



Explicit Credit Enhancements: Capital Market Instruments and Bank Facilities

22-09-2025 (Version 10)

Background

SEBI circular dated June 13, 2019 requires Rating Agencies to assign a suffix of 'CE' in respect of Ratings, which are supported by Explicit Credit Enhancement. The communicate was aimed at establishing linearity across the methodologies adopted by various rating agencies in treating borrowings/ structures based on External Credit Enhancement. The increasing number of such borrowings/ structures created a need to have sharp and well-defined criteria governing such cases. This is important since, there may be a significant divergence between the standalone credit profiles of the borrowers / issuers vis-a-vis the final ratings assigned after considering such explicit credit enhancements. Hence, it becomes imperative that the rating notch up based on such enhancements is logical & consistent across cases.

Recent Developments

RBI, vide its Guidance note dated April 22, 2022, has stipulated the principles for streamlining the policies, practices & methodologies across all CRAs in respect of Bank loan- CE ratings. RBI has further released a set of FAQs in the aforesaid matter on July 26, 2022 to ensure that that all the CRAs are on the same page in terms of their interpretation of the Guidance note. Subsequently SEBI has released its circular 'Credit rating supported by Credit Enhancement ' on September 28, 2022.

Acuité understands that the analytical approaches as per RBI's Guidance note & SEBI's Circular for CE are generally similar except in respect of certain instruments/ structures like Obligor-Co-Obligor Structures, Pledge of Shares etc. The differentiated treatment envisaged in respect of these instruments like Obligor-Co-obligor structures, pledge of securities etc. could be on account of factors like differences in regulatory environment and presence of monitoring mechanisms like debenture trustee in a capital market instrument vis a vis a bank loan.

In view of the aforesaid, Acuité has, vide this document elaborated its approach for External Credit Enhancement in respect of Capital market instruments & Bank facilities. Section I of this document covers Capital Market Instruments (i.e. all instruments listed or proposed to be listed falling within the purview of SEBI) & Section II covers Bank Borrowings / Facilities. (falling under the purview of RBI). The list is inclusive and not exhaustive.

SECTION I -

CAPITAL MARKET INSTRUMENTS

A. Capital Market Instruments COVERED BY CORPORATE GUARANTEES

In such borrowing arrangements, there exist an external entity (typically a parent entity of the borrower / or another entity from the group with established credentials) that undertakes to fulfil the debt repayment obligations on behalf of the issuer of the debt instrument in the event of a default and invocation of the guarantee by the investor or a representative of the investor such as debenture trustee. The legally enforceable commitment by an entity with a stronger credit

quality to meet the obligations to the investors significantly adds to their comfort especially in case the issuer is of a significantly weaker credit quality. In case of borrowings supported fully by Corporate Guarantees from a strong parent/Group entity, the final rating will depend on standalone rating of the issuer entity, rating of guarantor & notch up over the standalone rating of the issuer. Acuité arrives at an internal estimate of the shadow credit rating of the guaranteeing entity wherever there is no outstanding rating from Acuité. In case of unconditional and irrevocable structures, the rating is mapped (not necessarily equated) to that of the guaranteeing entity, based on a parent notch up framework. The presence of a Corporate Guarantee by itself does not necessarily qualify for equating the rating of the issuer with the corporate guarantor. Certain other aspects such as strategic interest to the Corporate Guarantor, magnitude of investment of guarantor in the issuer etc. will be examined while deciding the notch up.

In this regard, if considered necessary, Acuité may, examine the guarantee deed in to ascertain the following aspects:

- Unconditional & Irrevocable Nature of Guarantee
- Guarantee is Continuing in nature. Whether the guarantee covers the entire tenure of the instrument and also covers the interest and principal part of the instrument/ loan and other expenses incurred by the lender in connection with the borrowing.
- Guarantee should be legally enforceable across the tenure of the instrument/ borrowing.
- Guarantee shall have a Clause providing for payment on first demand without any demur or protest
- Payment under the guarantee should be without any deduction by the guarantor
- The guarantor shall be treated on par with the primary obligor i.e. lender can directly proceed against guarantor without exhausting his other legal remedies.
- Guarantee should be reaffirmed by the guarantor in case of any changes in the underlying terms of borrowing for it to remain valid.
- Timelines for invocation & payment upon receipt of invocation notice
- Guarantor should agree to make payments in case of insolvency, liquidation, dissolution or any other analogous proceedings against the rated entity.

Acuité seeks legal opinion from an independent law firm regarding the aforementioned aspects such as enforceability, unconditional & irrevocable nature etc. Acuité tries to assess possibility of any operational/ regulatory risks that could inhibit the guarantor from discharging the obligations under the guarantee, should such a situation arise

Existing Approach

In respect of capital market instruments fully covered by Corporate Guarantees, as per extant practice followed by Acuité, the ratings based on such structures is suffixed with the words 'CE' in parenthesis subject to the presence of a T-n structure

in the Guarantee. (T-n indicating that if T is the due date for any payment of interest/principal, then the issuer of the Undertaking commits to ensure funding in the account if the account is not funded 'n' days before the due date). This T-n structure is required besides the other routine clauses like irrevocability and unconditionality etc. The CE Suffix indicates that the rating factors in support in the form of external explicit credit enhancement. However, in case of guarantees without a T-n structure, Acuité still factors in support from the parent (using parent notch up framework) on the assumption that the parent/ guarantor shall continue to support the entity notwithstanding the absence of a T-n clause.

