ICRA

PRESS RELEASE

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Rs. 35,000 crore of the ICRA-rated debt with CE ratings to undergo rating transition; impact on the additional capital requirements of banks not material

The Reserve Bank of India (RBI) has issued a Guidance Note and an FAQ document, on April 22, 2022, and July 26, 2022, respectively, directing all credit rating agencies (CRAs) to adopt certain specific criteria while assigning credit enhanced (CE) ratings to the bank facilities. In view of the above, ICRA is making certain changes in its methodology for assessing explicit third-party support forms like guarantees, letters of comfort (LoC), co-obligor structures etc.

The implication of these changes on ICRA's portfolio of ratings:

- A potential **lowering of the credit ratings of around 100 entities**, corresponding to **Rs. 35,000 crore of the rated debt**
- The **Power, Healthcare, Engineering, Construction,** and **Roads** sectors account **for 60% of the total entities** whose ratings could be potentially affected; these sectors account for **44% of the total debt** that could be potentially affected

Some of the guidelines specified by the RBI to the CRAs:

- *Only guarantees may be considered as valid support forms*: The RBI has directed that for the purpose of drawing credit enhancement comfort, the CRAs can rely only on explicit guarantees extended by externally rated third parties, including parent/ group entities, or by financial institutions like banks and non-banking finance companies.
- *Other explicit support forms not to be considered for deriving at a rating comfort*: The CRAs are not permitted to rely on other forms of support structures like LoC, letter of support, obligor-co-obligor structure etc., for deriving rating comfort while assigning CE ratings.
- *Exceptions*: The CRAs, however, can rely on LoCs issued by the Central or state governments, and shortfall undertakings that are legally enforceable, irrevocable, and unconditional in nature—while assigning the CE ratings.
- *Ratings based on pledge of shares disallowed*: The CE ratings are not permitted to be assigned based on credit enhancement derived through the pledging of shares.

Commenting on the development, Mr. Jitin Makkar, Senior Vice President and Head-Credit Policy, said: *"Triggered by the methodology change, the revised non-CE ratings, on an average, could be expected to be around two notches lower than the existing CE ratings outstanding. The weighted average risk weight of the affected debt is estimated to be around 35% currently, which could increase to 48% upon a potential lowering of the ratings. This translates into a possible rise in the capital requirements of lenders by around Rs. 400 crore, which is not material."*

ANNEXURE

1. **What is an explicit third-party support?**

An 'explicit third-party support' is a promise made by a third-party/ support provider 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/ facility, 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.

2. **What are the various types of explicit support forms based on which ICRA currently assigns CE ratings?**

The common forms of explicit credit support are enlisted 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.

(1) Guarantee	(2) Partial Guarantee	(3) Standby Letter of Credit/ Support
(4) DSRA Replenishment Guarantee	(5) Shortfall Undertaking	(6) Covered Bond
(7) Guaranteed PLI/ PBI	(8) Co-Obligor Structure	(9) Letter of Comfort

3. **What has been ICRA's approach in determining the extent of credit enhancement based on various explicit support forms?**

The rating of a debt instrument could be credit enhanced based on the presence of various forms of explicit credit support. Each explicit support form has its own set of attributes, and an assessment of the strength of such attributes drives the extent of credit enhancement that could be achieved.

[1] Henceforth referred to as "instrument(s)", unless stated otherwise.

[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).

- 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.

- In other cases, the extent of credit enhancement may be limited or not achievable, depending on the nature of the deficiency.

4. **What was ICRA's analytical approach earlier and to what extent would it change because of the new norms introduced by the RBI?**

Change in the analytical approach when the explicit credit support is in the form of an LOC

Earlier Approach

ICRA recognised that an LOC was a relatively weaker form of explicit third-party support compared with a guarantee. Accordingly, the credit enhancement emanating by virtue of an LOC was restricted. The extent of credit enhancement achieved based on an LOC tended to be 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.

To assess whether an LOC furnished by a support provider was strong enough to be considered for providing some notch uplift vis-à-vis the unsupported rating of an instrument, the following broad attributes of the LOC were assessed by ICRA:

- Was the support approved by authorized members/ committee (such as Board of Directors)?
- Was the support unqualified/ unconditional? ·
- Was there a promise/ undertaking from the support provider to ensure, on a best effort basis, that the borrower fulfilled its debt obligations in a timely manner?
- Was the support valid for the entire tenure of the loan?
- Did the support cover the entire loan amount (including interest and any amount relating to the loan)?

