

RATING APPROACH – EXPLICIT THIRD-PARTY SUPPORT

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in October 2020. While the overall analytical approach to assess the various forms of explicit third-party support remains unchanged, certain revisions have been made in the approach to rating debt instruments/ facilities (henceforth referred to as “instruments”) that are backed by a letter of comfort (LoC or other equivalent explicit support forms), or a guarantee extended by a third-party. ICRA has also revised its analytical approach to rating co-obligor structures. These changes have been made to align ICRA's methodology with the Guidance Note and the FAQ document issued by the Reserve Bank of India (RBI) to the Credit Rating Agencies (CRAs) on April 22, 2022, and July 26, 2022, respectively.

Overview

ICRA's credit rating is a symbolic representation of its opinion on the relative credit risk associated with timely debt servicing by an entity. An entity's debt instrument may be rated relatively higher than the unsupported¹ rating in case it has attributes that ensure that the investors in that instrument are more likely, relative to investors in the entity's other debt instruments, to receive the payments in full and in a timely manner. This could be possible if there exists some form of explicit credit support from a stronger third-party or there are structural features (supported through the presence of an Escrow mechanism) associated with the debt instrument. The explicit credit support from a third-party could be through support mechanisms such as guarantees and shortfall undertakings.

This methodology document describes ICRA's approach to rating debt instruments that are backed by some form of explicit support from a third-party². The document has the following three sections.

- Types of explicit support forms
- Assessing the attributes of an explicit support form
- Extent of credit enhancement based on the strength of the explicit support

¹ The unsupported rating of an entity is the rating which is assessed based on the entity's own business and financial risks, while factoring-in the likelihood of extraordinary (implicit) support, whenever required, from a stronger parent or group (wherever applicable).

² To understand how ICRA evaluates the structural features associated with an instrument while assigning ratings, readers may refer to ICRA's methodology titled “Rating Approach - Structural Features (Non-Securitized Transactions)” available on ICRA's website www.icra.in. To know about the approach that ICRA adopts for assessing the strength of implicit support available to a rated entity from a third-party, please refer to ICRA's methodology titled “Rating Approach – Implicit Parent or Group Support” available on ICRA's website.

Types of Explicit Support Forms

An 'explicit credit support' is a promise made by a third-party (also referred to as support provider in this document) to support the servicing of debt obligations of the borrower in case the latter fails to do so on its own in accordance with the terms and conditions of the agreement with the lenders or investors.

The effect of such a promise is that it reduces the default risk pertaining to the supported debt instrument, vis-à-vis the unsupported debt of the borrower, given the presence of a supplementary credit support from a more creditworthy support provider. The promise from the support provider could be for all the debt instruments of the borrower or only for specific debt instruments and, therefore, the credit risk associated with different debt instruments of the same borrower could vary. Debt instruments that are credit enhanced by way of an explicit support from a stronger support provider are rated higher than other instruments to reflect the difference in their probability of default. Debt instruments whose rating is credit enhanced by virtue of explicit support from a support provider, carry the letters 'CE' in parenthesis suffixed to the rating symbol, to distinguish them from the entity's other instruments whose ratings would be based on the unsupported credit profile of the entity. The suffix to the rating symbol indicates that the rating so assigned is specific to the rated instrument, its terms and its structure and does not represent ICRA's opinion on the general credit quality of the entity concerned.

The common forms of explicit credit support, along with their typical characteristics, are discussed below. The list is not exhaustive as there could be several variations in the nomenclature and the structure of the support mechanism. As a result, each form of explicit support provided by a support provider is assessed by ICRA for its features on a case-by-case basis as the focus is on the essence and the intent of the support, rather than its nomenclature.

