Rating Methodology – Asset Backed Securities

MEANING OF CREDIT RATING

CRISL defines credit rating is a measure of assessing relative risk of default and the severity of default associated with particular securities issue, issuer and/or other financial assets. It is a symbolic indication of current opinion of the relative capability of timely servicing of the debts and obligations as per the terms of contract. It is an independent, impartial, best judged and professional OPINION on the ABILITY and WILLINGNESS of a borrower to discharge its debt when due. In case of a debt instrument, assessment of net worth, external liability and earning prospects is considered.

Rating agencies are perceived as impartial, professional and best judged opinion giving agencies in the investment process to safeguard the interest of the general investors. Rating reflects neutral and influence free professional opinion on the assessment of credit risk associated with an instrument or a corporate. The rating services provide a guideline to the investors as to the degree of certainty of payment of principal and interest in case of debt instrument and the degree of acceptability of the net worth and earning prospects of an entity seeking public finance.

CRISL RATING PERSPECTIVE

Understanding the increasingly important role of ratings, especially in the light of Basel II guidelines, consistent and uniform default definition is critical and it has significant impact on the reliability and comparability of ratings across rating agencies. A rigorous and transparent definition of default makes the ratings assigned by a rating agency meaningful. Ratings can either indicate probability of default (PD) or Expected Loss (EL). The underlying principles guiding each of these approaches are not similar, and ratings that indicate probability of default are not directly comparable with ratings that indicate Expected Loss, especially at lower rating levels. Investors and market participants, thus, will compare only those ratings that are based on similar approaches, or make appropriate adjustments before comparison.

Considering the stage of development of rating environment in Bangladesh CRISL adopted rating definition of “Probability of Default”. Therefore, all CRISL ratings indicate the probability of default and not the EL that may arise after the default.

DEFINITION OF DEFAULT

CRISL adopted the international definition of default as being adopted by global rating agencies. Under the above definition, Default is:

A) A missed installment (Principal and or Interest) which has not been discharged / paid as per schedule or within the grace period allowed by the regulators/ creditors.
B) Failure to honour the corporate guarantee obligations as per contract or within the allowed grace period;
C) The legal insolvency or bankruptcy of the issuer/ entity
D) A distress exchange in which the bondholders/ creditors are offered a substitute instrument with inferior terms and conditions
E) Restructuring of a financial obligation substantially disadvantageous to the creditors;

SCOPE AND LIMITATIONS OF CRISL RATINGS

CRISL ratings are in local currency and therefore, it does not take into consideration the sovereign risks and foreign currency risk of Bangladesh. CRISL being a domestic rating agency of Bangladesh considers the government of Bangladesh as the highest pay master and all government guaranteed securities are considered as AAA.

CRISL assigns two types of rating for the corporate namely Entity Rating and Debt Instruments Rating. Entity rating reflects ability and willingness of an entity to discharge its debt obligation when due. It also reflects earning prospects and increase in shareholders' value in the long run. The debt instrument rating reflects the inherent features and structures and extent of credit enhancement compared to unsecured creditors. It also reflects all associated risks that may affect the instrument over a period of its life.

TIME HORIZON

CRISL ratings are forward looking and sustainable throughout normal business cycle. CRISL issues normally two types of ratings – short term and long term. Short term rating carries the validity of six months while the long term rating is valid for one year. The change in economic scenario, complexities and change in government policy may have an impact on the ratings assigned over a period of time. CRISL updates the rating periodically with the cooperation of the client. Incase the client is not willing to cooperate, CRISL withdraws the rating after due notice to the client. Therefore, CRISL rating is to be read with the time

RATING DEFINITION

CRISL follows standard definition of ratings in line with the global rating agencies. It follows a ten scale with AAA being the highest while lowest rating D reflects default in discharging its liabilities in time. With the addition of plus (+) and minus (-) signs before the scale, the 10 scale reflects 26 notches. These plus and minus signs indicates the position of each rating in the scale. The rating scale along with the definition is enclosed at the end of this report.