ICRA also assessed the commitment of the support provider (typically a parent) in terms of maintaining a majority shareholding till all the obligations under the instrument were fully discharged.

If any of the above conditions were not met, the utility of an LOC was typically ignored by ICRA. The rating in such cases was assigned based on standalone considerations and by factoring-in implicit support from the support provider, if considered appropriate. The rating symbol in such cases was not accompanied by the (CE) suffix.

That said, even if all the above conditions were met, the mere presence of an LOC did not necessarily imply that the rating of the instrument could be credit enhanced. 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 might 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 an LOC was not considered by ICRA. The rating in such cases was assigned based on standalone considerations alone and the rating symbol in such cases was not accompanied by the (CE) suffix. Only in cases where ICRA considered providing some notch uplift to a rated instrument based on the strength of the LOC and the strength of the other linkages between the borrower and the support provider, was the (CE) suffix used alongside the rating symbol of such an instrument. In such cases, in the rating rationale of the entity, ICRA also disclosed the unsupported rating of the instrument, while including comments on the adequacy of credit enhancement, and other details, as required by the relevant SEBI circulars.

In summary:

EARLIER APPROACH		**Linkages between the rated entity and the support provider**	
		Strong	**Weak**
The LOC met the desired attributes as mentioned in the bullet points above	**Yes**	Notch uplift was done, but the uplifted rating did not necessarily get equalized with that of the support provider; The rating symbol was accompanied by the (CE) suffix	No uplift to the rating; The rating was without the (CE) suffix
	No	Notch uplift was done based on implicit support considerations alone; The benefits of the letter of comfort were typically ignored; the rating was without the (CE) suffix	No uplift to the rating; The rating was without the (CE) suffix

Revised Approach

In its Guidance Note, the RBI has stated that the CRAs should not rely on diluted and non-prudent support forms such as LOC, Letter of Support etc. Accordingly, henceforth, the benefit of an LOC will not be factored-in the rating by ICRA, as guided by the RBI and a CE suffix will not apply alongside the rating symbol. This is notwithstanding the fact that in ICRA's view, such a support form does represent 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, subject to the constraints mentioned earlier. Nonetheless, the rating of the instrument concerned will continue to be based on implicit support considerations. Further, for the LOCs that are furnished by the Central Government or a state government, the earlier ICRA approach will continue, as permitted by the RBI.

Implications of the revised approach

For fresh ratings: The revised approach would be applicable for all fresh rating assignments, henceforth. This implies that ICRA would no longer assign (CE) ratings to the bank facilities that are backed by an LOC. However, if the support form is only named as an LOC but it has the features of a deficiency-free guarantee, then a CE rating could be assigned based on the applicable rating approach.

For the existing CE ratings on bank facilities (that are based on the comfort of an LOC): The rating will be reviewed, and the revised approach will be applied by January 25, 2023, i.e., six months from the date of the FAQ document issued by the RBI, as permitted by the regulator. Upon a review of the rating, one among the following rating actions will apply:

(a) *When the rated entity explicitly requests ICRA to withdraw the (CE) rating*: The existing (CE) rating will be withdrawn based on the rated entity's request (a no-objection-certificate or NOC from the banker will not be required). The rating rationale, however, will disclose the non-CE rating arrived at based on implicit support considerations, OR

(b) *When the rated entity has not requested for a withdrawal of the (CE) rating*: The existing (CE) rating will be withdrawn and simultaneously a fresh non-CE rating will be assigned based on implicit support considerations. Both these rating actions (withdrawal and a fresh assignment to the same facility) will be captured in the same rating rationale.

In ICRA's portfolio, the ratings of the bank facilities of **seven entities** are credit enhanced by virtue of the presence of an LOC extended by a support provider. These ratings are going to be reviewed shortly.

Change in the analytical approach when the explicit credit support is in the form of a guarantee but one that lacks a well-defined invocation and payment mechanism

Earlier Approach

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.

Revised Approach

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), 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. Nonetheless, the rating of the instrument concerned will continue to be based on implicit support considerations.

Implications of the revised approach

For fresh ratings: The revised approach would be applicable for all fresh rating assignments, henceforth. This implies that ICRA would no longer assign (CE) ratings to the bank facilities that are backed by a guarantee that lacks an invocation and payment mechanism.

For the existing CE ratings on bank facilities (that are backed by guarantees but lack an invocation and payment mechanism: The existing CE ratings on such bank facilities 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, then such a (CE) rating will be revised to the non-CE rating level, while ignoring the presence of the guarantee. The timeline 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. The withdrawal-related approach mentioned in the previous point will be able to the above cases of guaranteed working capital facilities as well.

