CRISIL Ratings criteria for rating covered bonds

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Executive summary

Covered bonds are debt instruments secured by a specific pool of ring-fenced assets, primarily issued by banks and financial institutions. Unlike securitised instruments, where investors have recourse only to the underlying assets, covered bonds are dual recourse instruments, where investors have recourse to the issuer as well as the pool of assets acting as collateral (known as the cover pool).

The dual recourse may be achieved through contractual structures involving the transfer of assets in the cover pool to a bankruptcy-remote special purpose vehicle (SPV) upon the occurrence of a trigger event, following which the cover assets are available exclusively for the benefit of the covered bondholders.

CRISIL Ratings considers the issuer rating to be the rating floor for a covered bond. CRISIL Ratings may notch up the covered bond rating above the issuer rating if, based on legal analysis of the structure, it believes the cover assets will be effectively transferred to the SPV for the exclusive benefit of the covered bondholders following the occurrence of the trigger event, and that the other creditors of the issuer will not have any claim on the cover pool assets.

The extent of the notch-up will depend on the asset liability mismatch (ALMM) risks, the credit quality of the cover pool assets, and the overcollateralisation levels. CRISIL Ratings also considers the eligibility criteria for the selection of cover pool assets and the operational risks in the transaction.

The Reserve Bank of India on 24th September 2021, released the Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021. These directions lay down the conditions for transfer of loans, including allowing transfer of loans by lenders to only certain permitted transferees (Scheduled Commercial Banks, All India Financial Institutions, Small Finance Banks, NBFCs and HFCs). It is important to note that these conditions shall be without prejudice to the provisions of Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021. CRISIL Ratings understands that the RBI directions are not expected to impact covered bond transactions that were outstanding prior to the directions. However, these directions are expected restrict new covered bond issuances structured as per the prevalent market practices. As a result, the criteria addresses those covered bond transactions that were outstanding prior to the RBI directions.

Scope

This criteria article[1] outlines CRISIL Ratings' approach towards rating covered bonds. It focuses on the legal analysis of the covered bonds and the assessment of ALMM risks. It does not detail the methodologies to assess the credit quality of cover pool assets, coverage of shortfalls in pool collections, and counterparty risks in covered bonds, as these are similar to the ones employed in securitisation transactions. For more details, refer to the relevant sections of CRISIL Ratings' criteria, "Evaluating risks in securitisation transactions – A primer", available on www.crisil.com.

Structure of covered bonds

The distinguishing feature of a covered bond is the dual recourse it offers to the issuer as well as the assets in the cover pool. Under the dual recourse mechanism, the issuer makes payments to the covered bondholders from its