- » **Guarantee:** It is a promise made by the support provider to fulfil the debt servicing obligations of the borrower in case the latter is unable to service them on its own. The obligations of the support provider are generally co-extensive with that of the borrower, unless otherwise provided in the contract. In case of a default by the borrower, the lender is entitled to proceed against the support provider without waiting to exercise all its remedies against the borrower who is the principal debtor. The obligation of the support provider is to pay the guaranteed amount without demur and deductions as per the terms of the contract in case the borrower is unable to make the payment as per the agreed terms and timelines, and not merely to ensure payment by the borrower. Further, the support provider is required to make payment under the guarantee-terms on receipt of the first demand or notice from the lender as per the terms of the guarantee.
- » **Partial Guarantee:** A partially guaranteed structure is one that involves a guarantee from a third-party which covers only a portion of the total interest and principal payments which would fall due on the borrower's debt. An instrument could achieve a certain degree of credit enhancement (and not a credit substitution) with a guarantee that covers the dues of the instrument being rated, only partially. Though the partial guarantee does not fully cover the payments which may fall due on the debt over its tenor, it fully covers a few instalments. To the extent the credit enhancement in the structure is adequate to fully meet the debt-servicing obligations over a few due dates, default on those instalments can be avoided, thereby reducing the probability of default on the instrument³.
- » **Standby Letter of Credit/ Support:** A variant of a 'Guarantee' is a 'Standby Letter of Credit/ Support' which is generally furnished by a financial institution to an unrelated entity/ borrower on commercial terms to facilitate the latter to raise debt through instruments such as Commercial Papers or Gold Metal Loans. Here, the support provider promises to make the payment to the investors or lenders in case the borrower fails to make the payment as per the agreed terms and timelines.
- » **Debt Service Reserve Account (DSRA) Replenishment Guarantee:** Another variant of a 'Guarantee' is a 'DSRA Undertaking/ Replenishment Guarantee' wherein the support provider promises to ensure that the DSRA created for a

³ More details can be seen in ICRA's methodology for rating partially guaranteed debt available on the website www.icra.in.

debt instrument of the borrower is always available as per the agreed terms i.e., the support provider promises to replenish the DSRA in case it gets utilised and the borrower's cash flows are insufficient to replenish the DSRA. This arrangement ensures that adequate liquidity is always available for the upcoming scheduled debt obligations, thereby ensuring timely debt servicing.

- » **Shortfall Undertaking:** It is a promise made by the support provider to fulfil the debt servicing obligations of the borrower; however, only to the extent that the latter is unable to fulfil i.e. only to the extent of the shortfall.
- » **Covered Bond:** In a typical covered bond transaction, the entity (typically a financial sector entity) issues bonds, or non-convertible debentures (NCDs), and simultaneously assigns a pool comprising of loan receivables (collateral/ cover pool) to a Special Purpose Vehicle (SPV/ Trust). After assignment, the cover pool becomes the exclusive property of the Trust (bankruptcy remote from the other creditors of the entity) and all the rights, title, and interest of the entity in the cover pool gets transferred to the Trust. Alternatively, the assignment can happen post a trigger of certain pre-defined events wherein the cover pool shall become the exclusive property of the Trust at such a subsequent date. The SPV provides a Guarantee on the covered bonds to meet any shortfalls in the repayment of the bonds/ NCDs issued by the entity⁴.
- » **Guaranteed Pooled Loan Issuance (PLI)/ Pooled Bond Issuance (PBI):** In a PLI/ PBI structure, a guarantor provides a common guarantee to a pool of loans/ bonds which are availed/ issued by different entities. The common guarantee partially covers the aggregate amount of pool of loans/ bonds, like in the case of a Partial Guarantee. While a partial guarantee does not fully cover the underlying debt obligation, a PLI/PBI structure typically fully covers each debt individually, though on an aggregate basis, the cover is partial⁵.
- » **Co-Obligor Structure:** Under a co-obligor structure, multiple entities jointly avail debt facilities from the lenders (generally a common lender) and have a joint and several liability to repay the amount under the various facilities to the lenders. Each entity involved in a co-obligor structure has a primary obligation to fulfil the debt obligations, unlike a guarantee where the principal debtor has the primary obligation towards servicing the guaranteed facility and the obligation on the guarantor arises on the occurrence of default on the part of the principal debtor and is thus contingent.
- » **Letter of Comfort/ Letter of Intent/ Letter of Support (or other equivalent support forms):** It is an undertaking given by the support provider to take appropriate steps to ensure timely servicing of the debt obligations by the borrower. The borrower's obligations are not transferred to the support provider and the support provider's responsibility is generally limited to facilitate the borrower in servicing its obligations. A 'Letter of Comfort' and other such support mechanisms are generally not legally enforceable.

Assessing the attributes of an explicit support form

An explicit support form is evaluated on the following attributes before any benefit of its presence is provided to a rated debt instrument⁶. In addition to an internal assessment, in certain cases, ICRA may also seek an independent legal opinion with respect to these attributes.