Proposed Approach

Acuité will continue with its approach of suffixing a CE if the corporate guarantee has a T-n structure besides the regular clauses like unconditionality, irrevocability etc which are required as per regulatory requirements. Acuité observes that the unlike corporate guarantees formats for bank facilities which generally do not have clauses like T-n structures /invocation timelines, NCDs usually have such clauses.

Hitherto, Acuité approach has been that even in the absence of these clauses, the guaranteeing entity will continue to support the entity and hence final rating usually factor this support through implicit recognition. Acuité shall however cap the final rating to the of the guaranteeing entity's rating in cases where CE suffix cannot be used. This cap shall not be applicable to cases where the CE suffix is used or to issuances of entities owned & managed by Central / State Government. (Refer Point 2 below)

B. Capital Market Instruments COVERED BY PARTIAL GUARANTEE

In case of instruments with partial credit guarantees with T- n clause, Acuité notches up the rating based on the rating of the corporate guarantor, quantum of the guarantee and Strength of T-n structure. As per extant practice, this notch up can go up to 3 notches from the standalone rating of the issuer. These ratings are suffixed with 'CE'.

In respect of NCDs covered by partial guarantee, the final supported ratings shall be capped at lower of the two (i) 2 notches over standalone rating or (ii) the guarantor's rating.

C. Capital Market Instruments SUPPORTED BY CENTRAL/STATE GOVERNMENT GUARANTEES UNDERTAKINGS

It has been observed that governments (Central/ state) usually support the borrowing programmes of the public sector entities through issuances of guarantees. These entities could be entities with significant socio-economic importance such as State discoms. Civil supplies corporations, state finance corporations etc. Such entities are assessed based on their strategic importance to the government rather than being guided by their commercial performance. The standalone ratings of a states are used to differentiate between the relatively stronger and weaker ones. The guarantees issued by the Governments may in certain cases have T-n clauses or may not have T-n clause and usually for bank facilities, the guarantee formats do

not have such clauses. Hitherto Acuité 's approach has been to notch up the rating based on the State Government rating and suffix a CE in respect of borrowings with T-n structure. In respect of guarantees without T-n structure, the notch up is still considered but without a CE suffix. It is pertinent to note that the central / state government guarantees provided to a public sector enterprise (PSE) will not automatically extend to the subsidiary(s) of that PSE.

Proposed Approach

Acuité shall maintain a uniform approach for all ratings supported by State Government/ Central Government guarantees irrespective of the fact whether guarantee has T-n clause (i.e. CE suffix) or otherwise (without CE suffix). Acuité may equate the rating to the government rating based on the socio-economic importance of the issuer entity.

It may be noted that LoCs (Letters of Comfort) & Shortfall undertakings issued by Central/ State Governments shall also be considered as valid supporting structures for bonds/debentures.

D. Capital Market Instruments SUPPORTED BY BANK GUARANTEES/ SBLCs (STANDBY LETTERS OF CREDIT)

In respect of capital market instruments backed by Bank Guarantees/ Standby Letters of Credit from Banks/ Financial Institutions, the ratings will be linked to the credit quality of the Guaranteeing /SBLC issuing Bank. In such cases of Bank guarantee/ SBLC backed structures, in addition to its own assessment, Acuité may rely on external ratings assigned by other rating agencies to these banks/ financial institutions. In case of more than one rating, Acuité will generally consider the lowest rating. In case of overseas banks/ institutions, Acuité may map the international rating of the bank to the domestic scale and then assign a rating based on the domestic equivalent of the bank's rating. Acuité may suitably lower (notch-down) the final rating by 1-2 notches from the guaranteeing bank's rating/domestic equivalent rating. It is to be noted that such ratings are based on the credit quality of the guaranteeing bank and any revision in the credit rating of the said bank will result in a revision of the CE ratings assigned for the facilities/borrowings.

Acuité observes that Bank guarantees/ SBLCs are issued by banks as per pre-defined standardized formats and are usually post default in nature i.e. the lender generally invokes the guarantee /SBLC only after the occurrence of default. There is no T-n Structure in such guarantees Notwithstanding the absence of T-n clauses, the ratings assigned to such credit facilities will be suffixed with the words (CE) i.e. Credit Enhancement to indicate that these ratings do not reflect the standalone credit quality of the borrower/ issuer and are based on certain forms of credit enhancement from the bank. The reason for adopting this approach in respect of bank guarantee supported borrowings (vis a vis borrowing supported by Corporate/ State Government Guarantees as above) is that such guarantee/ SBLC issuances are part of bank's core activity. Typically, under these guarantees, the bank undertakes to pay the amount within a pre-agreed time after invocation. Any instance of non-payment by the bank/ delays in payment after receipt of invocation notice, can have adverse implications for the issuing bank's credibility. A

key difference between a corporate guarantee vis a vis a bank guarantee is that in case of a corporate guarantee which the ultimate payment is still subject to a credit risk even after invocation whereas the said risk is significantly mitigated for a bank.