RATING METHODOLOGY

In order to arrive at a meaningful rating, CRISL considers a large number of qualitative and quantitative factors and applies the same in its analytical rigor. In order to avoid biasness in analysis, CRISL tries to convert the qualitative factors into quantitative which ultimately assist CRISL for back testing of its methodologies. Quantitative factors include appraisal of the historic and projected financials, level of profitability, capacity utilization, capital expenditure need, cash flow adequacy, debt servicing capacity, free cash flow, time series analysis etc. In order to arrive at meaningful assessment, the financial statements are re-casted to make the ratios and analytical factors meaningful in line with the time horizon. All the factors considered by CRISL in rating may be clustered in to broad analytical risk blocks- Industry, Business Risk, Operational Risk, Financial Risk and Quality of Corporate Governance.

ABS RATING PHILOSOPHY

Asset backed securities has been playing a very important role as a financial product in recent days although the ABS market is yet to be popular in Bangladesh. CRISL's rating approach for asset-backed securities ("ABS") covers 4 main aspects, namely: (1) Asset risk; (2) Payment structure; (3) Legal and tax issues; and (4) Servicer and trustee review. Although details of the analytical process may vary according to the class of asset securitised, this generic approach to the rating of ABS can be applied to most assets such as consumer loans, credit card receivables, collateralised debt obligations ("CDO") and commercial mortgage-backed obligations.

ASSET RISK

CRISL's ABS rating approach starts with an in-depth analysis of the credit risk of the underlying assets. The main purpose of this part of the analysis is to evaluate the potential impairment of cash flow resulting from the delinquency or default on the securitised assets. Asset risk assessment can take different forms, depending on the nature of the underlying assets. For example, risk factors considered in analysing the cash flow from a commercial property such as a shopping mall would typically include the mall's location, tenants' profiles, and sustainability of rental income, market position and operating expenses. Meanwhile, risk factors considered in the analysis of trade receivables would include industry and obligor concentration, account seasoning and historical dilution, as well as delinquency and loss experience. The objective of this analysis is to answer the questions of "How risky are the securitised assets?" or "What can affect the securitised assets and cash flow generated by the assets?" and the resultant impact on the cash flow of the ABS issuer. This part of the analysis is also data-intensive as the historical performance of the underlying collateral assets has to be compiled and analysed. CRISL would require vintage static pool performance data on the underlying assets covering at least 1 complete economic cycle.

PAYMENT STRUCTURE

CRISL analyses the payment structure of the transaction and assesses the adequacy and timing of the cash flow to meet the promised payments on the ABS, based on the stated priority under the ABS structure. The aim is to identify where a potential mismatch in cash flow can arise and how this risk can be addressed or mitigated. The cash flow in an ABS transaction can be influenced by many factors such as payment priority, interest rate, pre-payment, reinvestment rate and liquidity. In the cash flow analysis, the adequacy and form of credit enhancement are also evaluated via stress-testing the asset's cash flow. The level of stress applied should commensurate with the rating assigned. Generally, higher stress tests are applied for higher-rated debt securities.

As part of the rating process, CRISL also evaluates the structural features incorporated into the transaction and how these mechanisms can mitigate the risks involved. Examples of structural features are trigger events as well as interest rate and currency exchange risk hedging arrangements. The credit risks of all counterparties who provide credit support to the transaction are also considered in the rating process.

LEGAL AND TAX ISSUES

The legal and tax reviews involve the analyses of the legal and tax structures governing the ABS transaction. Typically, the legal issues that need to be addressed in an ABS transaction include the mode of transfer of the assets to the special-purpose vehicle ("SPV"), enforceability, true sale, perfection of security interest and the bankruptcy remoteness of the SPV. CRISL requires expert opinions that address the legal and tax issues in respect of the transaction. The legal review would also cover a review of the transaction documents such as the trust deed, sale and purchase agreement, servicing agreement, swap agreement, guarantee investment contract, credit support agreement and liquidity support agreement. In all instances, the issuance of the final rating is subject to CRISL's satisfactory review of all the transaction documents as well legal and tax opinions.