- » **Enforceability:** The support should be legally enforceable. A legally enforceable support ensures that the support provider honours its promise as any failure on its part could have legal implications for it.

⁴ More details can be seen in ICRA's methodology for rating covered bonds available on ICRA's website.

⁵ More details can be seen in ICRA's methodology for rating pooled loan/ bond issuance structures available on ICRA's website.

⁶ The mere presence (or absence) of certain words in the support documents does not necessarily mean that the support adheres to (or does not adhere to) the relevant principles. The wording and language of the support documents is analysed in the context of their essence and intent as there may be provisions that dilute the strength of the support or despite the absence of certain words, the language of the support appropriately elucidates the intent of the support provider to abide by the relevant principles.

- » **Irrevocability:** The support should be irrevocable such that the support provider is not entitled to revoke the support till the debt obligations against which the support is available are paid in full to the lender. While the support provider might have the flexibility to revoke the support for the unutilised amount against the guaranteed lines of credit, after giving due notice, the support in lieu of the borrowings that are already drawn or outstanding should not be cancellable, for those to be considered irrevocable. ICRA does not consider a support which is revocable (for the borrowings which are already drawn or outstanding) as a source of credit enhancement.

Enforceability and irrevocability in case of explicit support from an overseas entity

In case of an explicit form of support from an overseas support provider, such that the support is governed by the laws of a foreign country and is under the jurisdiction of international courts, the enforceability and irrevocability of the support is assessed with respect to the laws of the foreign country on a best effort basis. Also, ICRA endeavours to seek a legal opinion (through the rated entity) on the enforceability of the support terms. If such legal opinion is not made available to ICRA, then no benefit of such support is typically considered while determining the rating of the debt instrument. In addition, the domestic as well as the foreign country's regulatory framework with respect to transfer of funds from the foreign country to India is also factored in to evaluate whether the support provider will be able to service the obligations upon invocation of the support.

- » **Waive-off of certain rights by the support provider:** The Indian Contract Act, 1872 relating to guarantees provides rights to the support provider that may relieve it of its obligations under certain situations (such as changes in the terms of the contract without the guarantor's consent as per Section 133). A debt instrument for which the support provider does not explicitly waive-off some specific rights till the obligation is paid to the lender in full, is exposed to the risk of the support getting revoked by the support provider. If such rights are not explicitly waived-off by the support provider as per the guarantee-deed, it diminishes the strength of the guarantee, and such guarantees are not considered for assigning credit enhanced ratings to a debt instrument.
- » **Un-conditional:** The support should be unconditional with no qualifications associated with the support provider honouring its obligations. The support should require the support provider to mandatorily pay to the lender upon invocation / receipt of the demand notice as per the terms of the support, without any demur, deductions, or recourse to any defence.
- » **Invocation and payment mechanism:** The contractual terms should specify the timelines for the invocation of the support by the lender/ investor and subsequent payment by the support provider to ensure servicing of the obligations⁷.

Pre-default versus post-default invocation and payment mechanism

The invocation and payment mechanism related to the support form is considered to be pre-default if the terms require the borrower to fund the designated payment account on or before the due date (T-n i.e., n business days before the due date T), and in case the borrower is unable to fund the account, the trustee or the lender should necessarily invoke the support and subsequently the support provider makes the payment such that the debt servicing happens in a timely manner (on or before the due date T).

⁷ As per ICRA's revised methodology, the presence of a defined invocation and payment mechanism is necessary for credit enhancing the rating of a supported instrument/ facility. The said mechanism need not necessarily be of a pre-default (T-n) nature. Even if the invocation and payment mechanism is of a post-default nature (T+n), the rating could be credit enhanced and a CE suffix could be applied alongside the rating symbol. In the case of a pre-default mechanism, ICRA's analytical approach is that of 'credit substitution' whereby the rating of the supported instrument/ facility is equalised with that of the support provider. In comparison, in the case of a post-default mechanism, ICRA assesses the standalone credit profile of the rated entity and further notches up the rating based on an assessment of the criticality of the rated entity to the parent.

In a post-default invocation and payment mechanism, while the timeline for the invocation of the support by the trustee or the lender as well as the timeline for the subsequent payment by the support provider are defined, the invocation of the support and/ or payment by the support provider are defined to occur after the due date. Thus, while such mechanisms support debt servicing, the timeliness is not ensured.

