Criteria for Rating Credit Enhanced Debt

[In supersession of CARE's Criteria for Rating Credit Enhanced Debt issued in June 2020]

Background

Credit Enhancement (CE) is a method of improving the credit quality of the underlying debt issuance by using various structures. It is a means of providing additional comfort to the investor that the obligation would be honoured by an additional external collateral, guarantee or insurance. A common form of CE is an unconditional & irrevocable guarantee from a higher-rated entity covering the issuer's debt obligations. Credit-enhanced debt structures are common in both financial as well as non-financial sectors.

CARE assigns the suffix (**CE)** to denote that the rating has been arrived at on the basis of an explicit external credit enhancement and not on the basis of the credit quality of the issuer alone. However, a detailed standalone credit assessment of the issuer is also being carried out as per SEBI circular No SEBI/HO/MIRSD/DOS3/CIR/P/2019/70 dated June 13, 2019.

Different forms of Credit Enhancement

The credit enhancement can be in the form of:

A. Unconditional and irrevocable guarantee (either 100% or partial). This is the most common type of credit enhancement.
B. Letter of Comfort
C. Pledge of Shares
D. Put option on group company/ parent/ third-party
E. Shortfall undertaking/ Undertaking towards maintaining Debt Service Reserve Account (DSRA) or maintaining desired Debt Service Coverage Ratio (DSCR) by an external entity
F. Standby letter of credit from a commercial bank majorly in case of Commercial Papers (CP)
G. Co-obligor structures

Methodology for arriving at ratings enhanced by guarantees:

The ratings assigned to the debt credit enhanced by guarantees depends on the extent of the guarantee. A guarantee for the entire debt obligation is akin to a direct credit substitution whereby the rating of the issuer's debt is directly equated with the guarantor's rating. However, anything less than a full guarantee would tantamount to a partial credit enhancement and not a credit substitution. Partial Credit Enhancement (PCE) is when credit enhancement covers less than 100% quantum of the debt obligation. This is a limited extent of support provided by a guarantor with a stronger credit profile than the issuer such that, a part of the obligation on the debt gets guaranteed and the rest is dependent on the credit profile of the issuer.

A partial CE can also be in the form of credit enhancement for a limited period. At times, CE may be contractually extinguished on achievement specific operational or financial parameters (viz., commencement of operations of SPV, capacity utilization levels, DSCR build-up etc.). In such cases, the rating of the guaranteed entity may not be equated to the guarantor's rating, but the instrument rating would be suitably notched down from the guarantor's rating, considering the fact that the guarantee does not cover the entire tenure of the instrument. Credit analysis in this case would involve assessment of possible credit quality of instrument at the time when guarantee ceases to exist. The principle underlying this approach is that the rating of the instrument should, at any point in time, be stable. Hence, even after removal of suffix (CE) post extinguishing of a guarantee, the rating should hold good, sans CE. The rating would be capped at the guarantors' rating till such limited period when guarantee is available.

A.1 Full guarantee

A full guarantee denotes a 100% guarantee with respect to repayment of both principal and interest. Such a guarantee to be considered as a CE has to be provided by an entity having a stronger credit profile to enhance the rating of the issuer. Generally, such guarantees are provided by a stronger entity - a parent / group company, government or any external entity. For CE by way of such unconditional and irrevocable 100% guarantee, CARE rates the guaranteed debt of the issuer at the same level of the rating of the guarantor.

While arriving at the guarantor's rating, the analysis incorporates the effect of guarantee on guarantor's credit quality and accordingly suitable view on rating of the guarantor is taken. In case the guarantor entity is not rated by CARE Ratings, 'Shadow rating' of the guarantor is done which is then reflected in the issuer's rating.

A.2 Partial guarantee

Partial guarantee (PG) credit analysis aims at arriving at a rating based on partial support from stronger entity. The 'uncovered' debt obligation is required to be serviced out of issuer's regular cash flows. The standalone credit quality of the issuer, guarantor and correlation of cash flows between guarantor and issuer are important factors that determine the rating for PCE debt. All else equal, the higher the credit rating of the guarantor, greater would be the notch up in standalone rating of the issuer. In essence, the final rating under the PG framework would lie somewhere in between the standalone rating of the issuer and the guarantor's rating. It is assumed that in an event of invocation of the guarantee, the liability so created on the issuer towards the guarantor would be subordinated and payable post redemption of the instrument being rated.

The credit analysis carried out differs from case to case considering the circumstances of the entity and the industry; however, broadly, the following approaches are followed:

A.2.1 Probability of Default (PD) approach

A.2.2 Cash flow Specific Stress Approach

A.2.3 Expected Loss Approach

A.2.1 Probability of Default (PD) Approach

This is a generic approach and is followed in all cases, irrespective of the industry. The approach is based on the principle of ratings linked to probability of default. To begin with, standalone rating of the issuer / guaranteed entity is arrived at using applicable credit assessment framework. In this approach, CARE Ratings uses its proprietary default statistics to arrive at final rating of the instrument. The rating is arrived at based on the ranges of various ratings as per the idealized default curve. Apart from guarantee coverage, the other crucial points in the analysis include nature of guarantee (first loss default guarantee), documentation and structure put in place for implementing the guarantee, stand-alone credit profiles of issuer and guarantor, etc.

