Criteria on Rating Credit Enhanced Debt

Overview

Credit enhancement is a method of improving the credit quality of the underlying debt issuance by using various structures. It is an additional comfort to the investor / lender that the debt obligations would be honoured by external credit support. A common form of credit enhancement is an unconditional and irrevocable guarantee from an entity with a better credit profile covering the issuer's / borrower's debt obligations. The credit enhanced debt structures are common in both, financial as well as non-financial sectors.

CareEdge Africa (CRAF) assigns the suffix 'SO' to denote that the rating has been arrived at based on an explicit external credit enhancement and not on the basis of the standalone credit quality of the issuer / borrower alone.

Applicability

This criteria is applicable for all the credit enhanced ratings and outlines the broad principles for assessing the validity of the support mechanisms for the credit enhanced ratings on various debt instruments / facilities.

Different forms of 'Credit Enhancement'

This document outlines various types of external credit enhancement structures which are valid support mechanisms for assigning the credit enhanced ratings. For the support mechanisms to be considered for enhancing the ratings, CRAF shall, inter-alia, consider the following:

- The support is unconditional, irrevocable, and legally enforceable till all the obligations of the rated security has been paid to the investors.
- CRAF 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 CRAF considers for assigning credit enhanced ratings based on the type of the rated debt. It may be noted that the actual nature and characteristics of credit enhancement structures prevail over the nomenclature used for such structures, in the assessment.

Bank facilities, Non-Convertible Debentures (NCDs), Bonds and Other Capital Market Instruments
Guarantees meeting all the principles laid down in this guidance note (detailed later in this document), whether full or partial guarantees
Letter of comfort (LOC) issued by Corporate/ Central Governments
Shortfall undertaking which is legally enforceable, irrevocable and unconditional
Guarantee towards maintaining debt service reserve account (DSRA) from a third party
Obligor / co-obligor structures or cross-default guarantee structures*
Commercial mortgage-backed securities (CMBS)-like structures
Payment waterfall, or DSRA etc., but with full guarantee or a DSRA replenishment guarantee from a third party
Debt backed by pledge of shares or other assets

*CRAF analyses the combined financials and the cash flows of all the co-obligors in accordance with CRAF criteria on 'Consolidation & Combined Approach' to arrive at the ratings. CRAF does not assign credit enhanced ratings for these structures.

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

Support mechanisms for all the rated debt facilities / instruments

A. Credit enhancement by guarantees:

An eligible guarantee for the entire debt obligations is akin to a direct credit substitution whereby the rating of the issuer's / borrower's debt is directly equated with the guarantor's rating. However, anything less than a full guarantee tantamount to a partial credit enhancement (PCE) and not a credit substitution. PCE arises when the credit enhancement covers less than 100% quantum of the debt obligations. This is a limited extent of support provided by a guarantor with a stronger credit profile than the issuer / borrower such that, a part of the debt obligations is guaranteed and the rest is dependent upon the credit profile of the issuer / borrower. A guarantee is considered for credit enhancement of the bank facilities, NCDs / bonds / other capital market instruments only if it is in compliance with all the principles detailed below.

A.1 Full guarantee:

A full guarantee denotes a 100% guarantee with respect to the repayment of both principal and interest. For considering such a guarantee as a credit enhancement, it must be provided by an entity having a stronger credit profile to enhance the rating of the issuer / borrower. Generally, such a guarantee is provided by a stronger entity - parent / group entities, government, or any external entity. In case of a valid guarantee, CRAF rates the guaranteed debt of the issuer / borrower 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 is not rated by CRAF, a 'Shadow Rating' of the guarantor is done, which is then reflected in the issuer's / borrower's credit enhanced 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 thereof of the guarantor is undertaken, till the tenure of the rating.

Principles laid down to factor credit enhancement from a guarantee:

It should be unconditional: The support extended should be unconditional in nature in honouring the debt obligations under the guarantee.

It should be irrevocable: The support provider should not revoke the guarantee till all the debt 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 case of partial guarantees, the rating comfort derived shall be restricted to the extent of partial guarantee provided.

Guarantee for payment: The obligations of the support provider should be to pay the guaranteed amount without demur as per the sanction terms in case of default by the borrower and not merely ensure the repayment by the borrower.

Payment mechanism: The guarantee deed should specify the timelines for payment by the support provider.

