could provide a guarantee. For such guarantees, CareEdge Ratings considers the rating of the guarantee provider to understand the counterparty risk associated with such an arrangement.

Assigning the Final Rating

Once the transaction has been placed, the originators are required to submit relevant documents of the transaction to CareEdge Ratings. CareEdge Ratings may require an audit report certifying the accuracy of the pool information from an external auditor and a legal opinion from a legal counsel on said documents regarding their validity, while also verifying the 'true sale' criteria and bankruptcy remoteness of the receivables from the seller. The FD receipts are also taken (where the cash collateral is in the form of FD) to confirm the cash collateral amount and that it is lien marked to the SPV.

Documents are to be provided within the SEBI-mandated timeframe of 90 days. In case the documents are not provided within 90 days, CareEdge Ratings may extend the timeline by an additional 90 days on a case-to-case basis. If the submitted documents are to the satisfaction of CareEdge Ratings, a final rating is assigned. If documents are not submitted within the initial or extended timeframe, appropriate rating action may be taken as per our 'Policy on Assignment of Provisional Ratings' available on CareEdge Ratings' website www.careratings.com.

Surveillance

CareEdge Ratings receives monthly Servicer reports and payout reports with information pertaining to the transaction such as collection efficiency, overdues, pool outstanding, DPD bucketing, payouts to investors, utilisation of cash collateral or corporate guarantee or bank guarantee, as applicable. Based on the above information, CareEdge Ratings undertakes periodic review of transactions.

[For previous version please refer "CARE's Rating Methodology - Asset / Mortgage Backed Securitisations" issued in [February 2023](#)]

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