Assessing the adequacy of the timelines for the invocation and payment mechanism

To ensure timely servicing of debt obligations, the timeline for the invocation and the payment mechanism associated with the support needs to be such that it considers the procedural (such as seeking approval for release of funds) and operational delays which may be involved with respect to the support. As an example, in cases where the administrative process involved in the release of funds is empirically longer, the T-n period defined for the invocation of support is typically prescribed to be longer.

Timelines for default recognition

As per the SEBI guidelines, for the fund-based facilities such as term loans that have a predefined repayment schedule, a delay of even one day from the scheduled repayment date is to be considered as a default. For fund-based facilities that are revolving in nature and do not have a pre-defined repayment schedule such as cash credit and overdraft facilities and for non-fund-based facilities such as Letters of Credit, Bank Guarantees and SBLCs, continuous overdrafts/ non-payment for 30 days is considered as a default. Thus, the default recognition by ICRA in both pre-default and post-default invocation and payment mechanisms is with respect to the aforementioned timelines and not with respect to the timelines available with the support provider to make the due payments.

Guaranteed bank facilities

In the case of guaranteed bank facilities, the contract is generally made in a format (as prescribed by the lender concerned) which may not have a defined payment and invocation mechanism. In addition, the guarantee in such cases can be generally invoked after the payment due date once the borrower defaults/ fails to service the obligations.

ICRA's approach prior to the issuance of the Guidance Note and FAQs by the RBI: In the case of guaranteed bank facilities that lacked an invocation and payment mechanism, while ICRA recognised this structural deficiency, it assessed to what extent the support provider was committed to ensure that the supported facility was serviced in a timely manner, regardless of invocation of the guarantee by the lenders. This was assessed both by looking at the manner in which the support provider expressed its commitment to ensure timely debt servicing of the guaranteed facility, and the willingness of the support provider to extend timely support. The extent of comfort taken from the support depended on the extent to which it was judged that the support provider had a strong self-interest in maintaining the creditworthiness of the borrower. This in turn depended on the degree of business linkages between them, the reputation sensitivity of the support provider and the degree of strategic importance of the borrower to the support provider. This assessment enabled ICRA to determine the extent to which the unsupported rating of the borrower needed to be uplifted to arrive at the rating of the guaranteed bank facility--that lacked a defined invocation and payment mechanism. Such an uplift wasn't typically to an extent that equalized the rating of the guaranteed bank facility with that of the support provider. The rating symbol in such cases was accompanied by the (CE) suffix.

ICRA's revised approach post the issuance of the Guidance Note and FAQs by the RBI: As per the Guidance Note issued by the RBI to the CRAs, if the explicit support form is deficient in any respect (i.e., it does not meet the evaluation mechanism/ criteria specified by the RBI and as explained in this methodology document), then the presence of such an explicit support form is not to be considered for credit enhancement. To align itself with the above regulatory guidance, ICRA would no longer be considering the benefit of such explicit support forms (specifically, guarantees for bank facilities that lack an invocation and payment mechanism), even as such a support form represents a relatively stronger expression of commitment on the part of the support provider for the supported instrument(s) in comparison with a support form that is only implicit in nature. The rating symbol in such cases will not be accompanied by the (CE) suffix.

For the fresh rating assignments undertaken for guaranteed bank lines that lack an invocation and payment mechanism, the revised approach would be applied by ICRA from the date of publication of this methodology. However, the existing CE ratings on bank facilities (that are based on guarantees that lack an invocation and payment mechanism), will continue as per the earlier analytical approach, till the residual tenor of the rated facilities—as guided by the RBI. Further, for the existing (CE) ratings outstanding on working capital facilities that are renewed periodically (like cash credit facilities that fall due for renewal at an annual frequency), the residual tenor of these facilities will be considered as the time remaining until the next due date of renewal. As an example, if a cash credit facility was last renewed by a lender in May 2022, then the (CE) rating could continue until May 2023, which would be the next date for the renewal of the facilities. In this example, if by May 2023, there is no amendment in the guarantee-deed such that the attributes of the explicit support remain mis-aligned with the evaluation criteria specified by the RBI in its Guidance Note (and as explained in this methodology document), then such a (CE) rating will be revised to the non-CE rating level, while ignoring the presence of the guarantee. The timeline available to review the existing (CE) ratings for working capital facilities would be the upcoming date of the facility renewal, or January 25, 2023, whichever is later.