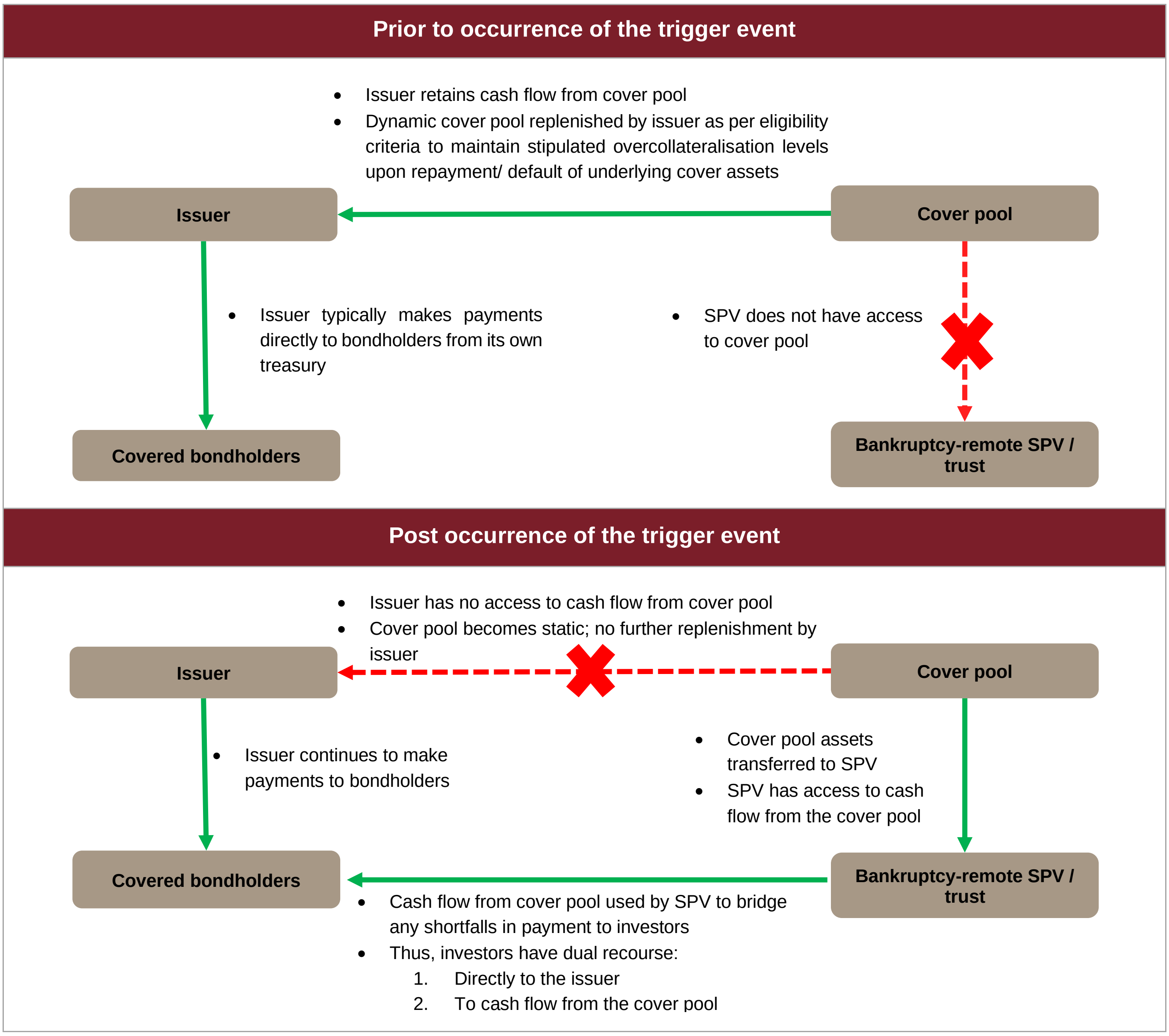
[1] The previous version of this article, which was published in October 2019, can be access here: https://www.crisil.com/content/dam/crisil/criteria_methodology/structured-finance/archive/crisils-criteria-for-ratingcovered-bonds-oct2019.pdf

own cash flows, and if the issuer defaults, the investors have access to the cash flows from the cover pool assets, which are segregated for the exclusive benefit of the covered bondholders.

The cover pool assets are selected based on specific eligibility criteria pertaining to the quality of assets, such as the asset class, loan-to-value ratios, and seasoning levels. The issuer typically maintains a level of overcollateralisation in the cover pool. The cover pool is dynamic in nature as the issuer replenishes it with new assets to replace maturing or defaulting cover assets so that the level of overcollateralisation is maintained.

Internationally, the dual recourse is achieved through specific covered bond legislations or through contractual structures involving the transfer of the cover pool to a bankruptcy-remote SPV. Considering the absence of a specific covered bond legislation in India, dual recourse is achieved through general contract laws by transferring the cover pool assets to a bankruptcy-remote SPV following the occurrence of any of the pre-defined trigger events, one of which may be linked to the rating levels of the issuer. There may also be instances where the cover pool is assigned to the SPV ab initio.

The following chart represents a typical structured covered bond transaction:



Rating methodology

CRISIL Ratings considers the corporate credit rating of the issuer to be the rating floor for a covered bond. Under the dual recourse mechanism, the issuer continues to be liable for the payments due to covered bondholders throughout the tenure of the transaction, even post the occurrence of the trigger event and the transfer of cover assets to the SPV. The claims of the covered bondholders also rank pari passu with the claims of senior unsecured debtors of the issuer.

CRISIL Ratings may notch up the covered bond rating above the issuer rating if, based on legal analysis, it believes the transfer of cover assets will become effective upon the occurrence of the trigger event, and that other creditors of the issuer will not have any rights over the cover assets.

Legal analysis

CRISIL Ratings obtains legal opinions to confirm that the dual recourse mechanism can be achieved through the structure of the transaction. The cover assets need to be clearly segregated, with exclusive charge created in favour of the covered bondholders, and need to be bankruptcy-remote from the other creditors of the issuer.

