CRISIL Ratings' methodology for future-flow securitisation

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Executive summary

In a future-flow securitisation transaction, the borrower (issuer) issues a debt instrument, the principal and interest obligations for which are met through receivables that the issuer expects to generate during its normal course of operations.

Typically, the ratings for future-flow transactions could be higher than the credit rating of the issuer based on an interplay of nine crucial factors (identified in this report). The primary factor is the extent of linkage of the future cash flow to the issuer's operating performance. A higher rating for an instrument issued under future-flow securitisation will enable the issuer to reduce the cost of funds.

In its assessment, CRISIL Ratings evaluates the issuer's creditworthiness and performance risk, the obligors' (counterparty's) creditworthiness, and the impact of the future-flow transaction on the issuer's other obligations. CRISIL Ratings also studies in detail the structure of the transaction, the mode of collection, and the schedule of payments to investors to assess the strength of future cash flow. The other factors analysed are robustness of a transaction's legal framework, presence of a no-lien escrow account in which all amounts due on the instrument are deposited from time to time, whether the transaction is structured with or without recourse to the issuer, and presence of proper documentation.

Scope

This criteria[1] document gives a brief explanation of future-flow securitisation transactions and details the aspects that determine ratings on such structures. The criteria will apply to situations where the issuer identifies a narrow (and small) sliver of future cash flow from its business and prioritises the cash flow for repayment of a specific debt instrument.

Understanding future-flow securitisation transactions

In a future-flow securitisation transaction, investor payments are met through cash flow that will be generated in the future, such as property rental receivables, toll receivables, credit card receivables, and oil and gas sale receivables. Thus, a future-flow transaction is backed by future claims that will arise out of future performance and not the existing claims.

Benefits of future-flow transactions

Future-flow transactions allow issuers to:

1. Borrow at lower cost than through traditional funding sources as the instrument could be rated higher than the issuer's credit rating
2. Borrow more than under traditional funding methods, as unlike a traditional lender who looks at the assets on the balance sheet, a future-flow investor looks at future-flow

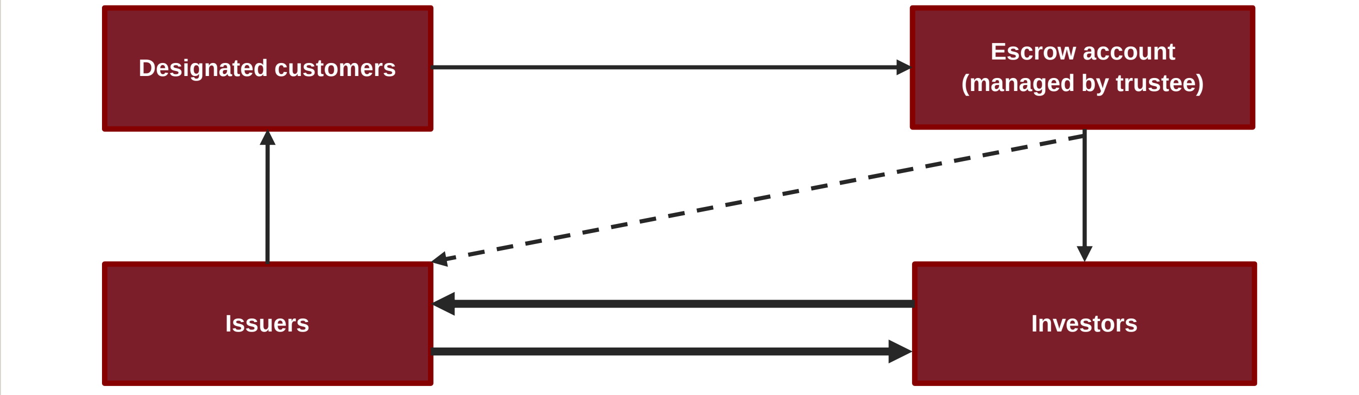
[1] *For accessing previously published document on "CRISIL Ratings' methodology for future-flow securitisation", follow the link:* *https://www.crisil.com/content/dam/crisil/criteria_methodology/structured-finance/archive/CRISILs-rating-methodology-for-future-flow-securitisation-sep-2018.pdf*

3. Access funds for a term longer than can be achieved by issuing unsecured debt securities, typically in cases where long-term contracts exist (such as collection from a toll road project)

Structure

In a typical future-flow securitisation transaction, the issuer earmarks the future cash flow directly or indirectly for servicing the debt raised against the future cash flow. The future cash flow will go directly to an escrow account managed by the trustee, which functions as per a defined waterfall. On top of the waterfall are the principal and interest payments to be made to the investor. Furthermore, any excess collection is forwarded to the issuer (refer to the diagram below).