A.2.2 Cash flow-specific Stress Approach

This approach is used when the nature of guarantee provided by guarantor is First Loss Default Guarantee (FLDG) and such guarantee helps to provide cushion to the cash flows available for debt servicing under different stressed scenarios. The general principle applied is that higher rating categories can, ceteris paribus, withstand higher level of stress.

This approach would apply typically to infrastructure assets, where the revenue earning capacity is not significantly affected even in case of inadequacy of cash flows to pay the entire debt. The conditions under which this approach can be employed are as under:

- Presence of a long-term arrangement that assures revenues, preferably from Government or quasi-government entity which has given an assurance based on laws of the land. A Power Purchase Agreement with a state utility which assures offtake at a specified tariff levels, has pass through of costs is an example.
- Concession agreement with a state-owned or GOI-owned concessioning authority or similar bodies which bestow the company/SPV the rights to get revenue like collection of toll, annuity, etc.

- Availability of track record which could be tested for stress scenarios.

Subject to satisfaction of the above conditions, CARE Ratings would critically analyze key assumptions underlying cash flow projections. These assumptions are 'stress tested' based on track record as also current scenario analysis. Typical variables (illustrative but not exhaustive) which could be 'stressed' in various types of infrastructure projects are given below.

Sector	Variability which could affect cash flows	Stress factors
Wind Power Project	➢ Wind flow ➢ Seasonal wind pattern ➢ Machine availability, breakdowns and maintenance schedules ➢ Collection efficiency of power dues	➢ Low wind flow as per past wind studies in the area ➢ Reduced machine availability ➢ Higher breakdowns and maintenance ➢ Higher O&M expenditure ➢ Elongated collection
Hydro Power Project	➢ Water flow patterns and flooding ➢ Plant availability ➢ Breakdowns and maintenance schedules ➢ Collection of power dues	➢ Low water flow leading to low generation or disruption due to flooding ➢ Reduced plant availability - Higher breakdowns and maintenance ➢ Higher O&M expenditure ➢ Elongated collection
Road Project (Toll based)	➢ Traffic composition ➢ Traffic volumes ➢ Lane availability ➢ Resistance to collect toll	➢ Less favourable traffic composition ➢ Higher O&M cost and traffic disruptions ➢ Event risk

The quantum of partial guarantee (typically defined as percentage of original principal value of Bond / debt) is then factored in the stressed level of cash flows to assess impact on the debt servicing capability.

The final credit rating is arrived at after assessing various other factors discussed below.

Nature of Credit Enhancement in partial guarantee structures:

For infrastructure projects, the following features are generally observed:

(i) The specified percentage of credit enhancement would be available throughout the tenure of the bonds.

(ii) Credit enhancement would be utilized in the event of inadequacy of cash flows, as per trigger mechanism stated in the documents.

(iii) The guarantee can be invoked any number of times during the tenure of the bonds.

The credit enhancement is usually in the form of an unconditional & irrevocable **First Loss Default Guarantee (FLDG)** to the extent of a specified percentage of the debt amount outstanding. FLDG can be invoked multiple times as long as the utilization at any point of time is within the eligible amount.

Amortizing vs. non-amortizing guarantee:

A partial guarantee can be non-amortizing (the absolute level of guarantee remaining constant throughout its tenor) or amortizing (level of guarantee reducing in line with amortization of the debt which it covers). Comfort provided by a non-amortizing guarantee will gradually increase with time as the covered debt gets paid off resulting in an increased coverage.

A2.3 Expected Loss approach:

This approach is used where partial guarantees are provided by third-parties for debt issuances of NBFCs/HFCs. Typically, this approach is applied for the issuers which are NBFCs/FIs and which are into retail lending and offer a retail asset pool as a collateral for such debt. Pool cover along with the partial guarantee provides added comfort in such cases especially for short to medium tenors of upto 3 years. There could be more than one guarantee provider and the enhancement in the credit rating would depend on the combined credit profile of the guarantee providers. This approach focuses on arriving at an expected loss of the instrument / pool based on PD, LGD & EAD for the life of the instrument / pool after factoring in the availability of the guarantee cover at various points in time during the instrument / pool tenor. The guarantee structure should be such that it should be available for draw down on or before the payment due date on the obligation with the undrawn amount remaining available for drawing later on during the life of the instrument / pool. Furthermore, the liability created by drawing the guarantee amount should remain subordinated to the guaranteed debt and should be made payable only after the full payment of the guaranteed debt. The guarantee should be unconditional & irrevocable in nature. Further, legal opinion should be obtained on the enforceability of the guarantee as it is done for full guarantees.