In view of such stringent clauses, the investor reckons such exposures as an exposure on the guaranteeing bank & the risk weightage assigned to such exposures will be based on the rating of the guaranteeing bank.

Acuité has observed that, the invocation of guarantees usually being a post default event, it is important to focus more on the post invocation timelines such as the date by which the funds will be made available post serving of invocation notice. Acuité also examines the timelines for intimation to the rating agency especially in case of debt (NCDs etc.) with debenture trustees.

E. (i) Capital Market Instruments BACKED BY DEBT SERVICE RESERVE ACCOUNT (DSRA) AND ESCROW ARRANGEMENT/ STRUCTURED PAYMENT MECHANISM WITH AN UNDERTAKING BY A THIRD PARTY FOR REPLENISHMENT OF DSRA.

In certain cases, the lender/ investor may stipulate creation of a DSRA (Debt service Reserve Account) which serves as a buffer in case of temporary mismatch in cash flows i.e. in case of inadequacy of funds in the escrow account, the lender can access the DSRA to recover his principal/ interest instalment. A DSRA helps in bridging temporary mismatches and ensuring stability of debt servicing in case of sharp variations in cash flow across time periods.

In case of a structure based on the creation of a DSRA, i.e. backed by liquid asset collateral such as FD, or G-sec bonds, the quantum of funds in the TRA (Trust & Retention Account)/ Escrow Account and the DSRA are to be evaluated in line with the total amount of debt to be serviced on each due date. The presence of an escrow account by itself does not guarantee the adequacy of funds for servicing. However, a strictly executed escrow arrangement can be useful for trapping the cash flows and utilising them as per the priority (waterfall mechanism) for meeting the debt servicing requirements.

Typically, a higher cover in the form of DSRA is representative of a high degree of safety & eligible for higher notch up. Acuité recognises the fact that funds placed in the DSRA are often associated with high opportunity costs, and thus increase the effective cost of borrowing for the issuer. The presence of a DSRA along with a Structured Payment Mechanism i.e. SPM (in the form of a T- n day structure) differentiates the instrument from other plain vanilla borrowings (without these features), as the likelihood of slippages in payments is mitigated due to such clauses. The presence of a corporate guarantee or a DSRA Replenishment Undertaking by a third-party act as a credit support, so that in the event of the DSRA being utilised, the third party shall replenish the DSRA or make the requisite payment (as per the guarantee/ undertaking document) after the demand/ invocation notice by the lender or debenture trustee. Acuité will also conduct an independent credit assessment of the third party who has provided the undertaking/ guarantee. The ability of the third party to meet their obligations under the undertaking is also assessed.

E. (ii). Capital Market Instruments backed by DEBT SERVICE RESERVE ACCOUNT (DSRA) AND ESCROW ARRANGEMENT/ STRUCTURED PAYMENT MECHANISM without replenishment undertaking/guarantee by third party

In certain cases, even where there is no replenishment undertaking by a third party, Acuité still considers the presence of a DSRA & Escrow account (along with a T structure) as a credit supportive mechanism and factor in the benefits accruing from the DSRA mechanism. The ratings in such cases does not consider the suffix CE however, Acuité mentions in its analytical approach that it has relied on the presence of a structure while arriving at the final rating.

Acuité shall however cap the notch-up in respect of aforementioned structures i.e. E (i) & E (ii) to 2 notches over the unsupported rating. A cap of 3 notches over unsupported rating shall be applicable in respect of Government owned entities (i.e. more than 50% equity shareholding held by Government owned entities) and/or Government guarantee for the instrument/facility being rated.

For E (i) Where there is an undertaking by a third party for replenishment of DSRA with a T-n structure, the final supported rating will be with CE suffix

For E (ii) Where the structure is without replenishment undertaking/guarantee by third party, it will be considered as an internal support mechanism, hence the final supported rating will be without CE suffix

The unsupported rating shall incorporate the benefit from the corporate guarantee in case there is a guarantee which fully covers the outstanding at all times during the tenure of the instrument and have other features like unconditionality, irrevocability, enforceability and first demand payment.

F. Capital Market instruments SECURED BY PLEDGE OF SHARES

The increasing trend in offering security coverage in the form of shares/ liquid investments has prompted the need for looking at such structures differently as opposed to structures based on a security of movable/ immovable assets. Generally, a rating is indicative of a probability of default and is generally unaffected by the collateral coverage. However, in cases of structures backed by liquid collateral, a right type of structure can mitigate the likelihood of default.

