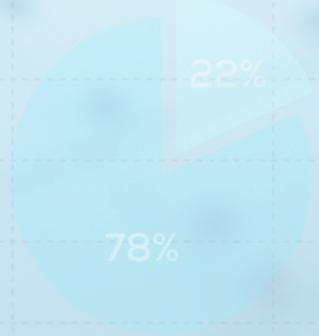




# Criteria for Rating Commercial Paper



## PREAMBLE

Commercial Paper (CP) is an unsecured money-market instrument, issued by corporate borrowers, financial institutions and primary dealers to raise short-term funds (usually ranging between 7 to 365 days) for funding working capital requirements. In India, CP has traditionally been used as a low-cost instrument to replace working capital borrowings from the banking system. In recent years, highly rated non-banking financial companies (NBFCs) have also started accessing CP in a large way to meet their short-term funding needs. The RBI guidelines on CP issuances of August 2017 cover the entire gamut of CP-related issues, such as eligibility to issue, credit rating requirements, reporting, appointment of IPA, roles and responsibilities of IPA, etc.

CP, as a short-term unsecured instrument, has to be essentially evaluated from the standpoint of the near-term liquidity profile of the issuer. It has been observed that, depending on the conditions in the money market, certain issuers may prefer to rollover/ refinance their CP Issue as a regular long-term practice, thereby warranting a medium-term view along with the short term. As per extant SEBI guidelines, the minimum rating for a CP shall be A3. In respect of eligible issuers with issuances of Rs.1000 cr. or above in a calendar year, CP ratings shall be obtained from at least two Credit Rating Agencies (CRAs) registered with SEBI and the lower of the two ratings shall be used. In case of the same ratings, the lower of the two amounts shall be used for which ratings are obtained.

Acuite believes that the process of rating a CP Issue entails the assessment of the fundamental risks in the entity and also ascertaining the structural (instrument-specific) risks in the issue. This largely covers liquidity and refinancing risk, apart from credit enhancement mechanisms (if any).

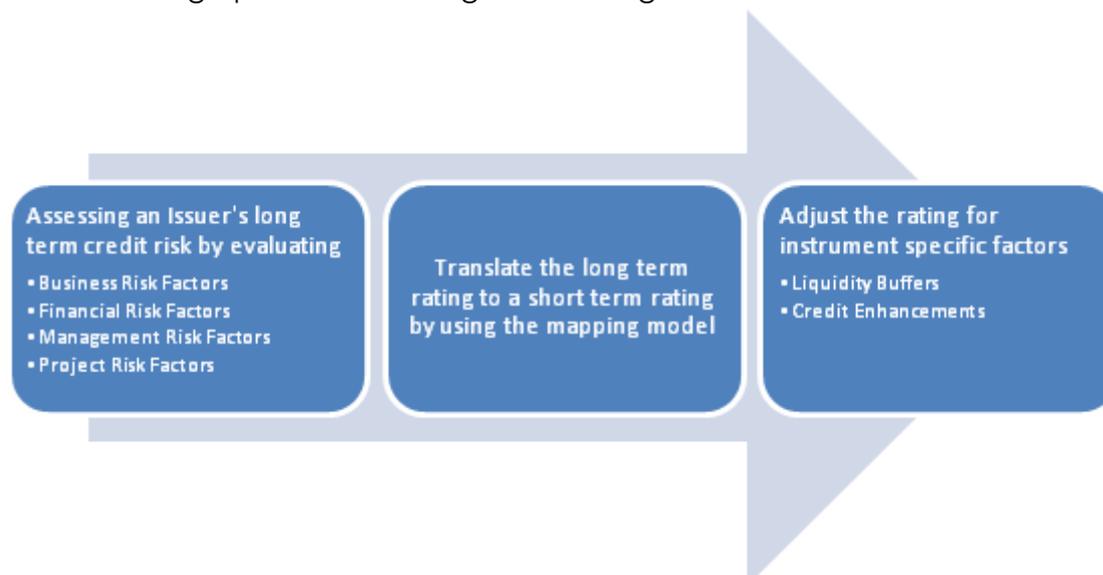
## Scope

This document outlines Acuite's approach towards rating of Commercial Paper and covers the following:

- Part I: Understanding the fundamental risks of the entity being rated
- Part II: Translation of long-term risk indicators onto a short-term scale
- Part III: Evaluating the structural and instrument-specific risks with credit enhancement mechanisms, if any.