- » **Amount and tenure covered:** The support should cover all the obligations that may arise with respect to the debt instrument (including in the event of debt acceleration) during its entire tenor. In the case of a partial guarantee which covers only a portion of the total obligations, the support is relatively lower, and the ensuing credit enhancement is thus limited⁸. However, if the support is not available for the entire tenor of the debt instrument, it is not considered as a source of credit enhancement, even in the case of a partial guarantee.
- » **Bankruptcy remoteness:** The support should be such that it could be invoked by the lenders or investors in a manner that supports timely debt servicing (through the support provider) even when bankruptcy and insolvency proceedings have been initiated against the borrower. A form of support that is not bankruptcy remote has a diminished efficacy in supporting timely debt servicing and is thus not considered for any credit enhancement.
- » **Guarantor as primary obligor:** In case of failure by the borrower / principal debtor in meeting the obligations, the lenders/ investors should have the right to demand payment from the support provider, without first waiting to exhaust all legal remedies against the borrower. On invocation of the support, the support provider should be considered at par with the borrower and the lenders/ investors should be entitled to take legal recourse against the support provider.

Extent of credit enhancement

The extent of credit enhancement for a debt instrument (based on explicit support from a support provider) over its unsupported rating could range from an equalisation of the rating of the debt instrument with that of the support provider (a case of credit substitution) to limited or no credit enhancement from the unsupported rating level (in case of a weak form of explicit support).

The extent of credit enhancement for a rated instrument based on the presence of a third-party explicit support depends on:

- The unsupported rating of the borrower—which determines the steepness of the hurdle to gain a notching uplift,
- The credit profile of the support provider—which drives the ability of the support provider to extend support⁹, and

⁸ More details can be seen in ICRA's methodology for rating partially guaranteed debt available on the website www.icra.in.

⁹ In a case where the support provider does not have an external rating by any domestic CRA, and ICRA is not able to apply the same standard of assessment/ surveillance as that of the borrower (to arrive at an internal rating opinion on the support provider), the benefit of the guarantee extended by such support provider is ignored, as guided by the RBI. Further, if an overseas support provider is not rated by Moody's, S&P, or Fitch, and ICRA is not able to apply the same standard of assessment/ surveillance as that of the borrower (to arrive at an internal rating opinion on the overseas support provider), the benefit of the guarantee extended by such overseas support provider is ignored, as guided by the RBI.

- The contractual features of the support—which determine the strength of the support

The strongest form of explicit support is one that is legally enforceable, irrevocable, is valid for the entire tenor and covers the full amount of the obligation, and where the support provider has an unconditional obligation to pay the entire obligation with respect to the debt instrument in a timely manner. Further, such support comes without the ability to defer, or limit paying for the obligation and has a well-defined pre-default invocation and payment mechanism, besides being bankruptcy remote. This typically results in ICRA following the credit substitution approach whereby the rating of the debt instrument is equated with that of the support provider.

The extent of credit enhancement vide other variants of explicit support forms is assessed by ICRA based on the approach outlined below:

Form of Support	Extent of Credit Enhancement
Guarantee/ Shortfall Undertaking/ Standby Letter of Credit	If upon an evaluation of the contractual terms of the explicit support form, it is determined that it meets all the attributes of the strongest form of support, as explained in the previous section, then the rating of the debt instrument is credit enhanced ¹⁰ . On the other hand, if the explicit support form does not meet all the attributes of the strongest form of support, no credit enhancement is considered on account of such support.
Partial Guarantee	In case there is a shortfall in the cash flows of the borrower, the presence of a partial guarantee does support debt servicing but only if the cash flow mismatch is temporary and there are no cross-default clauses with other loans. Further, if bankruptcy proceedings are initiated against the borrower because of default on an unsupported loan or otherwise, some instalments for the partially guaranteed loan can continue to be serviced. However, unlike a full guarantee whose presence can provide a multiple notch rating uplift to a supported instrument to the extent that its rating comes at par with that of the support provider; in case of a partial guarantee, the extent of notch uplift is limited (provided it meets all other attributes of the strong form of support) in view of the limited coverage and bankruptcy risk. A protracted period of bankruptcy for the borrower would result in a default on the supported instrument once the partial guarantee amount also gets consumed to pay a few installments.
DSRA Replenishment Guarantee	If a DSRA Replenishment Guarantee supports only the scheduled debt obligations and not the principal obligation that may arise upon debt acceleration because of a covenant breach, the credit enhancement possible in such cases would generally be limited, because of similar reasons as highlighted above for partial guarantees. However, if the DSRA replenishment guarantee covers even debt acceleration, and meets all the other criteria for the strongest forms of support, the treatment would be similar to that of a guarantee and the rating of the instrument could be equated with that of the support provider.
Covered Bond	The extent of notch uplift in the rating of covered bonds vis-a-vis the unsupported rating of the borrower depends on the credit rating of the borrower and the credit profile of the cover pool assets which is established via a modelling of the projected cash inflows and debt repayments with statistical techniques. The notch uplift for covered bonds can be constrained if the rated debt can be