Against this backdrop, Acuité's extant approach has been different vis a vis plain vanilla borrowing. Such structures are very common in case of borrowings by investment vehicles of promoters. It has been observed that generally promoters of listed companies prefer to hold their investments in their listed companies through a clutch of privately held companies. Typically, these private companies have moderate revenue streams mainly by way of dividends on the shares/ interest on investments. Such companies are structured as vehicles for promoter holding and typically do not have any other operations; their net worth and any debt requirements are for investments in promoter group companies. In the absence of any operations, these companies do not have any source of sustainable cash flow, they often go in for refinancing of their debts/ infusion of funds by promoters. Hence, refinancing ability/ financial flexibility is critical in evaluating such companies. Their

financial flexibility is directly linked to the market valuation of their investment portfolio.

Acuité's approach to evaluation of such issuers is based on the standalone credit profile of the issuer which would then be notched up for the structure. The extent of notching up will depend on two broad platforms (i) Strength of the Structure (ii) Nature and Quantum of liquid collateral.

Strength of Structure

Timelines for funding the account are generally spelt out in the financing document in terms of T-n days (where T is the due date). Typically, n ranges between 3-5 days in most of the cases, since it provides adequate time to the lender to initiate the process for selling the securities and ensuring that the funds are received in the account on the due date.

Secondly, tolerance for any dilution in security coverage is also a critical factor in evaluation of such structures. In case of structures backed by pledge of equity shares, if the security coverage falls below the minimum acceptable coverage stipulated in the term sheet, then an immediate top up must be arranged. Acuité believes that for such structures, any significant tolerance below the stipulated coverage beyond five consecutive trading days will render the structure infructuous. Needless to say, monitoring by the lender of the asset coverage on a periodic basis and initiating action for topping up wherever necessary is crucial in such structures. Hence, Acuité will examine the financing documents for these clauses.

Nature & Quantum of Liquid Collateral

Among other factors, Acuité also examines the following aspects while arriving at a notching up:

- 1) Market Capitalisation & Financial performance of the companies, whose shares are being offered as collateral
- 2) Volatility in the share prices
- 3) Financial Flexibility in the form of unencumbered shares available with the (borrower) promoter vis a vis pledge-based borrowing
- 4) Quantum of unencumbered promoter holding vis-a-vis encumbered promoter holding.

Acuité has been rating such borrowings based on pledge of shares with a suffix of CE to indicate that rating has been driven by adequate coverage of equity shares & presence of a strong monitoring structure to safeguard the interests of the lenders and initiate timely remedial action wherever necessary. Acuité shall continue with its existing approach of suffixing CE.

Similarly, borrowings/ instruments secured by other securities/ other liquid assets (i.e. besides equity shares & equity linked instruments) as mentioned in (B) below shall continue to be suffixed with CE in parenthesis after the rating.

G. Capital Market INSTRUMENTS SECURED BY PLEDGE OF HIGHLY RATED BONDS / DEBT SECURITIES (BOTH GOVERNMENT & BONDS/SECURITIES)

Acuite observes that capital market instruments secured by a pledge of Government Securities and highly rated bonds/ debentures issued by private corporate bodies and PSUs are increasingly gaining acceptance. The key borrowers under these instruments will be traders in government securities/ corporate bonds. These facilities are virtually credit risk free since the lender can easily liquidate the underlying securities without any significant price concession and recover the entire dues.

High credit quality of the Underlying security

The Securities issued by Government of India are almost risk free in terms of their AAA Rating due to the sovereign status of the issuer. However highly rated securities issued by other entities like private corporates/ PSU undertakings/ State Governments are at an elevated risk of deterioration in credit quality (usually evidenced by downgrade in the rating) over a medium to long term. Hence the key aspect to be examined is the extent of exposure to Non- Central Government securities (especially private sector bonds) permissible under the borrowing arrangement.

Liquid nature of the Security

Generally, the market for government securities is highly liquid mainly on account of their risk-free status and significant market participation in the form of players like primary dealers, mutual funds and most importantly banks (for Statutory Liquidity Ratio requirements). Within the government securities segments, certain segments have slightly higher liquidity than others depending on the tenor, pricing and quantum of paper available. As against government securities, the market for corporate bonds and other securities is relatively shallow since most of the long-term investors in these bonds/ securities prefer to stay invested till maturity. Besides the shallow nature of the counter, the liquidity in a bond/ debenture can also be impacted by changes in the credit quality of the borrower/ issuer. Sharp credit cliffs (i.e. downgrade by several notches) can also trigger a liquidity issue on a counter.

Availability of adequate margin to mitigate the risk of volatility over a single time period

Generally, the lenders/ investors will prefer some "skin in the game" of the issuer /borrower, which will be stipulated by way of margin requirements. Typically, the margin will be linked to the volatility over a given time period, based on past historical data. The volatility in prices of government securities is a function of factors like liquidity, interest rate announcements, size of borrowing programme, economy wise macro factors etc. Since the list of securities eligible for drawing under such facilities, includes a mix of central government securities as well as other securities including private securities, the actual margin stipulation is higher keeping in mind the probability of higher credit losses under the private sector can portfolio. The availability of adequate margin is a critical factor to be considered in this aspect

Similar to ratings on share pledge-based facilities in (F) above, the ratings assigned to the structures based on pledge of debt securities will also be suffixed with the words (CE) indicating that the rating factors in support from the presence of high-quality liquid collateral available to the lender & the flexibility available to the lender to recover his dues at a short notice.

