VIS

Credit Rating Company Limited

STRUCTURED COVERED BONDS/SUKUK

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SCOPE OF CRITERIA

"Covered bond" is a term that typically refers to a debt instrument that has dual recourse: first, to the issuer – which would typically be a financial institution; and, upon the issuer's default, to a pool of assets (also known as "cover assets"). Covered Bonds are ideal for refinancing receivables, typically existing mortgage loans, SME loans, personal unsecured loans, credit card receivables or micro loans etc.

To segregate assets of the covered pool from the bankrupt estate of the issuer, some of the jurisdictions have instituted special legislation where legal protection may be effected through ring-fencing the assets of the covered pool from issuer's other creditors' claims in case of financial distress/restructuring or issuer's insolvency. Due to such enabling legal framework, rating agencies may build multiple-notch rating uplift on the senior unsecured rating of the issuer.

In other jurisdictions like Malaysia and India where such specific legislations are not available, subject to tax and regulatory efficiency, existing securitization techniques have been used for such issuances. These instruments are known as Structured Covered Bonds (SCBs) which replicate the 'dual recourse' nature and may achieve a higher rating than that of the issuer (senior unsecured rating) as the cash flows generated by the pool of cover assets are used for servicing the instruments in case of non-payment to investors or insolvency of the issuer.

STRUCTURED COVERED BONDS IN PAKISTAN

Since structured covered instruments have gained confidence in regional countries, where regulatory/legislative support for such structures is also absent, like in Pakistan, VIS is of the view that financial institutions may also take benefit from this innovative method to access liquidity against refinancing, at lower rates given that these are higher rated instruments than the Issuer's standalone ratings. VIS has published this methodology to assist such issuers. VIS has taken the pioneering role in defining them and formulating an independent methodology for structured covered instruments to deepen the financial market in Pakistan.

However, it is important to mention here that instruments resembling plain-vanilla collateralized lending are not considered SCBs by VIS. The pool assets should mirror the debt profile of the issued instrument throughout its life until maturity. Unless covered pool assets do not provide adequate cushion/margin for servicing debt profile, any rating uplift will not be considered for the debt instruments under this methodology.

