# CRISIL's rating methodology for future-flow securitisation

## EXECUTIVE SUMMARY

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

CRISIL believes the ratings for future-flow transactions can be moved up to three notches higher than the credit quality of the issuer based on an interplay of nine crucial factors.

The primary factor is the extent of linkage of these future cash flows to the issuer's operating performance. The higher rating for an instrument issued under future-flow securitisation will enable the issuer to reduce the cost of funds.

In its assessment, CRISIL 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 also undertakes a detailed study of the structure of the transaction, the mode of collection, and the schedule of payments to investors to assess the strength of future cash flows. The other factors analysed are robustness of a transaction's legal framework, presence of a no-lien escrow account where all amounts due on the instrument from time to time are deposited, whether the transaction has been structured with or without recourse to the issuer, and presence of proper documentation.

## SCOPE

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

However, in situations where all or substantial portion of future cash flows are securitised (*typical examples include property lease rentals, road annuity/ toll, cash flows from take-or-pay with other counterparties*), these criteria will not be applicable as the difference between the issuer rating and the instrument (*backed by future flows*) rating would cease to exist.

## UNDERSTANDING FUTURE FLOW SECURITISATION TRANSACTIONS

In a future-flow securitisation transaction, investor payments are met through cash flows that will be generated in 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 existing claims against any performance.

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### Benefits of future-flow transactions

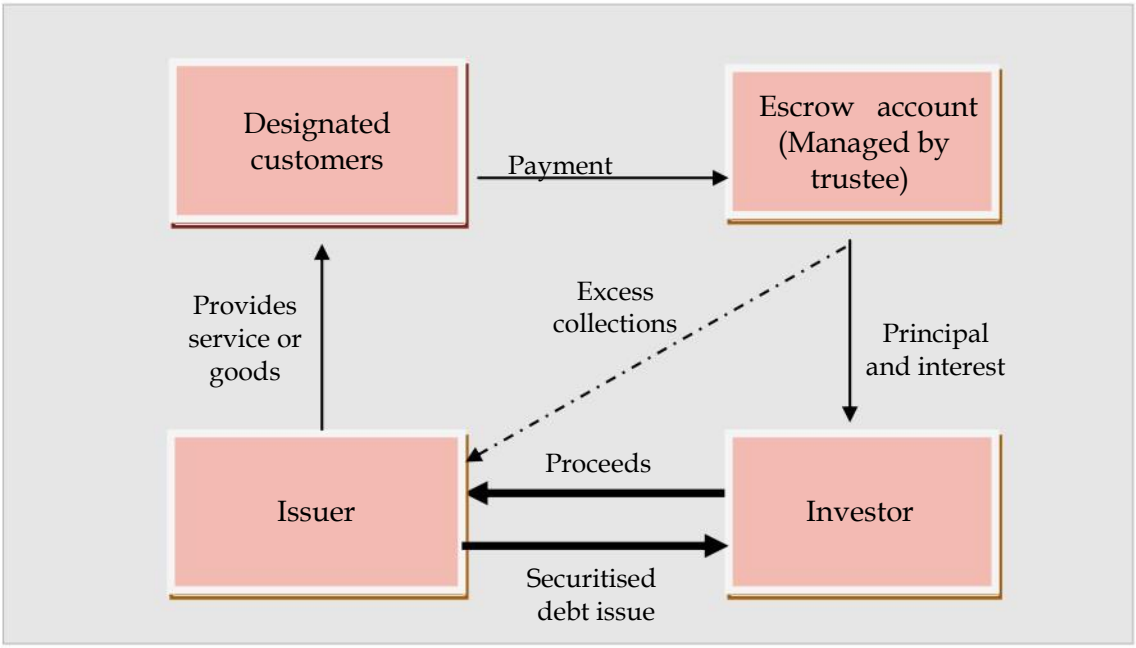
Future-flow transactions allow issuers to:

- Borrow at lower cost than through traditional funding sources as the instrument could be rated higher than the issuer's credit rating
- 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 flows
- 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 collections from a toll road project)

## Structure

In a typical future-flow securitisation transaction, the issuer earmarks the future cash flows directly or indirectly towards servicing the debt raised against those future cash flows. These future cash flows directly flow into 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 collections generated are forwarded to the issuer *(see diagram)*.

**Structure of a typical future-flow securitisation transaction**




Note:

- Initial debt issuance
- Periodic payments over the life of the instrument
- Excess collections flow back to the Issuer

## CRISIL'S ASSESSMENT OF FUTURE FLOW SECURITISATION TRANSACTIONS

CRISIL has rated several securities backed by future flows. The ratings could be **up to three notches higher than the credit quality of the issuer**. The extent of notch-up is based on interplay of various factors, which have been discussed in detail subsequently in this article.

CRISIL's rating criteria for future-flow transactions comprises an analysis of various aspects that have been depicted below:

## 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 flows for debt repayment is linked to the future activity to be carried out by the issuer, the ability of the issuer to generate these cash flows over the life of the rated instrument assumes paramount importance. The issuer's creditworthiness, measured by the credit rating, is the ability of the firm to service all the debt obligations in a timely manner.

