Rating Credit Enhanced Debt

[Issued in December 2022]

Overview:

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 credit support. A common form of CE is an unconditional and 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 Ratings Limited (CARE Ratings) 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 carried out as per Securities and Exchange Board of India (SEBI) circular No. SEBI/HO/MIRSD/DOS3/CIR/P/2019/70 dated June 13, 2019 and the Unsupported rating (without factoring the explicit credit enhancement) arrived at is disclosed as a part of the ratings' press release.

The Reserve Bank of India (RBI) issued a guidance note on 'Bank Loan – Credit Enhancement (CE) Ratings' on April 22, 2022, and FAQs on the same on July 26, 2022. Furthermore, SEBI issued a circular on September 28, 2022, on 'Credit Ratings supported by Credit Enhancement (CE)'. CARE Ratings has incorporated the principles laid down by RBI and SEBI in this criteria document.

Applicability

This criteria is applicable for all CE ratings and outlines the broad principles for assessing the validity of the support mechanisms for credit enhanced ratings on various instruments/facilities, as guided by SEBI and RBI. The impacted ratings will be reviewed by applying this criteria within timelines specified by SEBI/RBI.

Different forms of Credit Enhancement

This document outlines the various types of external credit enhancement structures which are valid support mechanisms for 'CE' ratings. For the support mechanisms to be considered for enhancing ratings, CARE Ratings shall inter alia factor the following:

- The support is unconditional, irrevocable, and legally enforceable till all the obligations of the support provider on the rated security/facility are paid to the investors/lenders.
- CARE Ratings shall undertake independent examination of financial strength of the support provider to ascertain the ability to honour the obligations guaranteed by the support provider.
- The support provider has a lower probability of default on a continuous basis, compared with the rated issuer, till the time such ratings are outstanding.

Given below are some of the support mechanisms that CARE Ratings will consider for enhancing ratings based on the type of facility/instrument rated. It may be noted that the actual nature and characteristics of the credit enhancement structures will prevail over the nomenclature used for such structures, in the assessment.

Bank facilities/Commercial Papers (CPs)/Fixed Deposits (FDs)	Non-Convertible Debentures/Bonds and other Capital market instruments
Guarantees[1] meeting all the principles laid down by RBI in its guidance note (detailed later in this document), whether full or partial guarantees	Unconditional, irrevocable and legally enforceable guarantees (full or partial)/shortfall undertakings/other such third-party credit enhancements
Letter of comfort issued by Central/State Governments	Covered bonds that have to be serviced primarily by the issuer (i.e., primary recourse to the issuer), with secondary recourse to the cash flows from the pool of loans housed in a trust
Shortfall undertaking which is legally enforceable, irrevocable and unconditional	Guaranteed Pooled bond issuance (PBI), not through a trust
Standby letter of credit (SBLC)	Letter of comfort
Guarantee towards maintaining a debt service reserve account (DSRA) from a third party	Commercial Mortgage-Backed Securities (CMBS)-like structures
	Standby Letter of Credit (SBLC)
	Obligor/Co-obligor structures or cross-default guarantee structures
	Payment Waterfall /Escrow, or DSRA etc., but with Full Guarantee or DSRA Replenishment Guarantee from a third party
	Debt backed by pledge of shares or other assets

The above-mentioned structures along with their typical characteristics are explained below:

Support mechanisms for all rated debt including bank facilities/CPs/FDs/NCDs/bonds/other capital market instruments

A. Ratings Enhanced by Guarantees/Covered Bonds/ Guaranteed Pooled bond issuance:

An eligible 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 will be 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 guarantee will be considered for credit enhancement of bank facilities/CPs/FDs, only if it is in compliance with all the principles mentioned by RBI in its guidance note/FAQs (detailed below). For NCDs/bonds/other capital market instruments, a guarantee will be considered for credit enhancement if it is unconditional, irrevocable and legally enforceable.

[1] Exceptions
In case of existing bank loan ratings on the date of RBI's FAQs, on fixed maturity loans based on guarantees as a support mechanism, the existing guarantees will be reckoned till the residual tenure of such rated bank loans. With respect to existing ratings on working capital facilities based on guarantees as a support mechanism, the existing guarantees will be reckoned till the timelines specified by RBI in its FAQs.

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. In case of a valid 100% guarantee, CARE Ratings rates the guaranteed debt of the issuer at the same level as the rating of the guarantor.

While arriving at the guarantor's rating, the analysis incorporates the effect of the guarantee on the guarantor's credit quality. In case the guarantor entity is not rated by CARE Ratings, the 'Shadow rating' of the guarantor is done, which is then reflected in the issuer's CE rating. A suitable 'Shadow' view on the rating of the guarantor is taken factoring in the business and financial risks, management quality, and other relevant parameters as applicable and continuous surveillance is undertaken thereof of the support provider, till the tenure of the rating.

