



RATINGS

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RATING METHODOLOGY: ASSET-BACKED SECURITIES

SUMMARY

This paper provides an overview of asset-backed securities ("ABS") and RAM Ratings' generic rating approach for ABS.

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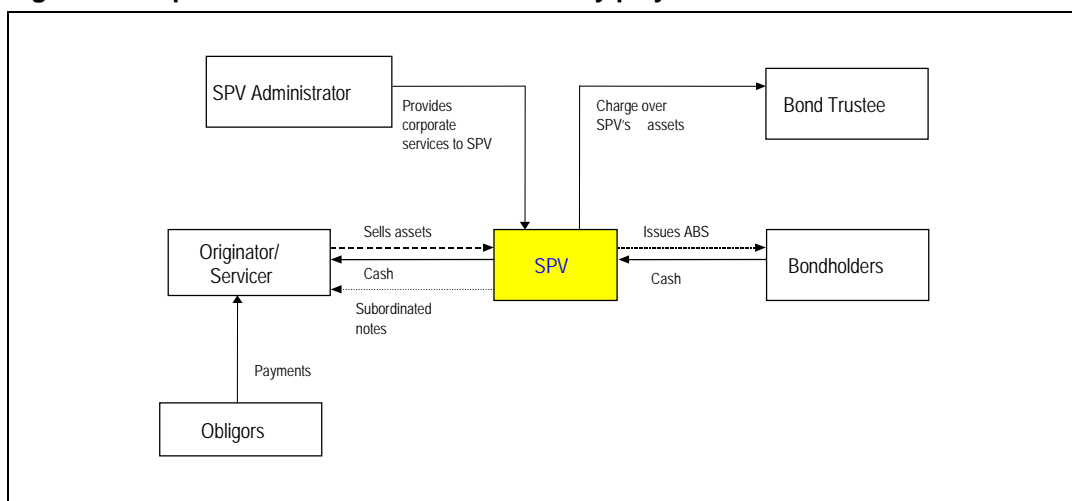
As the term suggests, asset-backed securities ("ABS") are debt securities that are backed by one or more particular asset(s). The source of cash flow for redemption of the ABS depends on the performance of and the cash flow generated by the underlying assets that are securitised. The process of asset securitisation involves the identification and pooling of cash-generating assets, usually via a bankruptcy-remote special-purpose company (or special-purpose vehicle, "SPV"). The SPV will issue ABS backed by the underlying assets and the cash flow generated by them.

There is a wide range of ABS transactions, depending on the underlying assets being securitised and the transaction structure. Examples of these include: mortgage-backed securities, where the underlying assets are residential mortgages and/or commercial property mortgages; and collateralised debt obligations, where the underlying assets are corporate bonds and/or loans. Similarly, consumer receivables such as credit card loans and car loans have also been successfully securitised in many other markets. An essential characteristic of the assets backing the securitisation is that they must be capable of producing cash flow to permit the payment of interest and principal on the ABS issued. The list of securitisable assets is almost unlimited. In more developed ABS markets, investment bankers have been very creative in developing new and innovative structures that package (or "securitise") the future cash flow to be generated by a diverse range of subjects - from patents and royalties to toll revenue and rental income - into ABS.

K EY CONCEPT OF SECURITISATION

The key concepts and flow of securitisation can be easily explained with the help of the following diagram.

Figure 1: Simple securitisation structure and key players



Note: The figure above does not show the range of credit and liquidity enhancements that may be incorporated to support the structure.

In a securitisation exercise, the underlying cash flow-producing assets are sold to an SPV. The SPV normally does not have any employees but engages agents to perform certain functions on its behalf. Such agents include the Servicer, who is engaged to collect and manage the underlying pool of assets owned by the SPV. A Transaction Administrator is also often engaged by the SPV to undertake the corporate administration of the SPV as well as to ensure the smooth performance of the transaction.