In ICRA's portfolio, the ratings of the working capital facilities of **66 entities** are credit enhanced by virtue of the presence of a guarantee that lacks an invocation and payment mechanism. These ratings are going to be reviewed shortly.

Change in the analytical approach when the rated bank facilities are part of a co-obligor structure

Earlier Approach

In most cases, a consolidated view was being taken by ICRA given the fungibility of surplus cash flows among the entities that are a part of the co-obligor structure. The fungibility was achieved by virtue of the contractual terms of the common loan agreement, which could involve certain additional structuring through cross-guarantees and cross-default clauses. The aggregate cash flows available with the individual entities tend to be structured to service the jointly held debt; and the entities concerned are jointly and severally liable for debt servicing (as validated by ICRA through a legal opinion). As far as the extent of notch-up was concerned, since the rating was determined by ICRA based on an assessment of the consolidated risk profile of the constituent entities, the relatively weaker entities saw a notch uplift to the extent of the consolidated group rating. In comparison, the strongest entity could see a notching haircut such that its rating did not breach the consolidated group rating. In effect, the same CE rating was assigned to the jointly held debt in these structures.

Revised Approach

Since the RBI now 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 premised, among other things, on an evaluation of cross-guarantees and cross-default clauses in the loan terms of the entities concerned.

- In case the cross-guarantees have all the attributes of a strong form of support, as indicated in the Guidance Note of the RBI, ICRA would continue to apply a consolidated rating approach and assign the same CE ratings to the cross-guaranteed debt in these structures. However, in case the guarantees are deficient in any respect, the presence of such cross-guarantees would be ignored.
- In case there are cross-guarantees (which have all the attributes of a strong form of support, except for the presence of a defined invocation and payment mechanism) or cross-default clauses among the loans of the entities concerned, the first step of the analytical approach would involve forming a notional credit opinion on 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 implicit support considerations. Thus, the ratings of the individual entities could differ from each other. The rating symbol too would not be accompanied by the CE suffix.

Implications of the revised approach

For fresh ratings: The revised approach would be applicable for all fresh rating assignments, henceforth. This implies that ICRA would no longer assign (CE) ratings to the bank facilities that are a part of a co-obligor structure.]

For existing CE ratings on bank facilities (that are based on co-obligor structures): The rating will be reviewed, and the revised approach will be applied by January 25, 2023. Upon a review of the rating, one among the following rating actions will apply:

(a) *When the rated entity explicitly requests ICRA to withdraw the (CE) rating*: The existing (CE) rating will be withdrawn based on the rated entity's request (NOC from the banker will not be required). The rating rationale, however, will disclose the non-CE rating arrived at while ignoring the benefit of the co-obligor structure, OR

(b) *When the rated entity has not requested for a withdrawal of the (CE) rating:* The rating action nomenclature would be withdrawal and a simultaneous assignment of a fresh non-CE rating. Both these rating actions (withdrawal and a fresh assignment to the same facility) will be captured in the same rating rationale.

In ICRA's portfolio, the ratings of **five co-obligor structures, involving 28 entities**, are credit enhanced by virtue of the presence of a co-obligor structure. These ratings are going to be reviewed shortly.

Analytical approach when the rated bank facilities are backed by a pledge of shares

Under these structures, adequate security/ asset (viz., equity shares) covering at least the full value of the payments to be made over the tenor of the debt instrument is available with the lenders or the investors. The debt is to be serviced either by mandatorily monetising/ utilising the security, or the security acts as a back-up which could be monetised/ utilised by the lenders or investor or trustee to meet the debt servicing obligations, if the entity is unable to make the payment on its own by a specific date.

The rating of the debt instruments which are expected to be serviced through security/ asset monetisation, could be assessed based on the likelihood of realising the amount equivalent to at least the debt obligations outstanding, in a timely manner. Thus, only if the security's cover, liquidity, and granularity as well as the gap between the initiation of the monetisation of the security and the due date for debt servicing is assessed to be adequate (in relation to the nature of the security), could it enhance the credit quality of the rated debt instrument.

ICRA's approach and rating implications

Given the inherent volatility in the stock market prices and the fact that it is difficult to predict the time required for liquidation of shares, ICRA did not consider it appropriate to assign ratings that were based principally on a structure involving the liquidation of the underlying pledged shares for timely debt servicing, and there are no such ratings outstanding. Accordingly, the RBI's recent directives to the CRAs not to assign CE ratings based on credit enhancement derived through the pledging of shares, does not have any implications on ICRA's rated portfolio.

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