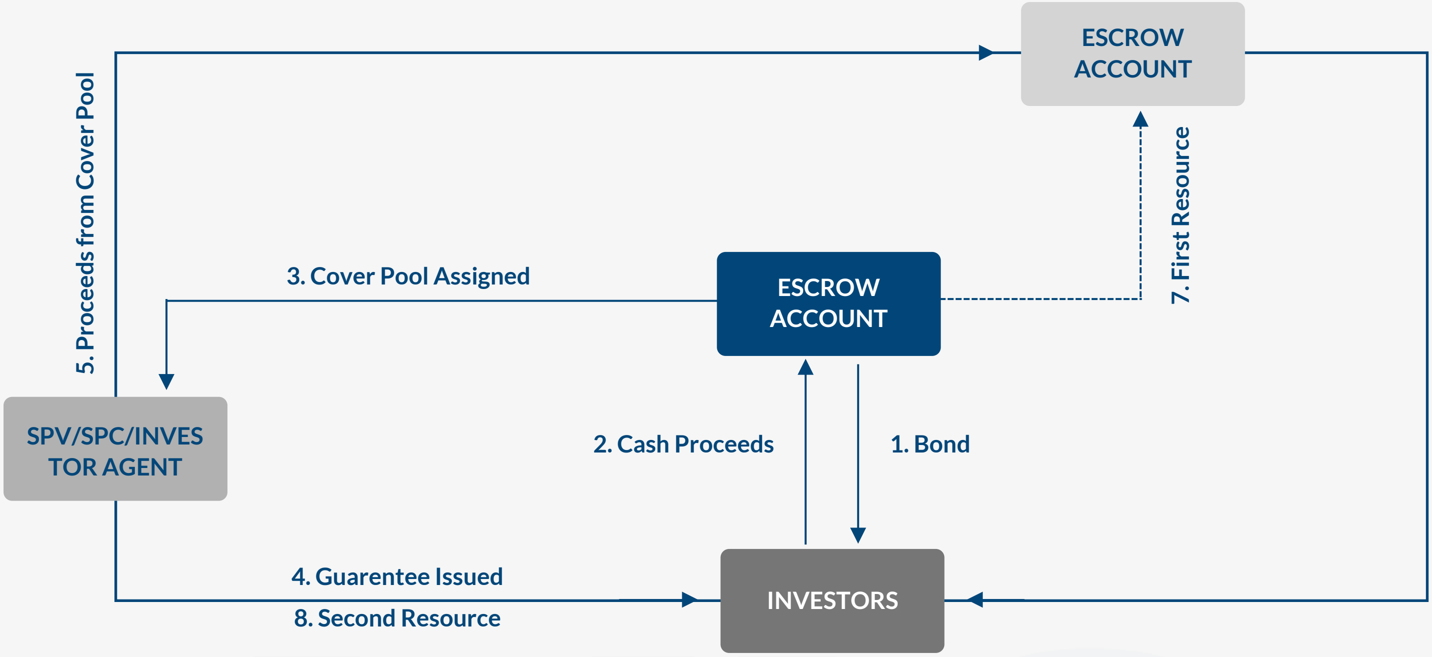
STRUCTURE

Covered debt instruments are issued directly from the balance sheet of the Issuer, as distinct from a typical securitized structure. An Issuer will issue Bonds/Sukuk and simultaneously assign a pool comprising a combination of loan receivables/or any other viable low risk assets (cover pool) as security to a third party (SPV/Trust/investor agent etc., (STI)). After assignment, the cover pool comes under the trust/supervision of the third party. In the normal course of business all the cash flows of the pool will be trapped, under an arrangement with the STI, in the designated escrow account.

The first recourse of payment for debt servicing obligations under SCB arrangement is upon the issuer. Upon default/ non-payment by the Issuer (first recourse) all the rights, title and interest of the cover pool will be transferred to the third party by way of full redemption call by STI and assignment/liquidation of the cover pool assets by triggering an existing irrevocable authorization to the STI. The pool will then be used to repay the bond/sukuk holders (second recourse). The transfer of the pool at the time of default of the Issuer should not need any further action or deed from the Issuer. In such an event the Bond/Sukuk repayments will be met by the funds generated by the identified pool. As the receivables from the pool assets are collected or/and the investment matures/sold, the funds are transferred to an already available escrow account which is dedicated for the investors under the supervision of the third party.

During the period of normal course of business and when the Issuer is solvent, the Issuer may be able to use these funds for its own business depending on the structure of the transaction.

STRUCTURED COVERED BOND FLOW



CREDIT ENHANCEMENT FRAMEWORK

Credit ratings assigned by VIS address timely payment of due principal and markup on the instrument being rated. A particular debt instrument of an Issuer can be rated higher relative to its issuer credit rating if the credit enhancement associated with that debt instrument ensures that the investors are more likely to receive all payments in full and in a timely manner, as per the instrument's repayment schedule.

Regular debt obligations are rated based on the balance sheet strength of the Issuer. The covered bond investors have the benefit of dual recourse – unlimited first recourse on the Issuer and second recourse on the cover pool assets in the event the Issuer's insolvency or non-payment to the investors. The covered pool assets are structured to be bankruptcy remote from the Issuer in the event of Issuer's financial distress, and therefore in ideal circumstances the assets comprising the pool should be transferred/sold to a third party at the outset, however assignment of pool to a third party and transfer at the time of default/pre-defined conditions of issuer is also likely to provide credit enhancement.

The assets in the pool are to be completely unencumbered and the investors should have an exclusive charge on the assets underlying the cover pool.

ANALYSIS FRAMEWORK FOR RATINGS OF STRUCTURED COVERED BONDS

There are many combinations which could be developed while structuring the covered pool. However, major areas which are considered during the analysis are:

A. RATING OF THE ISSUER:

Credit strength of the structured covered securities is linked to that of the issuer. The primary source of the timely payment of the covered bond will come from the issuer's overall credit quality and the Issuer's role. The Issuer's role as the servicer of the covered pool. A lower-rated issuer has less ability than the higher-rated issuer in terms of providing liquidity support to the structured covered instrument if the cover pool does not have sufficient cash flow to service the instruments.

Cover pools may also be fairly dynamic, meaning that the issuer often must replace non-performing receivables or maturing receivables with performing receivables to ensure that the cover pool quality remains satisfactory, and in line with the repayment profile of the issued instrument (total value of the pool shall never be less than the total outstanding value of the instrument at any given point in time plus any desired level of overcollateralization). The issuer's ability to continue to generate similar quality of assets over the life of the instrument will mitigate any replacement risk.

B. CREDIT QUALITY OF THE COVER POOL:

In the event of non-payment by the Issuer, either through insolvency or a pre-defined event of default, the most material source of payment to covered instrument investors will be the cash flows of assets in the cover pool. The Issuer will likely provide a pre-defined, disclosed eligibility criterion for the asset which will be part of the cover pool and through the life of the instrument only assets that meet the eligibility criteria will be allowed for replacement. VIS will apply its general credit rating approach to assess the quality of the assets placed in the cover pool and will monitor the stability/performance of the pool. VIS will update its view on the pool quality and its performance whenever possible by analyzing the pool quality report provided by the issuer on a regular basis on which the rating will be reviewed on periodic basis.