Other requirements as per SEBI circular

SEBI vide its circular dated September 28, 2022, requires the Credit Rating Agencies to mention in the press release for credit ratings, with or without the CE –suffix, backed by specified support considerations (please refer Annexure A below for the list), the following disclosures

- i. Unsupported ratings without factoring in the explicit credit enhancement or specified support considerations, and
- ii. Supported rating after factoring in the explicit credit enhancement or specified support considerations

Further, the Press Release shall also contain a detailed explanation of all the covenants of the security.

Further as required by SEBI, Acuité shall verify the documentation related to the specified support considerations to ensure inter alia the following:

The support is unconditional, irrevocable, and legally enforceable till all the obligations of the rated security has been paid to the investors. i. Acuité shall undertake independent examination of financial strength of the support provider to ascertain the ability to honour the obligations guaranteed by the support provider.

- iii. 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.

ANNEXURE A (Specified Support Considerations)

1	Guaranteed bond; Shortfall undertaking backed bond or other such third-party credit enhancement
2	Covered bonds which have to be serviced primarily by the issuer (i.e., primary recourse to issuer), with secondary recourse to the cash flows from the pool of loans housed in a trust
3	Partially guaranteed bond
4	Commercial Mortgage-Backed Securities (CMBS) like structures
5	Standby Letter of Credit (SBLC) backed securities
6	Debt backed by pledge of shares or other assets
7	Guaranteed Pooled bond issuance (PBI), not through a trust
8	Obligor/Co-obligor structures or Cross-default guarantee structures

9	Debt backed by Payment Waterfall /Escrow, or DSRA etc., but with Full Guarantee or DSRA Replenishment Guarantee from a third party
10	Letter of Comfort

SECTION II

BANK CREDIT FACILITIES

Acuité believes that the bank borrowings backed by Explicit Credit Enhancement shall mean and include any of the following. The list is inclusive and not exhaustive.

A. BANK BORROWINGS / FACILITIES COVERED BY CORPORATE GUARANTEES (OTHER THAN CENTRAL/STATE GOVERNMENT ENTITIES)

In such borrowing arrangements, there exist an external entity (typically a parent entity of the borrower or another entity from the group with established credentials) that undertakes to fulfil the debt repayment obligations on behalf of the borrower in the event of a default and invocation of the guarantee by the lender/ investor. The legally enforceable commitment by an entity with a stronger credit quality to meet the obligations to the lenders significantly adds to their comfort especially in case the borrower is of a significantly weaker credit quality. In case of borrowings supported fully by Corporate Guarantees from a strong parent/ group entity, the final rating will depend on standalone rating of the borrowing entity, rating of guarantor & notch up over the standalone rating of the borrowing entity/ issuer. Acuité arrives at an internal estimate of the shadow credit rating of the guaranteeing entity wherever there is no outstanding rating from Acuité . In case of unconditional and irrevocable structures, the rating is mapped (not necessarily equated) to that of the guaranteeing entity, based on a parent notch up framework. The presence of a Corporate Guarantee by itself does not necessarily qualify for equating the rating of the borrower with the corporate guarantor. Certain other aspects such as strategic interest to the Corporate Guarantor, magnitude of investment of guarantor in the borrower etc. will be examined while deciding the notch up.

In this regard, if considered necessary, Acuité may, examine the guarantee deed to ascertain the following aspects:

- Unconditional & Irrevocable Nature of Guarantee
- Guarantee is continuing in nature. Whether the guarantee covers the entire tenure of the instrument and also covers the interest and principal part of the instrument/ loan and other expenses incurred by the lender in connection with the borrowing.
- Guarantee should be legally enforceable across the tenure of the instrument/borrowing.
- Guarantee shall have a clause providing for payment on first demand without any demur or protest
- Payment under the guarantee should be without any deduction by the guarantor

- The guarantor shall be treated on par with the primary obligor i.e lender can directly proceed against guarantor without exhausting his other legal remedies.
- Guarantee should be reaffirmed by the guarantor in case of any changes in the underlying terms of borrowing for it to remain valid.
- Timelines for invocation & payment upon receipt of invocation notice
- Guarantor should agree to make payments in case of insolvency, liquidation, dissolution or any other analogous proceedings against the rated entity.

Acuité may seek a legal opinion from an independent law firm regarding the aforementioned aspects such as enforceability, unconditional & irrevocable nature etc. Acuité tries to assess possibility of any operational/ regulatory risks that could inhibit the guarantor from discharging the obligations under the guarantee, should such a situation arise

Existing Approach

In respect of borrowings fully covered by Corporate Guarantees, as per extant practice followed by Acuité, the ratings based on such structures is suffixed with the words 'CE' in parenthesis subject to the presence of a T-n structure in the Guarantee. (T-n indicating that if T is the due date for any payment of interest/ principal, then the issuer of the Undertaking commits to ensure funding in the account if the account is not funded 'n' days before the due date). This T-n structure is required besides the other routine clauses like irrevocability and unconditionality etc. The 'CE' Suffix indicates that the rating factors in support in the form of external explicit credit enhancement. However in case of guarantees without a T-n structure, Acuité still factors in support from the parent (using parent notchup framework) on the assumption that the parent/ guarantor shall continue to support the entity notwithstanding the absence of a T-n clause.