Some of the specific legal aspects that are analysed are as follows:

- The cover assets are segregated from the other assets of the issuer prior to the assignment/transfer to the SPV
- The issuer cannot create security/charge on the cover assets for the benefit of its other creditors
- The cover assets will be effectively transferred/assigned to the SPV on the occurrence of any of the pre-defined trigger events, one of which may be linked to the rating levels of the issuer
- The cover assets will be bankruptcy-remote from the other creditors of the issuer post the transfer/assignment

CRISIL Ratings may notch up the rating of the covered bond above the issuer rating if, based on legal analysis, the cover assets are available for the exclusive benefit of the covered bondholders. Else, the rating on the covered bond is equated to the issuer rating.

Asset liability mismatch (ALMM)

Covered bonds are typically exposed to ALMM risks as the amortisation of cover assets may not match the amortisation schedule of the covered bond. In case of an issuer default, the cash flows from the assets may not be sufficient to make timely payments to bondholders. Hence, the SPV may need to sell the assets in order to ensure timely payments to the covered bondholders.

The ability of the SPV to ensure timely payments to investors through the sale of cover assets, following an issuer default, will depend on the following:

- **Credit quality of cover assets:** The quality of cover assets plays an important role in ensuring the sale of assets in the market. CRISIL Ratings stresses on cover pool assets for potential credit shortfalls to determine the credit quality and, thereby, saleability in the market. As the cover pool is dynamic prior to the trigger event, the analysis of the credit quality also takes into consideration the eligibility criteria of the cover pool assets.
- **Refinancing costs:** Refinancing costs may be considered by applying haircuts to the value of the cover assets based on the historic high yield levels of the asset class and after factoring in the overcollateralisation levels in the cover pool that can provide a cushion against these refinancing costs.
- **Time for sale:** Availability of liquidity (in the form of cash/bank lines covering an extent of payments) and provisions for extending the maturity of bonds are analysed to determine their adequacy to enable the trustee to

liquidate the assets in a timely manner and avoid an imminent default on the covered bond following an issuer default.

The rating of the covered bond may be notched up from the issuer rating depending on the credit quality of the cover pool assets, the extent of refinancing costs covered through overcollateralisation, and the time available to liquidate the cover assets and ensure refinancing.

Other considerations

CRISIL Ratings also factors in operational risks, such as commingling of cash flows from the cover pool with other cash flows of the issuer in case the issuer continues to be the servicer of the cover pool assets post the occurrence of the trigger event, and the potential need for a back-up servicer in case of failure by issuer to service the loans. Such risks are assessed in line with CRISIL Ratings' methodology for assessing securitisation transactions. For more details, refer to the relevant sections of CRISIL Ratings' criteria, "Evaluating risks in securitization transactions – A primer", available on www.crisil.com.

Application of 'CE' or 'SO' suffix

CRISIL Ratings may apply its 'SO' (indicating structured obligation) or 'CE' (indicating credit enhancement) suffix to the rating of a covered bond depending on how the bond is structured.

CRISIL Ratings uses its 'SO' suffix in case the covered bonds are to be primarily serviced by the cash flows from the cover pool housed in the bankruptcy remote SPV, with secondary recourse to the issuer. This will typically be in cases where the cover pool is assigned to the SPV ab initio.

CRISIL Ratings uses its 'CE' suffix if the covered bonds are to be serviced primarily by the issuer. This will typically be in cases where the cover pool is not assigned to the SPV ab initio, but post the occurrence of a trigger event. However, the 'CE' suffix will be applied only if CRISIL Ratings believes that the presence of the cover pool provides a credit uplift over the rating on the issuer.

Conclusion

Covered bonds are debt instruments secured by a specific pool of ring-fenced assets, where the bondholders have dual recourse—to the issuer as well as the cover pool assets. CRISIL Ratings considers the issuer rating to be the rating floor for covered bonds, as covered bonds rank pari passu with senior unsecured obligations of the issuer. CRISIL Ratings may notch up the rating of the covered bond above the issuer rating if, based on legal analysis, it believes the cover assets are bankruptcy-remote from the other creditors of the issuers and will be available for the exclusive benefit of the covered bondholders. The extent of notch-up will depend primarily on the extent of ALMM risks involved, the credit quality of the cover assets, and the credit enhancement in the structure.

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

CRISIL Ratings is part of CRISIL Limited ("CRISIL"). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI"). With a tradition of independence, analytical rigour and innovation, CRISIL sets the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 1,10,000 MSMEs have been rated by us.

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