A typical future-flow transaction



Legend:

Initial debt Issuance

Periodic payment

Excess cash flow back to issuer

CRISIL Ratings' assessment of future-flow securitisation transaction

CRISIL Ratings has rated several securities backed by future cash flow. The ratings could be higher than the credit rating of the issuer. The extent of notch-up is based on various factors, which have been discussed in detail subsequently in this article.

CRISIL Ratings' methodology for future-flow transactions comprises an analysis of aspects depicted in the diagram below:

CRISIL Ratings' criteria for future-flow securitisation

1. Issuer's creditworthiness
2. Linkage with issuer's performance
3. Obligor's creditworthiness
4. Impact on other obligations
5. Structure and payment risk
6. Legal risk
7. Escrow structure
8. Recourse to issuer
9. Documentation

Originator's (issuer's) creditworthiness

The starting point of analysis in a future-flow securitisation transaction is the issuer's creditworthiness. As the generation of cash flow for debt repayment is linked to the activity to be carried out by the issuer, the ability of the issuer to generate the cash flow over the life of the rated instrument is of paramount importance. The issuer's creditworthiness, measured by the credit rating, is its ability to service all debt in a timely manner.

A future-flow securitisation structure does not entail generation of additional cash flow. It results only in prioritisation within the existing cash flow of the issuer. Hence, the linkage to the credit risk profile of the issuer assumes significance in all such transactions.

It is also pertinent to note that the rating on such instruments could be lower than the issuer's creditworthiness. If the transaction structure envisages that the investors do not have recourse to the issuer for debt repayment, then the rating on such instruments may be lower than the issuer's creditworthiness as it will depend on a specific future cash flow stream.

For transactions where firm take-or-pay contracts exist with the customers, thereby reducing the offtake risk, the difference between the rating on the instrument and the originator could be higher, constrained only by the performance risk of the issuer and the credit quality of the counterparty (Obligors).

Performance risk of the issuer

A future-flow transaction requires the issuer to continue to 'perform' so as to deliver the required goods or services and thereby generate the cash flow necessary to service the rated instrument (refer to Box 1). The probability of not being able to generate future cash flow to meet the rated debt obligation may be very different (and in all likelihood lower) than the probability of financial default by the issuer. CRISIL Ratings' large rated portfolio of around 8,000 entities includes many that may have weak debt protection metrics and high default risk, but continue to operate their businesses and generate cash flow. CRISIL Ratings analyses the following factors to assess the originator's ability to generate future cash flow:

1. *Extent of linkage between the assigned future cash flow and regular operations:*

   CRISIL Ratings believes the more the operational intervention of the issuer required to generate/produce/deliver the finished product/service to create the transaction cash flow, the more closely is the rating linked to that of the issuer. CRISIL Ratings assesses the degree of linkage between the originator's ability to deliver the promised goods/services (which will generate the cash flow) and the originator's normal operations. For example, rent revenue and toll revenue exhibit weak linkage with the issuer where minimal performance, such as maintenance or upkeep of the facilities, from the issuer is required to generate revenue. The cash flow is likely to become due just with passage of time. On the other hand, airline ticket revenue is an example of revenue with strong linkage to the operations of the issuer. The airline company will have to continue operating its flights and be able to attract customers to generate ticket sales. The complexity of 'performance' will also be assessed, and less complex operations (for example, maintenance of a static gas pipeline) will be viewed favourably compared with complex operations (for example, supply of forged automotive components of a specified quality).