Proposed Approach

RBI's guidance note of April 22, 2022 also requires that 'CE' can be suffixed if the guarantee has timeline clauses for invocation and payment besides the regular clauses like unconditionality, irrevocability etc. Acuité observes that the corporate guarantees formats for bank facilities generally do not have clauses like T-n structures /invocation timelines. Hence as per the abovementioned RBI guidance note the CE suffix shall not be applicable in such cases

In the absence of a T-n structure, the final rating shall not have CE suffix and Acuité shall cap the final rating to the rating of the guaranteeing entity. This cap shall not be applicable to cases where the CE suffix is used or bank borrowings of entities owned/managed by State Government/ Central Government entities.

B. BANK BORROWINGS / FACILITIES COVERED BY PARTIAL GUARANTEE

In case of borrowings with partial credit guarantees with T-n clause, Acuité notches up the rating based on the rating of the corporate guarantor, quantum of the guarantee and Strength of T-n structure. As per extant practice, this notch up can

go up to 3 notches from the standalone rating of the issuer. These ratings are suffixed with 'CE'.

In respect of bank borrowings, covered by partial guarantee, the final ratings shall be capped at whichever is lower among the following (i) maximum of 2 notches over standalone or (ii) The guarantor's rating.

C. BANK BORROWINGS / FACILITIES SUPPORTED BY CENTRAL GOVERNMENT/STATE GOVERNMENT GUARANTEES /UNDERTAKINGS

It has been observed that governments (Central/ State) usually support the borrowing programmes of the public sector entities through issuances of guarantees. These entities could be entities with significant socio-economic importance such as State discoms. Civil supplies corporations, state finance corporations etc. Such entities are assessed based on their strategic importance to the government rather than being guided by their commercial performance. The standalone ratings of states are used to differentiate between the relatively stronger and weaker ones. The guarantees issued by the Governments may or may not have T-n clauses and usually for bank facilities it has been observed that, the guarantee formats do not have such clauses. Hitherto, Acuité 's approach has been to notch up the rating based on the State Government rating and suffix a 'CE' in respect of borrowings with T-n structure. In respect of guarantees without T-n structure, the notch up is still considered but without a CE suffix. It is pertinent to note that the central / state government guarantees provided to a public sector enterprise (PSE) will not automatically extend to the subsidiary(s) of that PSE.

It may be noted that the aforementioned guidance note of RBI allows LoCs (Letters of Comfort) & Shortfall undertakings issued by Central/ State Governments as valid supporting structures subject to conditions like legal enforceability, irrevocability and unconditionality.

Proposed Approach

Acuité shall continue to adopt a uniform approach for all bank borrowings supported by Central /State Government guarantees adhering to RBI guidelines. Guarantees with a T-n clause only will be eligible for 'CE' suffix. The ratings may be equated to the state government ratings in both cases.

However, in case of states with an internal rating below "A" category, Acuité may adopt a differential approach between borrowings supported by guarantees with T-n clauses and borrowings supported by guarantees without these clauses. This distinction would be made based on factors like criticality of the entity to the state, fiscal profile of the state and past record in honouring guarantees commitments etc.

D. BANK BORROWINGS / FACILITIES SUPPORTED BY BANK GUARANTEES/ SBLCs (Standby Letters of Credit)

In respect of credit facilities availed from banks backed by Bank Guarantees/ Standby Letters of Credit from Banks/ Financial Institutions, the ratings will be linked to the credit quality of the Guaranteeing /SBLC issuing Bank. In such cases of Bank

guarantee/ SBLC backed structures, in addition to its own assessment, Acuité may rely on external ratings assigned by other rating agencies to these banks/ financial institutions. In case of more than one rating, Acuité will generally consider the lowest rating. In case of overseas banks/ institutions, Acuité may map the international rating of the bank to the domestic scale and then assign a rating based on the domestic equivalent of the bank's rating. Acuité may suitably lower (notch-down) the final rating by 1-2 notches from the guaranteeing bank's rating /domestic equivalent rating. It is to be noted that such ratings are based on the credit quality of the guaranteeing bank and any revision in the credit rating of the said bank will result in a revision of the CE ratings assigned for the facilities/ borrowings.

Acuité observes that Bank guarantees/ SBLCs are issued by banks as per pre-defined standardised formats and are usually post default in nature i.e. the lender generally invokes the guarantee /SBLC only after the occurrence of default. There is no T-n Structure in such guarantees notwithstanding the absence of T-n clauses, the ratings assigned to such credit facilities will be suffixed with the words (CE) i.e. Credit Enhancement, to indicate that these ratings do not reflect the standalone credit quality of the borrower/ issuer and are based on certain forms of credit enhancement from the bank. The reason for adopting this approach in respect of bank guarantee supported borrowings (vis a vis borrowing supported by Corporate/ State Government Guarantees as above) is that such guarantee/ SBLC issuances are part of bank's core activity. Typically, under these guarantees, the bank undertakes to pay the amount within a pre-agreed time after invocation. Any instance of non-payment by the bank/ delays in payment after receipt of invocation notice, can have adverse implications for the issuing bank's credibility. A key difference between a corporate guarantee vis a vis a bank guarantee is that in case of a corporate guarantee which the ultimate payment is still subject to a credit risk even after invocation whereas the said risk is significantly mitigated for a bank.

