

## Rating Methodology: Notching by factoring linkages with Government

[Issued in October 2020]

### Background

The credit risk assessment of entities supported in various ways by the central or state government would capture the linkages with government<sup>1</sup>. Public Sector Entities (PSEs) and/or entities majorly held by PSEs may receive support from the central/state governments depending upon their status, role and strategic importance. The analysis of linkages with the government would be applied as a building block on top of the individual risk assessment and will result in a rating which is notched up vis-à-vis the entity's standalone rating. This paper aims to provide an insight on the effect of these linkages and the extent of notch up based on their strength on the standalone rating of an entity.

CARE Ratings takes a view on the strength of linkages by assessing the following factors:

- **Economic and strategic importance of the entity to the centre/state**
  - Extent of ownership and control of the government
  - Policy function served through the entity
- **Demonstrated track record of support by the government**
  - Instances of timely support in the past
- **Legal or moral obligation of the government to support the entity**
  - Guarantees, Letters of Comfort, undertakings, etc. given by the government. Please refer to CARE Ratings' website ([www.careratings.com](http://www.careratings.com)) for the methodology on 'Rating Credit Enhanced Debt' for more details on this aspect.
  - Probable impact of default of the entity on the sector

The above factors are elaborated below:

#### a) Economic and strategic importance of the entity to the centre/state

- Extent of ownership and control of the government: The economic and strategic importance of an entity to the centre/state is assessed by the extent of ownership/control of the government in the operations of the entity. Government entities operating in sectors of significant economic and strategic importance would also be exhibiting strong linkages.

<sup>1</sup> This was part of rating methodology 'Consolidation and Factoring Linkages in Ratings' last reviewed in [Oct19](#).

- Policy function served through the entity: There are government entities established with a mandate to take forward certain socio-economic policies of the government like infrastructure development or providing finance to strategically important sectors, etc. These entities operate as extended arms of the government and the government is expected to provide the required support to these entities to take forward these socio-economic objectives. CARE Ratings takes into account the strategic importance of these objectives to the government while assessing these entities. It is expected that the government would support such entities in times of distress in view of the strategic importance of the socio-economic objectives.

**b) Demonstrated track record of support by the government**

The demonstrated track record of the government in extending support to the PSEs in the past underlines the government’s willingness to extend support. Explicit financial support by way of budget allocations, subsidy payments, facilitation of bank lines or other means of finance, capitalisation, extension of loans, etc., highlights the government’s stance towards supporting the PSEs.

**c) Legal or moral obligation of the government to support the entity**

- Guarantees/Letters of comfort from the government: The government’s commitment to the entity is further strengthened if there is explicit support extended in the form of legally enforceable arrangements like unconditional and irrevocable guarantees, undertakings, structured payment mechanisms, etc. An unconditional and irrevocable guarantee given by the government to the lenders of the PSE works on the principle of credit substitution and the rating of the PSE is equated to the rating of the government. Further, the support can also be demonstrated through arrangements like letters of comfort provided by the government which entail a moral obligation on the government. Presence of such arrangements further emphasizes the strength of the linkage and the rating of the PSE is notched up appropriately depending on the strength of the stated support. The ratings in these cases are suffixed with the symbol “CE” (Credit Enhancement) which denotes comfort derived from an explicit external credit enhancement to notch up the rating. Further details about the approach on external credit enhancements can be accessed in CARE Ratings’ methodology on ‘Rating credit enhanced debt’ on our website : [www.careratings.com](http://www.careratings.com).
- Probable impact of default of the entity on the sector: Public sector entities belonging to certain sectors like banks/Non-Banking Financial Institutions are systemically important and a default by

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any of these entities may have a spiral effect on the financial markets. It is thus expected that the government will support these entities in times of distress.

### **Extent of notch up**

CARE Ratings notches up the rating of the PSE depending on the extent of linkage as explained above. If the linkages are assessed to be very strong due to strategic importance of the entity to the government, the government's demonstrated track record to support the PSE or legal or moral obligation of the government to support the PSE, the standalone rating of the PSE can be notched up by multiple notches. The rating of central government entities which are of significant strategic importance to the centre may be equated with the sovereign ('CARE AAA') rating. In case, the extent of linkage is assessed to be moderate, the rating of the PSE after notching up will be somewhere between the standalone rating of the PSE and the rating of the government. A commercial entity not having significant socio-economic objectives, even if majorly owned by the government, would tend to operate largely independently and may face competition from private players in the segment. Such entities can be found mainly in the manufacturing sector and would exhibit lower integration with the government framework. These entities are assessed on the basis of their standalone credit profile without any significant notch up.

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