Principles laid down by RBI to factor credit enhancement from a guarantee:

- **It should be unconditional:** The support extended should be unconditional in nature in honouring the obligations under the guarantee.
- **It should be irrevocable:** The support provider should not revoke the guarantee till all the obligations of the borrower are fully paid to the lender.
- **It should be enforceable:** The support extended should be legally enforceable at any time during the tenure of the rated facility.
- **The support should be for the facility in its entirety:** The support should cover the entire facility being rated as applicable, including principal, interest, or any other amounts payable as per the terms of the facility. In the case of partial guarantees, the rating comfort derived shall be restricted to the extent of the partial guarantee provided.
- **Guarantee for payment:** The obligation of the support provider should be to pay the guaranteed amount without demur as per the sanctioning terms in case of default by the borrower and not merely ensure repayment by the borrower.
- **Payment mechanism:** The guarantee deed should specify the timelines for invocation of the guarantee by the lender, and for subsequent payment by the support provider.
- **Payment on first demand:** The support provider should make payment under the guarantee on receipt of the first demand or notice from the lender as per the terms of the guarantee.
- **Payment without deduction:** All guaranteed payments are to be made by the guarantor without any deductions.
- **Rights of support provider to be waived:** The Indian Contract Act, 1872 provides certain rights to the guarantors, including automatic termination of the guarantor's obligations under certain situations (such as change in the terms of contract without the guarantor's consent as per Section

133). Hence, in case of any change in the terms of the contract, the guarantee needs to be reaffirmed by the guarantor for it to be treated eligible as a valid support for deriving the CE rating.

- **Guarantor is primary obligor:** The lender is entitled to proceed against the support provider without waiting to exercise all its remedies.
- **Payment should happen in the event of insolvency:** The support provider should agree to make payments even in case of any insolvency, liquidation, dissolution or any other analogous proceedings against the rated entity.
- **Overseas guarantors:** If the guarantee is extended by an overseas support provider (foreign parent) in respect of subsidiaries/ group entities/ affiliates operating in India, all the aforementioned features of the guarantee are assessed to ensure that there are no regulatory or legal issues in the guarantor making remittances under the guarantee as per the existing legal/ regulatory framework in the jurisdiction of the guarantor. This assessment is based on a legal opinion which covers the aspect of ease of repatriation of funds between the rated entity and the support provider and the legal enforceability of the structure. At times, restrictions in the transfer of funds (foreign investments) to the country may have a larger bearing than the credit quality of the guarantor.

A.2 Partial Guarantee

Partial guarantee (PG) credit analysis aims at arriving at a rating based on partial support from the stronger entity. The standalone credit quality of the issuer, that of the guarantor, and other factors such as the probability of default, stressed cash flows and expected loss will be considered for arriving at the rating for partially credit enhanced (PCE) debt. All else being equal, the higher the credit rating of the guarantor, the greater will be the notch up in the standalone rating of the issuer. In essence, the final rating under the PG framework will lie somewhere in between the standalone rating of the issuer and the guarantor's rating.

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

A.2.2 Cash Flow specific stress approach

This approach is used typically for infrastructure assets when the nature of guarantee provided by guarantor is First Loss Default Guarantee (FLDG) and such a guarantee helps to provide a 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 a higher level of stress.

In infrastructure assets, 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 a Government or quasi government entity which has given an assurance based on laws of the land. A Power Purchase Agreement with a state utility that assures offtake at a specified tariff level, and has pass through of costs is an example.
- Concession agreement with a state-owned or Government of India (GOI)-owned concessioning authority or similar bodies that bestows the company/Special Purpose Vehicle (SPV) the rights to get revenue like collection of toll, annuity, etc.
- Availability of track record that could be tested for stress scenarios.

Subject to satisfaction of the above conditions, CARE Ratings will critically analyse key assumptions underlying the cash flow projections. These assumptions are also 'stress tested' based on track record and the prevailing environment.

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 the impact on the debt servicing capability.

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

- <u>Nature of credit enhancement in partial guarantee structures:</u>

  For infrastructure projects, the following features are generally observed:

  a) The specified percentage of credit enhancement will be available throughout the tenure of the bonds.

  b) Credit enhancement will be utilised in the event of inadequacy of cash flows, as per the trigger mechanism stated in the documents.

  c) 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 and 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 utilisation at any point in time is within the eligible amount.

- <u>Amortising vs. non-amortising guarantee:</u>

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

A2.3 Expected loss approach / Covered bonds / Guaranteed pooled bond issuance:

This approach is used where partial guarantees are provided by third parties for debt issuances of non-banking financial companies (NBFCs) or housing finance companies (HFCs). Typically, this approach is applied for the issuers which are NBFCs/financial institutions (FIs) and are generally 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 tenures generally upto three years. There can be more than one guarantee provider and the enhancement in the credit rating will 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 Probability of Default (PD), Loss Given Default (LGD) & Exposure at Default (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 and irrevocable in nature.