In view of such stringent clauses, the lending Bank/ investor reckons such exposures as an exposure on the guaranteeing bank & the risk weightage assigned to such exposures will be based on the rating of the guaranteeing bank.

Acuité has observed that, the invocation of guarantees especially in case of debt availed from banks/ financial institutions is a post default event. Acuité focusses more on the post invocation timelines such as the date by which the funds will be made available post serving of invocation notice. Acuité also examines the timelines for intimation to the rating agency especially in case of debt (NCDs etc.) with debenture trustees.

E. BANK BORROWINGS / FACILITIES SUPPORTED BY LETTERS OF COMFORT/ SUPPORT UNDERTAKING / OBLIGOR CO-OBLIGOR STRUCTURES / PLEDGE OF SHARES

As per the RBI Guidance Note, borrowings supported by non-prudent structures such as Letters of Comfort /Obligor- Co-obligor structures/ Pledge of Shares, the CE suffix shall not be used as they cannot be considered as an adequate support mechanism. Needless to say, this section does not apply to LoCs /Shortfall

Undertakings issued by Central/ State Governments which are unconditional, enforceable and irrevocable.`

Proposed Approach

The final rating will not be suffixed CE, however Acuite proposes to cap the final rating at least 3 notches below the LoC issuers standalone rating going forward. It is to be noted that LoCs/Shortfall undertakings issued by State/Central Governments may be considered as valid support structures subject to conditions like legal enforceability, irrevocability and unconditionality.

F. (i) BANK BORROWINGS / FACILITIES SUPPORTED BY DEBT SERVICE RESERVE ACCOUNT(DSRA) AND ESCROW ARRANGEMENT /STRUCTURED PAYMENT MECHANISM (SPM) where there is undertaking by a third party for replenishment of DSRA.

In certain cases, the lender may stipulate creation of a DSRA (Debt service Reserve Account) which serves as a buffer in case of temporary mismatch in cash flows i.e in case of inadequacy of funds in the escrow account, the lender can access the DSRA to recover his principal/ interest instalment. A DSRA helps in bridging temporary mismatches and ensuring stability of debt servicing in case of sharp variations in cash flow across time periods.

In case of a structure based on the creation of a DSRA, i.e. backed by liquid asset collateral such as FD, or G-sec bonds, the quantum of funds in the TRA (Trust & Retention Account)/ Escrow Account and the DSRA are to be evaluated in line with the total amount of debt to be serviced on each due date. The presence of an escrow account by itself does not guarantee the adequacy of funds for servicing. However, a strictly executed escrow arrangement can be useful for trapping the cash flows and utilising them as per the priority (waterfall mechanism) for meeting the debt servicing requirements.

Typically, a higher cover in the form of DSRA is representative of a high degree of safety & eligible for higher notch up. Acuite recognises the fact, that funds placed in the DSRA are often associated with high opportunity costs, and thus increase the effective cost of borrowing for the issuer. The presence of a DSRA along with a Structured Payment Mechanism i.e SPM (in the form of a T- n day structure) differentiates the instrument from other plain vanilla borrowings (without these features), as the likelihood of slippages in payments is mitigated due to such clauses. The presence of a corporate guarantee or a DSRA Replenishment Undertaking by a third-party act as a credit support, so that in the event of the DSRA being utilised, the third party shall replenish the DSRA or make the requisite payment (as per the guarantee/ undertaking document) after the demand/invocation notice by the lender or debenture trustee. Acuite will also conduct an independent credit assessment of the third party who has provided the undertaking/ guarantee. The ability of the third party to meet their obligations under the undertaking is also assessed.

F. (ii). BORROWINGS / FACILITIES SUPPORTED BY DEBT SERVICE RESERVE ACCOUNT (DSRA) AND ESCROW ARRANGEMENT /STRUCTURED PAYMENT MECHANISM (SPM) without replenishment undertaking/guarantee by third party

In certain cases, even where there is no replenishment undertaking by a third party, Acuité still considers the presence of a DSRA & Escrow account (along with a T structure) as an support mechanism & factors in the benefits accruing from the DSRA mechanism. The ratings in such cases does not carry the suffix 'CE'. However, Acuité mentions in its analytical approach that it has relied on the presence of a structure while arriving at the final rating.

It has been observed that significant operational challenges are encountered in monitoring a DSRA structure on an ongoing basis in respect of bank facilities. Hence, Acuité shall not consider any notch up for DSRA in respect of bank facilities.