2. *Factors that could impact the issuer's ability to deliver the promised goods/services:*

   - *Operating performance*: The issuer's operating performance is assessed by studying factors such as its operations, labour relations, managerial competence, and regulatory changes. The issuer's track record and ability to generate the identified future cash flow required to meet the rated debt obligation are analysed.
   - Financial performance: The issuer's financial performance is assessed to ensure that it is in a position to continue operations. This includes studying past financial performance, ability to raise funds, and expenditure plans. Although this parameter is also analysed while understanding the issuer's

creditworthiness, the focus here is on the ability to meet operational commitments (such as statutory dues, power charges, salaries and wages), non-payment of which can impede regular operations.

3. *Ability to continue operations in a financial distress scenario:*

   There could be circumstances where the issuer is in financial distress or has defaulted on other debt but continues to operate. Such an issuer could be a monopoly supplier of any product or service in the region, a government-owned entity (such as a municipal corporation or state electricity board), or an entity viewed as systemically important (such as a bank or financial institution). Future-flow from such entities is viewed more favourably than those from other corporates.

Box 1: Difference between asset backed and future-flow transactions

Bankruptcy remoteness possible in asset-backed securitisation

Traditionally, structured finance has been associated with asset-backed securitisation wherein the securities issued are backed by cash flow generated by an existing pool of assets (for instance, automotive loan receivables or mortgage receivables). Here, the receivables have already been generated by the originator and do not depend on the originator's future performance, and therefore, do not entail any 'performance risk'. The transaction can be structured as a true sale of loan receivables, enabling remoteness of the structure from the bankruptcy of the originator/seller of receivables. Therefore, such securities can achieve ratings that are not linked to (and typically are much higher than) the ratings of other debt issued by the originator.

Future-flow transactions rely on receivables to be generated

Future-flow transactions are backed by cash flow that must be generated in future and do not involve any 'sale of assets' but only a claim on future receivables. Hence, these transactions depend heavily on the ability of the issuer to either deliver a product or provide a service. As a result, the likelihood of payment on a future-flow transaction is more closely related to the issuer's operating performance than its financial performance. Also, the future-flow is not de-linked from the bankruptcy of the issuer. Hence, the rating of a future-flow structure cannot be de-linked entirely from the issuer rating.

Obligor's (counterparty's creditworthiness)

The next important aspect in a future-flow securitisation transaction is the creditworthiness of the obligor (counterparty) from whom the cash flow to service the rated debt is received, such as tenants in case of rental cash flow and identified electricity consumers in the case of state electricity board cash flow.

If there is a single obligor, the rating on the instrument may be constrained by the rating of the obligor. If there are multiple obligors, a rating view is taken on all the obligors, and the resultant rating will be a function of the individual ratings and their contribution to future cash flow, after factoring in the benefit of diversity of obligors. In the case of retail future-flow securitisation transactions (with a large number of obligors such as retail telephone consumers), the obligors' creditworthiness is assessed based on the diversity of the retail pool and track record of collection efficiency.

Impact of future-flow transaction on the issuer's other obligations

A future-flow securitisation transaction entails prioritisation within the total cash flow available to the issuer. Thus, if a large quantum of future-flow is used to meet the rated debt obligation, this may put pressure on the free cash flow, thereby impacting ability to meet other operational and financial obligations. Sustained non-payment of any of the other operational or financial obligations may impact the issuer's existing operations and future financial position. This could also impair ability to perform, and hence, can impact generation of the future cash flow identified for the rated transaction. CRISIL Ratings analyses the following factors to assess the impact of the future-flow transaction on the issuer's other obligations:

1. Size of the rated transaction in relation to the originator's scale of operations
2. Application of the proceeds of the rated debt
3. Residual cash flow after escrowing the future-flow for rated debt and its adequacy to meet operating commitments and any remaining debt obligation

Thus, CRISIL Ratings evaluates whether the future-flow structure impairs the originator's standalone performance and whether the originator's free revenue is sufficient to meet essential expenses (for example, to perform basic operations or pay salaries). In situations where all or a significant portion of the future cash flow is securitised, the difference between the issuer rating and the instrument rating will cease to exist.