Methodology for arriving at ratings enhanced by other forms of CE:

B. Letter of comfort (LOC) by stronger party:

The rating takes into account credit quality of LOC provider. Additionally, the analysis incorporates effect of LOC on LOC provider's credit quality, and accordingly, suitable view on the rating of the LOC provider is taken. LOC is more in the form of a moral rather than a legal obligation to pay the dues under LOC if situation demands. CARE evaluates the market reputation of the LOC provider, the strategic importance of the issuer to the LOC provider depicted by a common name, shared identities, business linkages, etc. CARE also evaluates the contents of the LOC document to decipher the intent of the LOC provider with regard to continuity of shareholding in the issuer and support for timely debt payment. Depending on the above factors, the standalone rating of the issuer will be suitably notched up such that it may lie somewhere in between the standalone rating of the issuer and that of the LOC provider's rating. If the intent as spelt out in the LOC toward repayment of issuer debt is strongly worded such that it assumes the character of a guarantee, the rating moves significantly closer to the LOC provider's rating. However, it is normally not equated to the LOC provider's rating as in case of 100% unconditional and irrevocable guarantee.

LOC from financial institutions providing credit enhancement to non-fund-based bank facilities

In some cases, financial institutions like IREDA, PTC India, REC, etc., provide LOCs based on which project developers avail non-fund-based limits from banks and these LOCs are backed by term loan sanctions from the financial institutions. These LOCs are very strongly worded and are akin to the guarantees and also incorporate 'T minus' payment mechanisms. The rating of these LOC-backed structures would thus move significantly close to the LOC provider's rating and in some cases may also be equated to the LOC provider's rating.

C. Pledge of Shares : (please refer to our methodology on 'Rating Loans by Investment holding companies (including backed by pledge of shares) on our website www.careratings.com)

D. Put option on Group Company / parent/third party:

A put option on the provider is considered akin to a guarantee if it is unconditional and irrevocable as also legally enforceable. Depending on the structure of extent of put option provided to the issuer's debt, the rating would follow the criteria as laid out earlier for either a partial or a full guarantee.

E. Shortfall undertaking/ Undertaking towards maintaining Debt Servicing Reserve Account (DSRA) or maintaining desired Debt Service Coverage Ratio (DSCR) by an external entity

Some structures have a Debt Service Reserve Account (DSRA) funded to the extent of the debt repayment scheduled for next one or two quarters (interest payment and principal repayment) through the tenure of the debt. The credit enhancement would be utilized in the event of inadequacy of cash inflows to meet the scheduled debt servicing obligations on the Bonds. For example, in an infrastructure SPV, there could be an undertaking provided by a stronger entity to meet the shortfall in the Debt Servicing / Debt Service Reserve Account (DSRA) of the SPV as and when need arises and keep the DSRA topped up all the time. For such structures having Shortfall Undertakings / DSRA undertakings, apart from various transaction-related nuances and legal opinion with respect to enforceability, the stress analysis is done to determine the extent of notch up that can be applied based on the structure.

A DSRA guarantee typically ensues that the rating is very close to the guarantor's rating. A variation of DSRA guarantee which stipulates full payment of the debt in any acceleration event including breach of covenants if given on an unconditional and irrevocable basis is akin to a pure guarantee and the rating is likely to be equated to the DSRA guarantor's rating.

F. Standby letter of credit majorly in case of Commercial Papers (CP)

In case of Standby Letter of Credit from a Bank for CP issued by a corporate, the rating is equated to the bank's short-term credit rating.

G. Co-Obligor Structures

In some cases, there exists a co-obligor structure wherein all the co-obligors are jointly and severally liable to repay the debt of all of them. In case of co-obligor structures, CARE analyses the combined financials and cash flows to arrive at common rating for all co-obligors.

Additional factors considered for CE ratings:

1) **Legal risk**

   The documents providing credit enhancement are examined to establish their unconditional and irrevocable nature. The period of guarantee should cover entire period of debt. CARE Ratings seeks legal opinion on these parameters and also the strength of 'enforceability' of the structure, before confirming the rating to the credit enhanced debt.

2) **Payment Mechanism, i.e., T minus structures**

   Normally, CE structure stipulates a particular number of days before the due date when the issuer has to arrange for cash to the extent of the total repayment obligation (including interest) and maintain the same in an account operated by the trustee. If the issuer fails to arrange for the required amount, the trustee will have the right to invoke the CE.

   In case of bank loans / facilities, it is generally observed that the credit enhancement structures do not stipulate a T minus structure. On the other hand, they do stipulate the period after the due date in which the guarantee has to be invoked and paid by the guarantor. Hence, for the

purpose of rating, an event of default would occur after invocation of such guarantee and non-payment of the same subsequent to such invocation within the stipulated period of time.
In case the guarantor entity is a foreign entity, assessment of credit quality of guarantor also factors in mechanisms for transfer of funds to India, etc. At times, restriction in transfer of funds (foreign investments) to the country may have a larger bearing than the credit quality of the guarantor.

CARE's approach for non 'explicit and external Credit Enhancement'

Certain ratings are not based on explicit credit enhancement from third-party but are based on some form of internal credit enhancement, e.g., presence of a payment mechanism / structure on cash flows of the issuer. In such cases, if CARE is satisfied about bankruptcy remote nature of the structure, and it is believed to enhance the credit profile of the instrument; then suffix **'SO'** is attached to the rating to denote that the rating has been arrived at based on an internal, bankruptcy remote credit enhancement and not on the basis of the credit quality of the issuer alone.

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