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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in September 2020. While this revised version incorporates a few modifications, ICRA's overall approach to rating partially guaranteed transactions remains materially similar.

What is a Partial Guarantee?

A partially guaranteed transaction is one that involves a guarantee furnished by a third party that covers only a portion of the total interest and principal payments, which would fall due on the issuer's debt.

Analytical Framework

Credit ratings assigned by ICRA address the timely payment of the principal and interest on the debt being rated. A single-day-single-rupee delay in the payment of the amounts due is treated as default. Thus, a particular debt instrument of an issuer can be rated higher relative to its standalone credit rating if the credit enhancement associated with that instrument ensures that the investor in this instrument is more likely – relative to the issuer's other debt holders – to receive the payments in a timely manner, as per the instrument's repayment schedule.

A common form of credit enhancement for an instrument is an unconditional and irrevocable guarantee covering the entire principal and interest through the full tenure of the instrument from an entity (the guarantor) that is rated higher than the issuer of the said instrument. The guarantee, coupled with timely invocation and a payment mechanism, ensures that the probability of default of the instrument is the same as that implied by the credit rating of the guarantor. This is a classic case of credit substitution, i.e. the credit rating of the instrument is equated to the credit rating of the guarantor.

However, there could be scenarios wherein an instrument could achieve a certain degree of credit enhancement (if not credit substitution) with a guarantee that covers the amount payable on the debt instrument being rated, only partially. For instance, even if the guarantee is partial (i.e. the aggregate amount of guarantee is lower than the aggregate amount of principal and interest, which is payable over the tenor of the instrument), it could be designed as a first-loss default guarantee (i.e. the guarantor agrees to pay the entire shortfall pertaining to one or few instalments rather than a limited proportion of the instalment). To the extent the credit enhancement in the structure is adequate to fully meet the debt-servicing obligations for a few instalments, default on those instalments can be avoided, thereby reducing the overall probability of default of the debt instrument. Nevertheless, if the issuer has other debt on its balance sheet, which is rated lower (or has a lower unsupported rating), the extent of credit enhancement from the partial guarantee is generally limited, given the bankruptcy risk associated with the default on the lower rated debt of the issuer.

Key Considerations While Assessing a Partially Guaranteed Transaction Structure

The key considerations while evaluating a typical partially guaranteed structure have been summarised below¹.

- First-loss nature of partial guarantee – Any improvement in the credit rating of a debt instrument can happen only if there is a reduction in the probability of default, based on the comfort of the partial guarantee. For this to happen, the partial guarantee should be designed as a first-loss default guarantee, i.e. any shortfall in the debt-servicing obligations should be met from the partial guarantee amount as long as the net cumulative utilisation of the guarantee is lower than the stipulated quantum of the guarantee. If the partial guarantee is to be utilised on a pro-rata basis in the event of a shortfall in the cash flows to meet the debt-servicing obligations (for example, if the guarantee is 20% of the issue size, and on each event of shortfall, the guarantor pays 20% of the shortfall amount), it would result in a default at each instance of shortfall. Therefore, such a guarantee would not enhance the credit profile of the debt being rated.
- Cross default and acceleration with the other debt of the issuer – An improvement in the credit rating because of the presence of a partial guarantee would be constrained if the issuer has other debt on its balance sheet or incremental debt is envisaged in future and/or the debt backed by a partial guarantee has an acceleration clause owing to cross default by the issuer on its other debt.

In case of the presence of cross-default clauses, any default on other debt (rated lower than the rating of the partial-guarantee-backed debt) would trigger an acceleration of the partial-guarantee-backed debt, leading to a high likelihood of default on the latter (as the guarantee coverage in the event of acceleration of debt would only be partial). Thus, the probability of default of a partially guaranteed debt may not be materially different from the probability of default of the other debt. As a result, the presence of cross-default clauses, which may lead to the acceleration of the partially guaranteed debt, would not enhance the credit profile of such debt.

- Partial guarantee to be unconditional and irrevocable – The partial guarantee must be unconditional and irrevocable. Further, post invocation, any payments to the guarantor should be subordinated to payments on the rated debt, at least till the time there is no payment default on the rated debt. Similarly, non-payment to the guarantor should not constitute an event of default for the rated debt.
- Non-amortising/amortising guarantee – The partial guarantee can be non-amortising (i.e. it remains fixed in absolute terms during the tenure of the debt, thereby increasing in percentage terms as the debt amortises), amortising (i.e. it amortises in line with the amortisation schedule of the debt being rated) or somewhere in between (i.e. it builds up in percentage terms initially with debt amortisation and remains at the same level in percentage terms thereafter). Comfort drawn from a non-amortising guarantee would be higher compared to an amortising guarantee if all other factors remain the same. This is because in an amortising guarantee, the absolute level of the guarantee declines as the debt amortises. Therefore, the number of instalments covered by the guarantee may also reduce. While an amortising guarantee may cover several instalments at the time of debt issuance, it may cover only a fraction of an instalment towards the end of the tenure of the rated debt. If the partial guarantee does not cover at least a few instalments till the maturity of the debt instrument, no benefit of the partial guarantee is considered.
- Guarantee invocation and payment mechanism – The timelines for the invocation of the partial guarantee and the subsequent payment by the guarantor should be defined and the payments should be made in a timely manner such that there is no default on the rated instrument. In these structures, the issuer must fund a designated account prior to the due date of payment to the investors. The lender or the Debenture Trustee checks the adequacy of funds and invokes the guarantee in the event of any shortfall. The guarantor is obligated to fund the designated account prior to the due date to ensure timely payment to the investors on the due date.

¹ Please also refer to the rating approach on 'Explicit Third-Party Support' available at www.icra.in for details on the attributes evaluated for an explicit support form

- Cash flow waterfall – The priority of payments or the cash flow waterfall is an important element (for instance, the treatment of excess cash flows in the transaction, mechanism for the reinstatement of the guarantee, etc). An important factor in this regard is that the guarantor's claim on the cash flows should be subordinate to that of the senior debt lender. In other words, in the event that a part of the guarantee has been utilised, in the subsequent period, the payment to the guarantor should only be made if there is any excess left after meeting the senior debt dues during that period.
- Credit quality of issuer and guarantor – ICRA analyses the credit profile of the issuer as well as the guarantor, following the applicable sector methodology, to determine the individual entities' probability of default (as represented by the credit rating). This is important as the partial guarantee will be invoked only in case of a default by the issuer and once the guarantee is invoked, the guarantor's probability of default determines the likelihood of the receipt of payment under the guarantee. The level of credit enhancement is determined, depending on the attributes of the issuer, the extent of coverage of the partial guarantee and the resultant probability of default. The rating of a partially guaranteed debt is likely to be lower than the rating of the guarantor.

Summary

The approach used by ICRA to evaluate the credit rating of debt instruments backed by a partially guaranteed structure incorporates the assessment of the credit risk of the underlying entity and the guarantor as well as the number of repayments covered by the partial guarantee. The assumptions for a particular rating may change from time-to-time based on market or economic conditions, the specific structure of the transaction, issuer-specific characteristics or even new factors that may have been observed.

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