¹⁰ For credit substitution to apply, the invocation and payment mechanism should be of a pre-default nature [[i.e., it should be of the T-n type, rather than the T+n type]. In case the mechanism is of T+n type, while the rating of the supported instrument may experience a credit enhancement, the rating may not necessarily be equalized with that of the support provider.

Form of Support	Extent of Credit Enhancement
	<p>accelerated or the borrower has either other debt on its balance sheet or incremental debt is envisaged in future such that the covered bonds have a cross-default linkage with them that could lead to debt acceleration. In case of the presence of cross-default clauses, any default on other debt (rated lower than the rating of covered bonds) would trigger an acceleration of the covered bonds, leading to the same likelihood of default on the latter as that of unsupported debt (as collections from the pool assets that provide support to the covered bonds would only be realised over a longer period of time). Thus, in such cases, the scope for credit enhancement would be restricted.</p>
PLI/ PBI	<p>The extent of credit enhancement in PLI/ PBI structures--in terms of number of notches of rating uplift--depends on:</p> <ol style="list-style-type: none"> Credit rating of individual borrower entities Credit rating of the guarantor Various other parameters, including the relative size of debt of each borrower entity, timing of the scheduled debt pay-outs, partial guarantee amount, correlation among the borrower entities, and the recovery assumptions post default etc. <p>The extent of credit enhancement could be constrained if the borrowers have other debt on their balance sheets or if incremental debt is envisaged in future and the debt backed by the common partial guarantee has an acceleration clause owing to a cross default by the entity on its other debt. In such a scenario, any default on the other debt (rated lower than the rating of the common partial guarantee-backed debt) by a borrower would trigger an acceleration of the common partial guarantee-backed debt for that borrower, leading to the faster utilisation of the common partial guarantee. Hence, the remaining borrowers in the structure would have lower residual guarantee available for credit enhancement.</p>
Co-Obligor Structure	<p><i>ICRA's approach prior to the issuance of the Guidance Note and FAQs by the RBI:</i> The entities that are a part of a co-obligor structure, are contractually tied together through a common loan agreement, which may also involve certain additional structuring including cross-guarantees and cross-default clauses. The aggregate cash flows available with the borrowers constituting the co-obligor structure are used to service the jointly held debt. Therefore, a consolidated rating approach was being followed by ICRA to assign the same CE ratings to the jointly held debt in these structures.</p> <p><i>ICRA's revised approach post the issuance of the Guidance Note and FAQs by the RBI:</i> Since the RBI no longer permits the CRAs to consider the benefit of a co-obligor structure, irrespective of the presence of a common loan agreement, ICRA's revised approach would be based on, among other things, an evaluation of cross-guarantees and cross-default clauses in the loan terms of the entities concerned.</p> <ul style="list-style-type: none"> In case the cross-guarantees have all the attributes of a strong form of support, as explained in the earlier sections of this methodology document (including the presence of a T-n type invocation and payment mechanism), ICRA would continue to apply a consolidated rating approach and assign the same CE rating to the cross-guaranteed debt in these structures. In case there are cross-guarantees (which have all the attributes of a strong form of support and where the invocation and payment mechanism is of T+n type) or there are cross-default linkages between the loans of the entities concerned, the first step of the analytical approach would involve forming a notional credit opinion on