Cover asset pool may also contain partial cash deposits or highly rated debt instruments and/or sovereign obligations for credit enhancement of the cover pool.

Keeping in view the target rating and loss ratios commensurate with it, VIS can determine the gap that needs to be covered through overcollateralization. VIS will also consider backup servicer's fee that may be chargeable when the pool is transferred and managed by STI, as well as any potential loss of income on the pool of assets, in the event of pre-payments, distress sale or delays caused by administrator's actions, for calculating such over-collateralization.

The asset-liability mismatch between the cover pool and the structured covered instrument is another area which will have effect on the credit assessment of an issue. VIS believes that if the maturity of the pool assets is well matched with the tenor and outflows to the investors, the replacement risk will be lower and the ability to judge the quality of the pool assets at the outset of the issuance of the instrument will be superior.

C. OTHER CONSIDERATIONS:

- Guarantee provided by a third party to the cover Bond/Sukuk investors needs to be unconditional and irrevocable.
- Cover pool assets as a proportion of total assets of the Issuer will have a bearing on the credit quality of the issuer. If the covered pool is a significant portion of the issuer's asset base, the entity rating of the Issuer may come under stress.
- The current and incremental debt envisaged in the future on the balance sheet may also constrain the ratings.
- Any other form of credit enhancement may be built into the structure of the instrument to protect the investor from shortfall owing to delay in repayment, such as excess markup/profit spread or overcollateralization. Any external source of enhancement may also be provided.
- The overall management capacity of the appointed backup servicer, especially, from the stand point of it assuming the role of cover pool manager, in case of Issuer default.

In short, the ratings of the SCBs take into account the evaluation of the Issuers credit risk as a first step, and the statistical analysis of the covered pool assets determines the credit enhancement required for the targeted ratings. The covered pool simulation also helps in estimating the ultimate recovery from the pool assets which could be realized or the cash flows which are expected to be generated without disruption in order to satisfy the investors' obligation.

It is important to reiterate that any uplift to ratings over and above the senior unsecured ratings of a banking company, is either a function of providing priority to bond/sukuk holders above general creditors/depositors or ring-fencing superior quality assets from bankrupt estate of the Issuer. This methodology addresses the securitization techniques used for ring-fencing the pool assets to provide any rating up-lift.

VIS recommends that a legal framework should be introduced to facilitate the issuances of covered instruments to further deepen the capital markets in Pakistan.

Faheem Ahmad
President & CEO, VIS Credit Rating Company Limited
Founder, VIS Group Chairman,
Association of Credit Rating Agencies in Asia

Mr. Ahmad possesses 30+ years experience in financial risk assessment with focus on Islamic finance, venture capital and general management. He has top level management experience at international level in the fields of credit ratings, Islamic and conventional financial risk assessment modeling, industrial management and construction engineering. Mr. Ahmad is an active participant at international forums on Credit Ratings. He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters Degrees in Engineering and Business Administration from USA.

Javed A. Callea - Member
Advisor

Mr. Callea is a professional in the financial sector with over 35 years of experience mostly in the financial institutions with certain exposure to service and infrastructure sectors in Pakistan. He has held the position of Chief Executive of a leasing company for 10 years. His core areas of expertise cover leasing, development financing, project management, investment & merchant banking, strategic investment management and real estate. Major financial institutions he worked for include Pakistan Industrial Credit and Investment Corporation, State Life Insurance Corporation, Bankers Equity, Crescent Leasing Corporation and Saudi Pak Ind. & Agri. Inv. Company. He has also served as Member Finance of Water & Power Development Authority of Pakistan and as member of the Inquiry committee on stock exchange crises in 2000 commissioned by the SECP. He earned his MBA degree from the Institute of Business Administration in 1974.

Jahangir Kothari Parade (Lady LLoyd Pier) Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose genrosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.

VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, VIS is positioned to aim for an international mark. In this regard, the global experience of our international affiliates and partners have been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors. The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, VIS continues its endeavour to remain an emblem of trust.

INTERNATIONAL

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Islamic International Rating Agency – **Bahrain –** iira.com
Credit Rating Information & Services Ltd. – **Bangladesh –** crislbd.com

Collaborations

Japan Credit Rating Agency, Ltd. - **Japan**
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