## Methodology for Rating Commercial Paper Issues

The three-stage process for rating CP Issue is given below:



### A. Assessing Long-Term Credit Risk

A CP is a short-term instrument which may be rolled over on maturity, thereby imparting a medium/ long term character as it tends to remain outstanding on a long-term basis. In case the issuer faces challenges in rollover of the outstanding CPs, the issuer may have to rely on alternate sources of financing such as fresh borrowings from banks/ institutions or through other short-term capital market instruments to meet its CP-related commitments. Hence, the assessment of the long-term credit risk also becomes relevant. Therefore, the long-term credit rating is indicative of the refinancing risk and the roll-over (or repricing) risk inherent to an issuing entity.

In order to assess the long-term credit risk of the issuer, Acuité believes that an organisation needs to consider three primary sources of risk:

- a. **Business Profile:** Business Risks are a function of the entity's market position and operating efficiency, apart from being exposed to the systemic risks in the industry in which the entity operates.
- b. **Financial Profile:** The Financing mix, the strength and weakness of the financials and the financial structure of the entity, along with the stability of earnings, profitability and the margins, design of various sources of funding and the funding instruments, along with the entity's liquidity and resource mobilisation ability, are evaluated to understand the financial risk inherent in the entity.
- c. **Management Profile:** The management's ability to adequately capitalise on its financial structure, the corporate governance practices adopted, competence, integrity and risk appetite are the factors that Acuité takes into consideration to evaluate the inherent management risk in the entity.

Acuité places special emphasis on understanding the liquidity risk of the issuer, the long-term resource mobilisation ability and financial flexibility.

## B. Long Term Liquidity Risk and Resource Mobilisation Ability

After arriving at the long-term rating, Acuité believes that it is imperative to evaluate the issuer's liquidity position and stability in the periodic cash flows. To this effect, two key aspects are analysed:

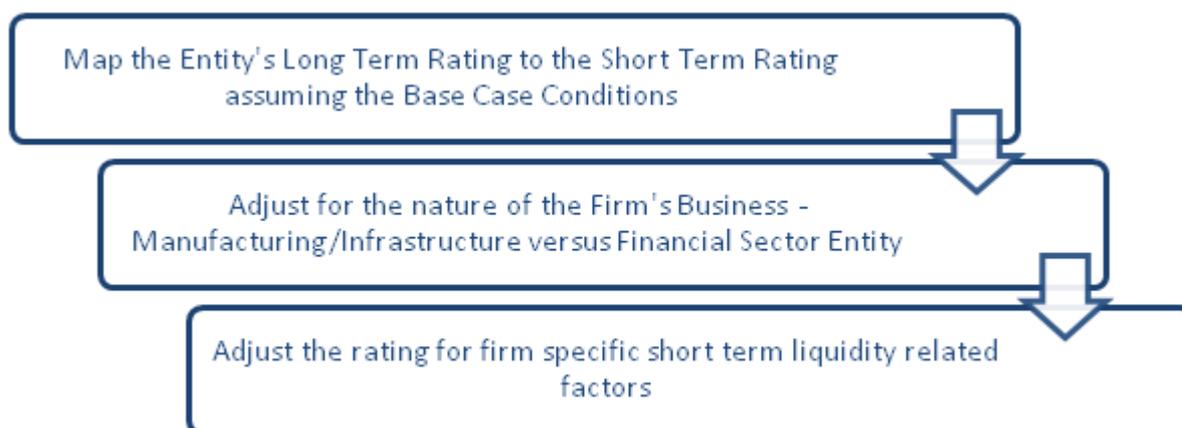
- The monthly working capital limit utilisation during the last six to 12 months
- Projected cash flows in the short to medium term