Form of Support	Extent of Credit Enhancement
	<p>the entities concerned on a consolidated basis. Such notional credit rating would typically act as a cap on the rating of the individual entities. The rating of the individual entities would be determined based on their standalone analysis, while also factoring-in the support from the consolidated entities. The ratings of the individual entities could differ from each other. When the ratings draw comfort from the presence of cross-guarantees with a well-defined invocation and payment mechanism, the rating symbol would be accompanied by the CE suffix. However, when the rating approach takes into account the presence of cross-default linkages among the loans of the entities concerned, the CE suffix will not apply—as cross-default linkages are not considered an explicit support form.</p>
LoC or other equivalents	<p><i>ICRA's approach prior to the issuance of the Guidance Note and FAQs by the RBI:</i> ICRA recognised that an LoC was a relatively weaker form of explicit third-party support compared with a guarantee. Accordingly, the credit enhancement by virtue of an LoC was restricted. The extent of credit enhancement achieved based on a LoC was lower than that achieved based on the strength of a guarantee, although it was generally higher than that achieved based on implicit support considerations alone. Further, the mere presence of an LoC did not necessarily imply that the rating of the instrument was credit enhanced by ICRA. In case the support provider was related to the borrower but the business linkages between them were weak, or the support provider did not consider the latter to be strategically important, or a default by the borrower would not have inflicted harm on the support provider's own reputation, it was likely that the support provider reneged on its commitment to support the borrower, in a period of stress. In such cases, any credit enhancement in the rating of the borrower, based on a LoC, was not considered.</p> <p><i>ICRA's revised approach post the issuance of the Guidance Note and FAQs by the RBI:</i></p> <p>For LoCs extended by the Central Government or a state government: The existing ICRA approach will continue and the rating symbol would continue to be accompanied by the (CE) suffix.</p> <p>For LoCs extended by entities other than the Central Government or state governments: (a) The presence of an LoC would be ignored, as directed by the RBI. However, the rating could continue to be based on implicit support considerations, wherever applicable. Also, the (CE) suffix will not apply.</p>

NOTE: The analytical approach expressed above incorporates the extant regulatory guidance. In case there is any change in the regulatory stance, ICRA would review its approach.

In case there is any change in the structure of the support with respect to any of the attributes discussed earlier, it would mean that one of the key assumptions underpinning the credit enhanced rating is not valid anymore. In such a scenario, ICRA would review the rating based on the revised contours of the support structure and take an appropriate rating action depending on the merits of the case. As an example, consider a case where the rating is based on factoring-in some form of explicit third-party support form, but later it is observed that either the support becomes redundant, or is no longer available, or the terms

of the contract are amended. In such a case, ICRA may withdraw the (CE) rating and simultaneously assign a fresh non-CE rating after considering the revised circumstance¹¹.

Rating Suffix

The debt instruments whose rating is credit enhanced by an explicit support, carry the letters 'CE' in parenthesis suffixed to the rating symbol, to distinguish them from the entity's other instruments. The various forms of explicit credit enhancement include a corporate guarantee, partial guarantee, an SBLC, shortfall undertaking, guaranteed pooled bond or loan issuances, covered bonds, and so on.

Wherever the rating symbol is accompanied by the (CE) suffix, the rating rationale for the entities concerned or other publications also disclose the following:

- The rating without factoring in the explicit credit enhancement
- Comments on the adequacy of the credit enhancement structure under various scenarios, including the stress scenarios
- The salient covenants pertaining to the instrument

Summing Up

Credit enhancement of a debt instrument based on the presence of some form of explicit support from a stronger support provider is common in the non-financial as well as the financial sectors. The enhancement in the rating on account of explicit credit support not only enables a borrower to get access to credit, but also helps reduce its cost. While assigning ratings based on such support mechanisms, ICRA follows a transaction-specific approach to evaluate the extent of credit enhancement, which could be accorded to a given debt instrument over the unsupported rating of the borrower. Overall, the stronger the explicit credit support, the higher the enhancement possible over the unsupported rating. Accordingly, the rating outcome could vary from equalisation of the rating of the borrower's debt instrument with that of the support provider, to limited or no credit enhancement from the unsupported rating level, in case of a weak form of credit support.

¹¹ The withdrawal of the earlier rating and the concurrent assignment of the fresh rating would be communicated via the same rating rationale.

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