



ICRA RATING FEATURE

ICRA METHODOLOGY FOR RATING OF PARTIALLY GUARANTEE STRUCTURES

Background

In recent times, the Indian debt market has seen growing interest in partial guarantee structures. The interest has been driven mainly by the inclination among multilateral agencies and other financial institutions to offer such guarantees. The issuers, on the other hand, have also shown interest in these instruments, as they enable them to target a higher rating at a cost, which is lower than if they were to go in for a full guarantee. A higher rating, in turn, enables a borrower to raise funds at competitive interest rates and for a longer tenure.

The purpose of any guarantee structure is to enhance the credit rating of a debt issue by providing credit support from an independent, higher rated entity. While in a full guarantee structure the benefit of the fundamental rating of the issuer is not there as the rating of the structure generally reflects the rating of the guarantor¹; in a partial guarantee structure, credit is given for the fundamental credit quality both of the issuer as well as the guarantor. The savings in interest expenses on the debt raised can be expected to more than compensate for the incremental cost of obtaining the guarantee. As is well known, increasingly, banks and financial institutions (FIs) are preferring to subscribe to debt instruments carrying ratings in the higher safety categories. However, not many corporate entities are able to attain such ratings on a standalone basis, and this severely restricts their ability to raise funds at competitive interest rates. ICRA believes that the partial guarantee mechanism would aid the financing plans of corporate entities while serving to broaden the primary debt market as well.

Rating Methodology

The rating process for a partial guarantee (PG) structure follows a pattern similar to the corporate rating process, wherein ICRA evaluates the standalone credit quality of the issuer. However, additionally, ICRA takes into account the credit quality of the guarantor. The final rating also incorporates a legal opinion on the covenants of the guarantee. Like other structured finance ratings, PG ratings reflect an opinion on the expected loss to the investor.

Thus, the parameters considered for arriving at a rating decision on a PG structure are as follows:

1. Standalone rating of the issuer.

¹ A LA and a LAA rated company may both be rated LAAA (SO) rating based on a full guarantee from a LAAA rated guarantor. However, exceptions to this case are manufacturing companies, which can be referred to BIFR because of which the effectiveness of the guarantee may be hampered.

2. Rating of the guarantor(s)
3. Default correlation, if any, between the issuer and the guarantor
4. The guarantee mechanism including legal covenants.

Each of the above parameters is discussed here.

Standalone Rating of the Issuer

The standalone rating of the issuer is an opinion on the expected loss on the instrument, which, in turn, is a product of the probability of default by the issuer and the severity of loss on default. The probability of default (POD) is a function of time and increases with tenure, that is, the probability of default on an instrument with a shorter tenure is lower than that with a longer tenure. ICRA uses idealised past default rates and severity rates based on historical default data for all rating levels. A normal default curve build-up (that is, POD over time) is also used for each rating level, which, if required, is adjusted, depending on the projected cashflows of the issuer.

Rating of the Guarantor

A similar analysis as above is done for the guarantor. However, as in most transactions, guarantors are typically rated in the highest safety category, the POD for the guarantor is low. Thus, the risk of loss to the investor because of default by the guarantor is low. In case the guarantor is rated at a lower level, that would be treated as a cap on the final rating of the structure.

Default Correlation

An important factor in PG rating is the default correlation between the issuer and the guarantor. A default correlation could exist between two entities because of a number of reasons. For instance, they could both belong to the same industry, they could have common raw materials or markets, or they could belong to the same business group. Besides these specific factors, a default correlation may exist among all companies in the same economy. However, for structures guaranteed by multilateral agencies, there may not exist any default correlation with the issuer.

Mechanism of the Guarantee

The mechanism for invocation of a guarantee is an important criterion for the rating as it can affect the expected loss to the investor. There are a number of possible structures, which ICRA has evaluated and they primarily differ in the way in which the guarantees are executed. Some of these are discussed here.

- **Accelerated versus non-accelerated structures:** The partial guarantee could either be fixed as a proportion of total interest plus principal payment, or as a proportion of only the principal amount. In case of the former, the guarantee is not accelerated and is paid as and when the amount to the investor becomes due. However, in case of the latter, on the issuer defaulting on a scheduled payment under the obligation, the guarantee would be accelerated and the entire guaranteed amount would be paid out to the investor, thereby enhancing the effective coverage.