It is also very important for the SPV to achieve a “bankruptcy-remote” status. Provisions to ensure the bankruptcy remoteness are generally either included in the Memorandum and Articles of Association of the SPV, or as restrictive covenants in the relevant transaction documents which the SPV is a party to. Such provisions include limitations on the SPV’s activities and its ability to incur additional debts, as well as limited-recourse and non-petition provisions in the contracts between the SPV and other transaction parties, including its agents and the bondholders. This is to minimise the bankruptcy risk of the SPV, which could interrupt the transaction.

The rights and ownership to the assets sold to the SPV must be on a “true sale” basis. This is an important feature of all securitisation transactions for the purpose of isolating the SPV’s

assets and their associated cash flow from the credit or bankruptcy risk of the Originator. To achieve this objective, the transaction must be structured to withstand all attempts by the creditors or receivers of the Originator to access the assets sold to the SPV, such that the assets are totally removed from the bankrupt estate of the Originator. The structure should also effectively eliminate or limit commingling risk vis-à-vis the SPV's assets and those of the Originator, to the extent commensurate with the required ratings.

Apart from the underlying assets, ABS transactions usually incorporate features such as credit enhancement (e.g. overcollateralisation, senior-subordination, financial guarantee insurance and spread account) and liquidity supports (e.g. liquidity lines and expense reserves). The specific form and extent of the credit enhancements will arise from detailed analysis of the asset risk, counterparty risk, features of the debt issued, structure of the transaction and the targeted transaction ratings. Typically, a cash flow model is created to quantify these risks and help determine the required credit enhancement measures.

Structure plays an important role in securitisation and is one of the key elements that differentiates ABS from traditional corporate bonds. In most instances, it is these structural features that allow the SPV bonds to meet the targeted ratings in cases where the assets are, by themselves, insufficient to support the desired ratings.

R AM's RATING APPROACH FOR ABS

As elaborated above, there are many differences between ABS and conventional corporate bonds, both in terms of structure and the risks involved. While the credit ratings assigned by RAM Ratings to both types of debt securities reflect the same thing, i.e. the risk of default on the rated securities, the analytical approaches for these 2 types of securities are different. Unlike that for corporate debt securities, RAM Ratings' approach for ABS generally covers 4 main aspects: asset risk; payment structure; legal and tax issues; and servicer and trustee review. Although details of the analytical process may vary according to the class of asset securitised, this generic approach for the rating of ABS can be applied to most assets such as consumer loans, credit card receivables, collateralised debt obligations and commercial mortgage-backed obligations.

Asset Risk

RAM Ratings' 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, the risk factors considered when analysing cash flow from a commercial property such as a shopping mall would typically include the mall's location,

tenants' profiles, sustainability of rental income, market position and operating expenses. Meanwhile, the risk factors examined in the evaluation 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 question 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. RAM Ratings would require vintage static pool performance data on the underlying assets, covering at least 1 complete economic cycle.

Payment Structure

RAM Ratings analyses the payment structure of the transaction and assesses the adequacy and timing of the cash flow in meeting the promised payments on the ABS, based on the stated priorities 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 cash flow of the asset(s). The level of stress applied should commensurate with the assigned rating. Generally, more stringent stress tests are applied for higher-rated debt securities.

As part of the rating process, RAM Ratings 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 risks hedging arrangements. The credit risks of all the counterparties who provide credit support to the transaction are also considered in the rating process.

Legal and Tax Issues

Legal and tax reviews involve the analysis 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 SPV, enforceability, true sale, perfection of security interest and the bankruptcy remoteness of the SPV. RAM Ratings requires expert opinions that address the legal and tax issues in respect of the transaction. The legal assessment would also cover a review of the transaction documents such as the trust deed, sale and purchase agreement, servicing agreement, swap agreement and guarantee

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No statement in this methodology is to be construed as a recommendation to buy, sell or hold securities, or as investment advice, as it does not comment on the security's market price or suitability for any particular investor.

While every effort has been made to incorporate the salient points of RAM Ratings' experience in relation to the methodology, we note that the information contained could be updated and altered depending on changes in our internal views, market conditions, accounting practices and regulations. The methodology is also based on factors relevant to Malaysia and may require adaptation to local conditions.

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