A.3 Limited-period guarantee

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

B. Guarantee towards maintaining DSRA from a third party

Some structures have a DSRA funded to the extent of the debt repayment scheduled for generally the next one or two quarters (interest payment and principal repayment) throughout the tenure of the debt. The external support in such cases will be utilised in the event of inadequacy of cash-flows of the issuer to meet the scheduled debt servicing obligations. For example, in an infrastructure SPV, there can be a DSRA guarantee provided by the sponsor to replenish the DSRA of the SPV as and when the need arises and keep the DSRA topped up all the time. A DSRA guarantee that stipulates full payment of the debt in any acceleration event including breach of covenants is akin to a pure guarantee and the rating is likely to be equated to the DSRA guarantor's rating if the DSRA guarantee is unconditional, irrevocable and legally enforceable.

C. Letter of Comfort (LOC):

For ratings on bank facilities/CPs/FDs, only LOCs provided by Central/State Governments will be considered as valid credit enhancement structures, while for ratings on NCDs/bonds/other capital market instruments, the LOCs will be generally treated as valid support mechanisms, provided the LOC is from an entity having a better credit profile than the issuer of the debt rated.

LOC is a document vide which the external support provider provides an explicit comfort to support the issuer without assuming the position of the primary obligor and it only facilitates debt repayment and does not guarantee debt repayment.

The rating considers the credit quality of the LOC provider. Additionally, the analysis incorporates the effect of LOC on the LOC provider's credit quality, and accordingly, suitable view on the rating of the LOC provider is taken.

CARE Ratings 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, shareholding, etc. to understand the extent of the moral obligation of the LOC provider to support the issuer if the situation demands. CARE Ratings also evaluates the content of the LOC document to decipher the intent of the LOC provider with respect to continuity of shareholding in the issuer and support for timely debt payment. Depending on the above factors, the credit enhanced rating 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 towards repayment of the issuer's 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 the case of a 100% unconditional and irrevocable guarantee.

D. Shortfall Undertaking which is legally enforceable, irrevocable and unconditional in nature

Undertakings towards meeting the shortfall in debt repayments that are legally enforceable, irrevocable and unconditional are akin to guarantees, and hence, treated as valid support structures, provided they have an embedded payment mechanism ensuring payment before the due date. Also, a legal opinion is sought to determine whether the shortfall undertaking is legally enforceable, irrevocable, unconditional in nature, covers the entire tenure of the debt and whether the payment mechanism is adequate. The credit enhanced rating may lie somewhere in between the standalone rating of the issuer and that of the shortfall undertaking provider. If the intent as spelt out in the shortfall undertaking towards repayment of the issuer's debt is strongly worded such that it assumes the character of a guarantee, the rating moves significantly closer to the support provider's rating and may also be equated to the support provider's rating.

E. Standby Letter of Credit

A Standby Letter of Credit is similar to a guarantee, generally issued by a bank or FI for instruments like CPs issued by a corporate. The rating is equated to the bank's/FI's credit rating.

<u>Support mechanisms only for NCDs/bonds/other capital market instruments</u>

A. 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 such cases, CARE Ratings will analyse the combined financials and cash flows of all the co-obligors in accordance with CARE Ratings' Criteria on 'Consolidation' to arrive at the ratings.

B. Pledge of Shares:

Please refer to our methodology on 'Rating Loans by Investment holding companies (including backed by pledge of shares).

Additional factors for CE ratings:

1. **Legal risk**

   CARE Ratings seeks a legal opinion on all the applicable principles as elaborated earlier in this document, before assigning a rating to the credit enhanced debt.

2. **Payment mechanism**

   Normally, the 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/lender. If the issuer fails to arrange for the required amount, the trustee/lender will have the right to invoke the CE.

   However, in the 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. These structures will be considered as valid support structures, provided the date for invocation of the guarantee and payment by guarantor is very close to the due date.

Approach for Non-Explicit and Internal Credit Enhancement

Certain ratings are not based on explicit credit enhancement from a third party but are based on some form of internal credit enhancement, for example, the presence of a payment mechanism / structure on the cash flows of the issuer. In such cases, if CARE Ratings 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 based on the credit quality of the issuer alone.

[For the previous version, please refer to CARE Ratings' Criteria for 'Rating Credit Enhanced Debt' issued in **September 2020**]

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and detailed research. CARE Ratings Ltd, the parent company in the group, is one of the leading credit rating agencies in India. Established in 1993, it has a credible track record of rating companies across multiple sectors and has played a pivotal role in developing the corporate debt market in India. The wholly-owned subsidiaries of CARE Ratings are (I) CARE Advisory, Research & Training Ltd, which offers customised advisory services, credible business research and analytical services (II) CARE Risk Solutions Private Ltd, which provides risk management solutions.