Rating Methodology- Market Linked Notes (Includes Equity Linked Notes)

[In supersession of "CARE's Rating Methodology -Rating of Market Linked Notes (Includes Equity Linked Notes)"issued in October 2018]

Introduction

A Market-Linked Note (MLN) is a debt instrument that differs from a standard fixed-income security in the sense that the coupon on the instrument is linked to a variable market indicator such as an equity index, commodity price such as gold etc. MLNs are primarily of two types. First type wherein MLN is a principal-protected instrument designed to return 100% of the original investment at maturity subject to credit risk of the issuer. While a portion of the capital may be invested by the issuer in debt instruments to bring in the feature of capital protection, the return may be linked to an external market indicator such as equity index to capture the market upside. In the second type, the issuers may also issue non principal protected instruments wherein both the principal as well as coupon are linked to performance of external market indices.

SEBI had released guidelines for issue and listing of structured products/market linked debentures on September 28, 2011. These guidelines specify that for Principal Protected Market Linked Debentures, credit rating agency shall prefix 'PP-MLD' followed by standardised rating symbols for long term/short term as per SEBI circular dated June 15, 2011. Hence, CARE provides credit ratings only for Principal Protected Market Linked Debentures.

CARE's Credit Rating of MLNs

CARE's credit ratings of Market Linked Notes are opinions on the credit quality of the issuer of the MLNs.

What MLN Ratings are not?

CARE's rating on the MLNs would only be an expression of its opinion on the credit risk associated with the issuer concerned. The rating would not address the risks associated with variability in returns resulting from adverse movements in the variable(s) concerned. It would essentially be an opinion on the willingness and ability of the issuer to meet the obligation under the MLN issuance. CARE assumes that the issuer would be clearly stating the terms of the MLN in the information memorandum/offer document and fully expects the investors to understand the nature and terms of the MLNs. Thus the market risk sensitivity of the instrument is expected to be apparent to the investors who are expected to take an informed decision. CARE would not, as a matter of policy, rate self-referencing products, i.e. where the linkage lies with the performance of the issuer's own equity shares.

Example of an Equity Linked Note (ELN) Credit Rating Assessment

Example 1: Instrument Structure: **Coupon linked to Nifty 10 year benchmark GSec index**. In this structure initial levels and date are fixed and final date for redemption is fixed. The underlying performance is tracked on the basis of difference in final levels (official closing levels of Nifty 10 year benchmark GSec Index) at the time of redemption and initial levels and based on the underlying performance, coupon is determined. For e.g. say if the final level is more than 40% of initial level then 'Y' coupon is paid and if final level is less than 40% then coupon will be nil.

Example 2: Instrument Structure: **Coupon linked to Nifty 50 index.** In this structure initial levels and date are fixed and final date for redemption is fixed. The underlying performance is tracked on the basis of difference in final levels (official closing levels of Nifty 50 Index) at the time of redemption and initial levels and based on the underlying performance, coupon is determined. For e.g. say if the final level is negative to that of the initial level then a fixed coupon can be paid say "8%" and if the final levels increase beyond the initial levels based on the underlying performance coupon will go on increasing and on final redemption date, if the final levels are 100% of initial level, coupon can be "20%".

Rating Assessment: The issuer with senior debt rating at "CARE A+; Stable" approaches CARE Ratings for rating of ELN issue for above stated two structures mentioned in Examples 1 and 2. CARE will assign the ELN issue a rating of "CARE PP-MLD A+; Stable", reflecting the issuer's credit risk to pay interest and principal but not reflecting the potential volatility of the interest payments which are linked to market variables.

CARE's Rating Methodology

Since the rating of the Market Linked Notes is ultimately an opinion on the creditworthiness of the issuer, the rating methodology would be dependent on the issuer. CARE has defined rating methodologies for various sectors and the appropriate methodologies are applied to the issuers of MLNs based on its industry.

Rating Scale

CARE uses standardised rating symbols for long term/short term ratings on the lines specified by SEBI. Specifically, for 'Principal Protected Market Linked Debentures', the standard rating symbols carry a prefix of 'PP-MLD'. MLNs with the same credit rating and comparable credit risk may thus have substantially different market risk, depending on their terms.

Ongoing Review, Monitoring / Surveillance and Withdrawal of Rating

CARE Ratings would review relevant information on the company being rated on an ongoing basis for the credit risk as defined above. CARE Ratings would rely on information obtained from the issuer and/or from publicly available sources.

[Reviewed in January 2020. Next review due in January 2021]