Structure and payment risk

The structure and payment risk analysis involves a detailed study of factors such as the structure of the transaction, the mode of collection, and the schedule of payments to investors to assess the strength of future cash flow. CRISIL Ratings examines the following:

1. Agreements with obligors (such as nature of take-or-pay contract, if any) and payment terms
2. Historical collection pattern
3. Assumptions made for projecting future-flow (including pricing agreements and interest earned on bank balance)
4. Co-mingling risk (mingling of the identified future cash flow with the issuer's other cash flow)
5. Other factors that can result in variability in future-flow

Typically, CRISIL Ratings analyses the payment structure followed by the issuer and the trustee. CRISIL Ratings requires that the payment structure be properly documented and confirmed by all parties to the transaction, that is, the issuer, the trustee, and the account bank. It is also mandatory that the payment structure be disclosed in the offer document.

Based on the strength of the cash flow, the structure of the instrument, and past collection efficiency, CRISIL Ratings will determine the sufficiency of cash collateral or over-collateralisation, if any, that is consistent with the instrument's rating.

Legal risk

If the originator continues to generate sufficient cash flow, timely payment on the rated instrument is strongly linked to the robustness of the transaction's legal framework. There are differing opinions on how future-flow structures would be treated if the originator declares bankruptcy. The report of the Reserve Bank of India's in-house working group on asset securitisation classifies future-flow transactions as executory contracts. To quote:

"A transfer of property that is not in existence operates as a contract to be performed in future or in other words as an executory contract. The implication of this provision is that in case of bankruptcy of the Originator, the contract can be treated by the Liquidator as being an executory contract, which can be therefore terminated by him. The monies that are paid as consideration by the investors for the purchase of the receivables, while recoverable, would be as unsecured creditors of the Originator."

CRISIL Ratings' rating on an issuer's ordinary debt assesses the likelihood of full and timely payment on the debt and does not necessarily reflect the probability of continued operations. CRISIL Ratings' rating for the instrument under future-flow securitisation transaction captures this difference. Hence, to that extent, the higher rating factors in lower probability of discontinuation of operations than the probability of timely payment on other rated debt.

Escrow structure

In future-flow transactions, the issuer needs to maintain an escrow account into which all amounts due on the instrument are deposited from time to time. As the servicing of the debt instrument depends on payments from the escrowed cash flow, it is essential that the cash flow be accessible to the investors at all times.

CRISIL Ratings' criteria require the escrow account to be under the control of the trustee at all times. CRISIL Ratings will also take into account whether the cash flow is charged in favour of any other creditors of the issuer. If prior encumbrances exist, the issuer will need to obtain requisite consents/pari passu letters.

Recourse to issuer

A future-flow transaction can be structured with or without recourse to the issuer. Where the instrument is with recourse to the issuer, the floor for such a rating is the issuer's credit rating. Such transactions are then viewed simply as escrow structures and may not qualify as securitisation transactions. On the other hand, there is no such 'floor' rating for non-recourse instruments.

Typically, future-flow securitisation transactions with high performance risk tend to be with recourse to the issuer, implying that if there is a shortfall in collection under the envisaged structure, the issuer is obliged to make the debt payment just like its other debt obligations. In such transactions, the rating assigned to the debt instrument will be subject to the floor of the issuer's rating.

A future-flow securitisation transaction can be structured without recourse to the issuer. This is more common when the linkage between future cash flow and the performance of the issuer is very weak and the cash flow certainty is high. In such cases, sufficient cushion in the form of cash collateral or over-collateralisation is usually required to protect investors' interests from variability in cash flow from the underlying receivables.

Documentation

For a future-flow transaction, CRISIL Ratings requires the following documents to be in place:

1. A tripartite agreement between the trustee, the issuer, and the account bank, incorporating the payment structure and establishing the trustee's rights over the cash flow

2. Trustee agreement/Trust deed

3. Offer document which should contain the payment mechanism. The risk may be mitigated by maintaining adequate liquidity over a sufficient debt service coverage ratio (DSCR)

CRISIL Ratings will review the transaction documents to ascertain whether they adhere to the criteria articulated in this article.

Conclusion

CRISIL Ratings' analysis of a future-flow securitisation transaction focuses on the credit risk profile of the originator and the extent of linkage of the future cash flow to the issuer's operating performance. In addition, CRISIL Ratings may factor in external credit enhancements in the form of guarantees (partial or full) while assigning ratings to the debt instruments.

About CRISIL Ratings Limited (A subsidiary of CRISIL Limited)

CRISIL Ratings pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we set 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 33,000 large and mid-scale corporates and financial institutions. We have also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and infrastructure investment trusts (InvITs).

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