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

It is also pertinent to note that the rating on such instruments can, in fact, be lower than the issuer's creditworthiness. If the transaction structure envisages that investors do not have recourse to the issuer for debt repayment, then the rating on such instruments can in fact be lower than the issuer's creditworthiness since it will be dependent 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 notching up could be higher, constrained only by the performance risk of the issuer and the credit quality of the customers.

### 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 flows necessary to service the rated instrument *(refer to Box 1)*. The probability of not being able to generate future cash flows to meet the rated debt obligations may be very different (and in all likelihood lower) than the probability of financial default by the issuer. CRISIL's large rated portfolio of 14,000 entities consists of many firms who may be defaulting on their debt repayments but still continue to operate their businesses and generate cash flows. CRISIL analyses the following factors to assess the originator's ability to generate future cash flows:

- *Extent of linkage between assigned future cash flows and regular operations:*
  CRISIL 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 assesses the degree of linkage between the originator's ability to deliver the promised goods/services (which will generate the cash flows) and the originator's normal operations. The following broad matrix is used as a guiding factor in such evaluation:

**Table 1: Ranking of future-flow transactions, in order of performance risk**

| Performance risk | Linkage with issuer's rating | Examples |
|---|---|---|
| Low | Farthest | Toll revenues<br>Rent revenues<br>Revenues from static gas pipelines |
| Medium | Medium | Crude oil revenues<br>Utility bills revenues |
| High | Closest | Airline ticket sales<br>Revenues from supply of automotive components |

Rent revenues and toll revenues are examples of weak linkages where minimal performance, such as maintenance or upkeep of the facilities, from the issuer is required to generate the revenues. These cash flows are likely to become due just with passage of time. On the other hand, airline ticket revenues are an example of revenues that have a strong linkage to the operations of the issuer. The airline company will have to continue operating its flights and be able to attract customers for ticket sales to be generated. The complexity of 'performance' will also be assessed, and less complex operations (for example, maintenance of a static gas pipeline) will be viewed favorably compared with complex operations (for example, supply of forged automotive components of specified quality).

- *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 company's track record and its ability to generate the identified future cash flows required to meet the rated debt obligations are analysed.
  - *Financial performance:* The issuer's financial performance is assessed to ensure that the issuer is in a position to continue operations. This includes studying the issuer's past financial performance, its ability to raise funds, and its expenditure plans. Although this parameter is also analysed while understanding the issuer's creditworthiness, the focus here is on the issuer's ability to meet operational commitments (such as statutory dues, power charges, salaries and wages), non-payment of which can impede its regular operations.
- *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 can be a monopoly supplier of any product or services 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 flows from such entities are viewed more favorably 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 flows 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; they do not therefore 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 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 flows 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 produce 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 flows are 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.

## Obligors' (counterparty's) creditworthiness

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

In the case of a **single obligor**, the rating on the instrument may be constrained by the rating of the obligor. In case there are **multiple obligors**, a rating view is taken on all the obligors, and the resultant rating would be a function of the individual ratings and their contribution to future cash flows, after factoring in the benefit on account 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 by diversity of the retail pool and track record of collection efficiencies.

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

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

- Size of the rated transaction in relation to the originator's scale of operations
- Application of the proceeds of the rated debt
- Residual cash flows after escrowing the future flows for rated debt and their adequacy to meet operating commitments and any remaining debt servicing

Thus, CRISIL 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 flows are securitised, the difference between the issuer rating and the instrument rating would 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 flows. CRISIL examines the following:

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

Typically, CRISIL analyses the payment structure followed by the issuer and the trustee. CRISIL 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 flows, the structure of the instrument, and past collection efficiency, CRISIL 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 flows, 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 in the event of the originator's 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 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's 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's 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 from time to time are deposited. As the servicing of the debt instrument is dependent on payments from the escrowed cash flows, it is essential that the cash flows be accessible to the investors at all times.

CRISIL's criteria require the escrow account to be under the control of the trustee at all times. CRISIL will also take into account whether the cash flows are 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/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 in the event of a shortfall in collection under the envisaged structure, the issuer is obliged to make the debt payments just like its other debt obligations. In such transactions, the rating assigned to the debt instrument will be subject to a floor of issuer rating.

A future-flow securitisation transaction can be structured without recourse to the issuer. This is more common in cases where the linkage between future cash flows 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 flows from the underlying receivables.

## Documentation

In case of a future-flow transaction, CRISIL requires the following documents to be in place:

- A tripartite agreement between the trustee, the issuer and the account bank, incorporating the payment structure and establishing the trustee's rights over the cashflows
- Trustee agreement/ Trust deed
- Offer document which should contain the payment mechanism

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

## CONCLUSION

CRISIL's assessment of future-flow securitisation transactions takes into account several factors. CRISIL would typically rate these transactions up to three notches higher than the originator's credit rating.

## About CRISIL Limited

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**CRISIL Limited**
CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai - 400076. India
Phone: +91 22 3342 3000 | Fax: +91 22 3342 3001
www.crisil.com