G. BANK BORROWINGS / FACILITIES BASED ON PLEDGE OF HIGHLY RATED BONDS/DEBT SECURITIES (both Government securities & Private bonds)

Acuité observes that certain bank facilities secured by a pledge of Government Securities/ and highly rated bonds/ debentures issued by private corporate bodies and PSUs are increasingly gaining acceptance. The key borrowers under these instruments will be traders in government securities/ corporate bonds. These facilities are virtually credit risk free since the lender can easily liquidate the underlying securities without any significant price concession and recover the entire dues.

High credit quality of the Underlying security

The Securities issued by Government of India are almost risk free in terms of their AAA Rating due to the sovereign status of the issuer. However highly rated securities issued by other entities like private corporates / PSU undertakings/ State Governments are at an elevated risk of deterioration in credit quality (usually evidenced by downgrade in the rating) over a medium to long term. Hence the key aspect to be examined is the extent of exposure to Non-Central Government securities permissible under the borrowing arrangement.

Liquid nature of the Security

Generally, the market for government securities is highly liquid mainly on account of their risk-free status and significant market participation in the form of players like primary dealers, mutual funds and most importantly banks (for Statutory Liquidity Ratio requirements). Within the government securities segments, certain segments have slightly higher liquidity than others depending on the tenor, pricing and quantum of paper available. As against government securities, the market for corporate bonds and other securities is relatively shallow since most of the long-term investors in these bonds/ Securities prefer to stay invested till maturity. Besides the shallow nature of the counter, the liquidity in a bond/ debenture can also be impacted by changes in the credit quality of the borrower. Sharp credit cliffs (i.e downgrade by several notches) can also trigger a liquidity issue on a counter.

Availability of adequate margin to mitigate the risk of volatility over a single time period

Generally, the lenders will prefer some "skin in the game" of the borrower, which will be stipulated by way of margin requirements. Typically, the margin will be linked to the volatility over a given time period, based on past historical data. The volatility in prices of government securities is a function of factors like liquidity, interest rate announcements, size of borrowing programme, economy wide macro factors etc. Since the list of securities eligible for drawing under such facilities, includes a mix of central government securities as well as other securities including private securities, the actual margin stipulation is higher keeping in mind the probability of higher credit losses under the private sector can portfolio. The availability of adequate margin is a critical factor to be considered in this aspect Similar to ratings on share pledge-based facilities, the ratings assigned to the structures based on pledge of debt securities will be suffixed with the words 'CE' indicating that the rating factors in support from the presence of high-quality liquid collateral available to the lender & the flexibility available to the lender to recover his dues at a short notice.

In a nutshell, the ratings on following categories of borrowings (illustrative) will also be suffixed with the words 'CE':

Type of Instrument / Structure	Rationale for CE suffix
Fully Guaranteed Loan (Corporate / Government /SBLC) with T-N structure	External credit enhancement
Partially guaranteed Loans (with T- N structure	External credit enhancement
Partially guaranteed bond	External credit enhancement
State Government/ Central Government issued LOC/ Shortfall undertaking backed loan or other such third-party credit enhancement	External credit enhancement
Loans secured by pledge of debt securities	External credit enhancement

Long term Credit Enhancement securities: Securities with original maturity exceeding one year

Ratings	Definition
ACUITÉ AAA (CE)	Securities with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such securities carry lowest credit risk.
ACUITÉ AA (CE)	Securities with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such securities carry very low credit risk.

ACUITÉ A (CE)	Securities with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such securities carry low credit risk.
ACUITÉ BBB (CE)	Securities with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such securities carry moderate credit risk.
ACUITÉ BB (CE)	Securities with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
ACUITÉ B (CE)	Securities with this rating are considered to have high risk of default regarding timely servicing of financial obligations
ACUITÉ C (CE)	Securities with this rating are considered to have very high likelihood of default regarding timely payment of financial obligations.
ACUITÉ D (CE)	Securities with this rating are in default or are expected to be in default soon.

Acuite may apply '+' (plus) or '-' (minus) signs for ratings from 'ACUITÉ AA (CE)' to 'ACUITÉ C (CE)' to reflect comparative standing within the category.

Short term Credit Enhanced Securities: Securities with original maturity of up to one year

Ratings	Definition
ACUITÉ A1 (CE)	Securities with this rating are considered to have very strong degree of safety regarding timely payment of financial obligation. Such securities carry lowest credit risk.
ACUITÉ A2 (CE)	Securities with this rating are considered to have strong degree of safety regarding timely payment of financial obligation. Such securities carry low credit risk.
ACUITÉ A3 (CE)	Securities with this rating are considered to have moderate degree of safety regarding timely payment of financial obligation. Such securities carry higher credit risk as compared to instruments rated in the two higher categories.
ACUITÉ A4 (CE)	Securities with this rating are considered to have minimal degree of safety regarding timely payment of financial obligation. Such securities carry very high credit risk and are susceptible to default.

ACUITÉ D (CE)	Securities with this rating are in default or expected to be in default on maturity.
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Acuite may apply '+' (plus) sign for ratings from 'ACUITÉ A1 (CE)' to 'ACUITÉ A4 (CE)' to reflect comparative standing within the category.

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