Overseas guarantors: If the guarantee is extended by an overseas support provider (foreign parent) in respect of the 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 the 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 the 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 Limited-period guarantee:

A guarantee can also be in the form of a credit enhancement for a limited period. At times, a credit enhancement may be contractually extinguished on achievement of specific operational or financial parameters (viz., commencement of operations of the SPV, capacity utilisation level, debt service coverage ratio (DSCR) build-up, etc.). In such cases, the rating of the guaranteed debt may not be equated to the guarantor's rating. However, such a rating suitably factor the fact that the guarantee does not cover the entire tenure of the debt. The 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 the SO suffix post extinguishment of a guarantee, the rating should hold good, sans the credit enhancement.

B. Guarantee towards maintaining DSRA from a third party:

Some structures have the DSRA funded to the extent of the debt repayment scheduled generally for 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 the cash flows of the issuer / borrower 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. LOC:

For the ratings on the bank facilities, NCDs / bonds / other capital market instruments, LOCs are generally treated as valid support mechanisms for assigning the credit enhanced ratings, provided that the LOC is from an entity having a better credit profile than the issuer of the rated debt.

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

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

CRAF evaluates the market reputation of the LOC provider, strategic importance of the issuer / borrower to the LOC provider depicted by a common name, shared identities, business linkages, shareholding, etc. to understand the extent of moral obligation of the LOC provider to support the issuer / borrower, if the situation demands. CRAF also evaluates the content of the LOC document to decipher the intent of the LOC provider with respect to continuity of the shareholding in the issuer / borrower and support for the timely debt repayment. Depending upon the above factors, the credit enhanced rating may lie somewhere in between the standalone rating of the issuer / borrower and that of the LOC provider's rating. If the intent, as spelt out in the LOC towards the repayment of the issuer's / borrower's debt, is strongly worded such that it assumes the character of a guarantee, such as unconditional and irrevocable along with payment mechanism, 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 a full unconditional and irrevocable guarantee.

D. Shortfall undertaking, which is legally enforceable, irrevocable and unconditional in nature: Undertakings towards meeting the shortfall in the debt repayments that are legally enforceable, irrevocable and unconditional are akin to guarantees, and hence, are treated as valid support structures, provided that 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 / borrower and that of the shortfall undertaking provider. If the intent as spelt out in the shortfall undertaking towards the repayment of the issuer's / borrower's debt is strongly worded such that it assumes the character of a guarantee, the rating moves significantly closer to the shortfall undertaking provider's rating and may also be equated to the shortfall undertaking provider's rating.

Support mechanisms only for NCDs / bonds / other capital market instruments

A. Pledge of shares:
CRAF assigns the suffix 'CE' to the rating of loan against shares (LAS) transactions where the credit enhancement is external or from third parties (i.e., shares are owned by third parties) and has a pre-defined payment mechanism.

Additional factors for the credit enhanced ratings

1. **Legal risk:**
   CRAF seeks a legal opinion on all the applicable principles as elaborated earlier in this document, while assigning a rating to the credit enhanced debt.

2. **Payment mechanism:**
   Normally, credit enhancement structures stipulate a particular number of days before the payment due date when the issuer / borrower has to arrange for cash to the extent of the total debt servicing obligations (including interest).

Approach for non-explicit and internal credit enhancement
Certain ratings are not based on an explicit credit enhancement from a third party but are based on some form of an internal credit enhancement, for example, presence of a structure on the cash flows of the issuer / borrower. In such cases, if CRAF is satisfied about the bankruptcy remote nature of the structure, and it is believed to enhance the credit profile of the debt, then the 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 / borrower alone.

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and CRAF (Africa) Private Limited (CRAF) is the first credit rating agency to be licensed by the Financial Services Commission of Mauritius in May 2015. It is also recognized by Bank of Mauritius as External Credit Assessment Institution (ECAI) from May 2016. CRAF is also licensed by Capital Markets Authority of Kenya to operate as a Credit Rating Agency in Kenya. CRAF intends to expand across other geographies in Africa with Mauritius as its hub of operations. With an equitable position in the Mauritius capital market, CRAF (Africa) Private Limited provides a wide array of credit rating services that help corporates to raise capital and enable investors to make informed decisions backed by knowledge and assessment provided by the company.

CRAF's shareholders are CRAF Limited, African Development Bank, MCB Equity Fund and SBM (NFC) Holdings Limited.

CRAF gets its technical support in the areas such as rating systems and procedures, methodologies, etc. from CRAF Limited on an ongoing basis. CRAF Limited, with an established track record of rating companies over almost three decades, follows a robust and transparent rating process that leverages its domain and analytical expertise backed by the methodologies congruent with the international best practices.

CRAF's Rating Committee consist of full-time members comprising of Senior Rating officials from CRAF Limited and a panel of experienced professionals from Mauritius and African Development Bank.

CRAF has had a pivotal role to play in developing bank debt and capital market instruments including MMIs, corporate bonds and structured credit.