SERVICER AND TRUSTEE REVIEW

As part of the rating consideration, CRISL assesses the adequacy of the relevant transaction parties' (e.g. collateral manager, servicer, back-up servicer and trustee) systems and capacities to perform their respective duties in relation to the transaction. The servicer must also possess adequate capability in managing the purchased assets and servicing the ABS transaction. Although the credit rating of the servicer is generally not the determining factor in assigning the rating to the ABS, it does, however, have a bearing on the rating assigned.

CRISL RATING SCALES AND DEFINITIONS

LONG TERM RATINGS OF DEBT INSTRUMENT

RATING	DEFINITION
AAA Triple A (Highest Safety)	Investment Grade Securities rated in this category are adjudged to be of highest credit quality. This level of rating indicates highest level of safety for timely payment of interest and principal. Risk factors are negligible and nearest to risk free government securities.
AA+, AA, AA- (Double A) (High Safety)	Securities rated in this category are adjudged to be of high credit quality and offer higher safety. This level of rating indicates a security with sound credit profile and without significant problems. Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.
A+, A, A- Single A (Adequate Safety)	Securities rated in this category are adjudged to be of good credit quality and offer adequate safety for timely repayment of financial obligations. Protection factors are considered variable and more susceptible to changes in circumstances than securities in higher-rated categories.
BBB+, BBB, BBB- Triple B (Moderate Safety)	Securities rated in this category are adjudged to offer moderate safety for timely repayment of financial obligations. This level of rating indicates deficiencies in certain protective elements but still considered sufficient for prudent investment. Risk factors are more variable in periods of economic stress than those rated in the higher categories.
BB+, BB, BB- Double B (Inadequate Safety)	Speculative Grade Securities rated in this category are considered to be of speculative grade but deemed likely to meet obligations when due. Present or prospective financial protection factors fluctuate according to industry conditions or company fortunes. Overall quality may move up or down frequently within this category.
B+, B, B- Single B (High Risk)	Securities rated in this category are considered to be of highly speculative grade. This level of rating indicates high risk associated with timely repayment of interest and principal. Financial protection factors will fluctuate widely according to economic cycles, industry conditions and/or company fortunes. Potential exists for frequent changes in the rating within this category or into a higher or lower rating grade.
CCC+,CCC,CCC- (Vulnerable)	Securities rated in this category is currently vulnerable to non-repayment, and is dependent upon favourable business conditions for the obligor to meet its financial commitments on the obligation.
CC+,CC,CC- (High Vulnerable)	Securities rated in this category is currently high vulnerable to non-repayment.
C+,C,C- (Near to Default)	Securities rated in this category are considered to be near to default. Protection factors are scarce. Timely repayment of interest and principal is possible only if favorable circumstances continue.
D (Default)	Default Grade Defaulted debt obligations. Issuer failed to meet scheduled principal and/or interest payments.

For long-term ratings, CRISL assigns + (plus) sign to indicate that the issue is ranked at the upper-end of its generic rating category and - (minus) sign to indicate that the issue is ranked at the bottom end of its generic rating category. Long term ratings without any sign denote mid-levels of each group.

SHORT-TERM OF DEBT INSTRUMENTS

ST-1	Highest Grade Highest certainty with regard to the obligor's capacity to meet its financial commitments. Safety is almost like risk free government short-term securities.
ST-2	High Grade High certainty with regard to the obligor's capacity to meet its financial commitments. Risk factors are very small.
ST-3	Good Grade Good certainty with regard to the obligor's capacity to meet its financial commitments. Risk factors are small.
ST-4	Satisfactory Grade Satisfactory protection factors qualify a security to be in investment grade. Risk factors are larger and subject to more variation those rated in higher categories.
ST-5	Speculative Grade Speculative investment characteristics with high risk of default. Obligor's capacity to meet its financial commitments depends upon favorable business, financial and economic conditions.
ST-6	Default Grade Defaulted debt obligations. Issuer failed to meet scheduled principal and/or interest payments.