Commercial Paper issues tend to be refinanced and thus Acuité believes that it is imperative to analyse the entity's ability to refinance its CP issue on maturity– either by rolling over the issue or through alternative sources of funding. Acuité adopts a three-stage approach to ascertain the same:

- c. **Assessment of the un-utilised Working Capital Limits:** It is observed that entities with lower levels of utilisation, on a consistent basis, warrant higher ratings, especially if the un-utilised limit is sufficient to cover the size of the issue.
- d. **Assessment of the Issuer's Ability to Raise Funds at a Short Notice:** Entities that enjoy better relationships with banks/ financial institutions (FIs) and have a good repayment/ financial track record are able to raise funds at a short notice. Besides, the following factors also enable such entities to easily raise funds-
  - Presence of high-quality/ liquid assets that can easily be accepted as primary security or collateral by banks and FIs.
  - Support and commitment from the promoters, group entities or any other entity.
- e. **Assessment of the Current Liquidity Levels:** Historical presence of adequate high-quality liquid assets and commitment to maintain them in future reduces the degree of liquidity risk in the entity.

## C. Translating the Long-Term Rating to the Short-Term Scale

Acuité-assigned Short-Term Ratings are dependent on the Long-Term Ratings. Given below is the two-step process followed by Acuité to map the ratings.



#### D. Firm Specific Adjustments in Short-Term Ratings

Acuite may assign a higher or lower credit rating as against the base case mapping model presented below to account for substantial differences in an entity's liquidity profile. For instance, the availability of comfortable short-term liquidity in the form of cash collateral or liquid investments or any other similar factor reduces the short-term liquidity risk of the entity. Acuite may also consider other arrangements, such as liquidity backstop arrangements, etc., while arriving at the rating for the CP. Acuite may take an upward deviation and assign a higher short-term rating for a particular long-term rating as indicated in the mapping model below.

#### E. Base Case Mapping Framework:

<b>Long-Term Rating</b>	<b>Short-Term Rating</b>
Acuite AAA	Acuite A1+
Acuite AA+	
Acuite AA	
Acuite AA-	
Acuite A+	Acuite A1
Acuite A	
Acuite A-	Acuite A2+
Acuite BBB+	Acuite A2
Acuite BBB	Acuite A3+
Acuite BBB-	Acuite A3
Acuite BB+	Acuite A4+

Acuité BB	Acuité A4
Acuité BB-	
Acuité B+	
Acuité B	
Acuité B-	
Acuité C	
Acuité D	Acuité D

#### F. Liquidity Back Up and Credit Enhancement Options

A Liquidity Back-Up facility is a mechanism that allows the CP Issuer to draw funds from a pre-arranged line if they choose not to roll over the issue. Such lines constitute lines of credits from banks and other financial institutions and are factored in assigning ratings to CPs. However, no credit enhancement is extended on account of the mere presence of such facilities. The reason behind the same is the possibility of such lines not being made available by banks, in case of a steep deterioration in the credit quality of the issuer.

CP Ratings are only enhanced by the presence of Credit Enhancement Options in the form of unconditional and irrevocable credit support facilities such as BackStop Facilities, Guarantees by commercial banks or corporate entities. Such facilities are evaluated on three parameters:

- The distinction between the liquidity back-up and standby credit facility.
- Whether the credit facility is irrevocable and unconditional and is available under all circumstances.
- Whether the credit enhancement would be available before the maturity date (ideally a T minus structure with sufficient buffer to ensure that in case the issuer fails to arrange the funds, the credit enhancement can come into force before the date of maturity).

In such cases, the rating is enhanced, based on the credit risk profile of the entity providing the credit enhancement.

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