ICRA also evaluates the impact of such an acceleration of the guarantee on the credit quality of the guarantor, while determining the credit quality of the guarantor. However, in our experience, the guarantor, generally being a large financial institution would not be impacted substantially by acceleration, as the guarantee amount in relation to its overall size is generally negligible.

- **Fixed versus declining guarantee:** The guarantee could be a fixed amount (fixed as a proportion of the issue amount), which would remain same in absolute terms even while the debt instrument amortises. Thus, as a proportion of the outstanding dues, the guarantee amount increases over a period of time. The other option is to have a guarantee that is a fixed proportion of the dues payable; here, the guarantee amount reduces with the amortisation of the instrument.
- **Back-ended guarantee:** As the element of uncertainty associated with estimating cash flows increases with time, some partial guarantee structures are back-ended to achieve better rating. The guarantor does not guarantee payments scheduled during the initial period, or guarantees only a proportion of it, but takes care of all payments beyond a point in time. These structures are preferred by issuers whose near term credit strength is reasonably high but longer-term performance is uncertain.

Apart from the guarantee mechanism, ICRA reviews the guarantee documents to ascertain whether the guarantee is unconditional and irrevocable. Further, the presence of trigger mechanisms to invoke the guarantee are evaluated.

Arriving at the guarantee required

For arriving at the quantum of guarantee consistent with the target rating, ICRA calculates the various default scenarios and the expected losses associated with these scenarios. The sum of the expected losses for all default scenarios is then calculated and compared against the target expected loss (hurdle rate), that is, the expected loss associated with the target rating. This calculation results in the determination of the quantum of guarantee required to achieve the target rating for the structured obligation. In this evaluation, the cashflow from the issuer, guarantor and any other additional credit protection mechanism is also factored to arrive at the rating level.

A simple illustration is provided here.

Bond Amount:	Rs.100 million
Tenure:	5 years
Repayment:	Rs. 150 million
Coupon:	Zero coupon

Let us assume that the standalone rating of the bond corresponds to a 5-year probability of default (the recovery after default is assumed to be nil, thus the expected loss is also 8.0%).

Now suppose that the expected loss for the target rating is 2.0%. Let 'X%' be the amount of partial guarantee required to achieve the target rating on the bond and 'R%' be the recovery rate (assumed to be nil in this case); then

$$2.0\% = 8.0\% * (1-X\%-R\%)$$

Or

$$X = 75.0\% \text{ or Rs. 75 million guarantee}$$

It should be kept in mind that the guarantee does not influence the probability of default by the issuer but changes the loss to the investor on the structured obligation, in case the bond defaults. In the case illustrated, a 75.0% guarantee would ensure that the expected loss on the structured obligation is similar to the expected loss of the target rating².

It should also be noted that the recovery % assumption was nil within the scheduled term of the structured obligation, which may not always be the case. However, ICRA assumes nil recovery for most structures unless the instrument is secured by a liquid security, timely realisation of which is reasonably certain.

ICRA's Experience

ICRA has been involved in rating six partial guarantee structures during the past two years, involving a total amount of Rs. 14.3 billion. The partial guarantee (cash collateral based) ratings currently outstanding are:

Company	Rating	Date	Amount Rs. Crore	Guarantor/Cash Collateral
TNUDF	LAA+(SO)	Aug-00	110	Cash Collateral
Bangalore Development Authority	LAA+ (SO)	Feb-01	100	Cash Collateral*
Bharti Mobile	LAA+ (SO)	Feb-01	267	IFC, Washington
Municipal Corporation of Hyderabad	LAA+ (SO)	Oct-01	100	Cash Collateral

* Also includes reserve account and cash flows based triggers

² In practice evaluation of a partial guarantee structure is rarely as simple. It involves estimation of the default curve of the issuer based on its estimated future cash flows and credit rating level and application of this default curve on the structure to determine the appropriate rating level for a specified level of guarantee.



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