

RATING APPROACH – STRUCTURAL FEATURES (NON-SECURITISATION TRANSACTIONS)

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in September 2021. The revised document incorporates a few changes intended to provide more clarity on the various structural features that back a debt instrument. ICRA's overall analytical approach to evaluate the structural features, however, remains materially similar.

Overview

ICRA's credit rating is a symbolic representation of its opinion on the relative credit risks associated with timely debt servicing by an entity. One debt instrument of an entity may be rated higher than its other debt instruments, in case it has attributes that ensure that the investors in that instrument are more likely, relative to investors in the entity's other debt instruments, to receive the payments in full and in a timely manner. This could be possible if there exists some form of explicit credit support for a rated debt instrument from a stronger third-party through support mechanisms like guarantees, shortfall undertakings and standby letters of credit, or if there are structural features associated with a debt instrument such as a defined cash flow waterfall through an escrow mechanism or a security/asset that provides a pre-default utility.

This methodology document describes how ICRA evaluates the structural features associated with an instrument while assigning ratings in cases where the presence of such structural features is a credit differentiator¹. The note is organised into the following three sections:

- **Types of structural features**
- **Key attributes of various structural features**
- **Approach to assess the credit profile of debt instruments backed by structural features**

¹ To know about the approach that ICRA follows for assessing the strength of implicit support available to the rated entity from a third party, please refer to ICRA's methodology titled 'Rating Approach - Implicit Parent or Group Support' available on ICRA's website www.icra.in. To understand how ICRA evaluates the strength of explicit support available to a debt instrument from a third-party, readers may refer to ICRA's methodologies titled 'Rating Approach - Explicit third-party support' and 'Rating Approach – Partially Guaranteed Debt' available on ICRA's website.

Types of structural features

The structural features associated with a debt instrument either:

- Prevent the mingling of cash flows that are earmarked for the servicing of the rated debt instrument with the entity's other cash flows, by way of an escrow mechanism (*this may or may not be accompanied by other features such as cash sweep or cash trap*), or
- Involve a security/asset that can be monetised or utilised to ensure timely debt servicing.

While the debt instrument of an entity that is supported by structural features could potentially be rated higher than the entity's other debt instruments to reflect the difference in their probability of default, the difference between such ratings is generally limited. This is because such structural features are on-balance sheet support mechanisms and a given debt instrument would not be isolated from the risk faced by the entity as a whole—such as bankruptcy risk, which may arise upon the initiation of insolvency proceedings by operational creditors or financial creditors of the entity. In other words, the presence of structural features can generally provide credit enhancement to a debt instrument only to a limited extent, unlike the case of a bankruptcy remote third-party explicit credit support, based on which the extent of credit enhancement may be, though not necessarily, much higher.

The structural features could be associated with all the debt instruments of an entity or with only a few specific instruments. Moreover, the characteristics of the structural features associated with the different debt instruments could also differ. As a result, the credit risks associated with the different debt instruments of the same entity could vary based on the attributes of the associated assets and the specific structural features associated with the debt instruments.

The commonly seen structural features along with their attributes that provide credit support are described below:

Structural Feature	Description
Escrow mechanism	<p>An escrow mechanism enables ring-fencing of an identified stream of cash inflows for servicing a specific debt instrument. Such identified stream of cash inflows is required to be deposited in a designated escrow account that is monitored by the lender(s) or the investor(s) or a trustee appointed by the investor(s). Only after their consent or after meeting the pre-specified pay-outs as per the contractual terms, are the surpluses from the escrow account permitted to be distributed by the entity. Such structuring of cash flows is predominantly seen in sectors with a long-term revenue visibility or concession agreement, such as operational commercial real estate with long-term leasing arrangements, renewable power projects with a long-term power purchase agreement and toll roads with a long-term concession agreement, among others.</p> <p>This structure ensures that the earmarked cash inflows do not mingle with the entity's other cash flows and are utilised in a pre-determined sequence as stipulated in the loan agreement (<i>such as debt servicing, replenishment of reserves such as DSRA², pre-payment of debt, payment of statutory dues or meeting of operating expenses</i>) and only the surplus is available for other uses, including distribution to shareholders.</p>

² Debt Service Reserve Account

Structural Feature	Description
	The escrow mechanism could also be complemented with other features such as a cash trap (<i>to create contingency liquidity reserves</i>) and a cash sweep (<i>to mandate prepayments</i>).
Presence of a security/ asset that is mandated to be/ can be monetised or utilised by the lender or investor or trustee before the due date for debt servicing.	<p>Under this structure, adequate security/ asset covering at least the full value of the payments to be made over the tenor of the debt is available with the lenders or the investors. The debt is to be serviced either mandatorily by 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 (n). This date (n) should be before the due date (T) defined for debt servicing such that the underlying security/asset could be monetised/ utilised to make the payment by the due date.</p> <p>If the security/asset is external or provided by a third party, the ratings assigned to such instruments carry the suffix (CE), if the instrument is a listed or proposed to be listed security. <i>Example:</i> CMBS-like structures³. However, if the security/asset is held directly by the entity such as in the form of cash or financial investments, the rating symbol is not accompanied by any suffix.</p>

Apart from the above, there may be certain features associated with debt instruments such as covenants in loan documents restricting an entity from taking additional borrowings or a provision to regularly fund a reserve to ensure adequate funding availability for a scheduled large expenditure. However, such features impact the credit profile for all the debt instruments of an entity equally and, thus, are not credit differentiators among the various debt instruments of an entity.

A DSRA, either in the form of (1) cash (generally in the form of a fixed deposit with a financial institution), or (2) a fund based / non-fund based facility (from a financial institution), equivalent to debt repayment obligations over a certain time period, typically three to six months, is considered for liquidity assessment, rather than as a structural feature—if the DSRA could be utilised before the due date of debt servicing. In such cases, the DSRA helps reduce the risk of default caused by temporary cash flow mismatches. Moreover, the DSRA is generally associated with a specific debt instrument and is present along with an escrow mechanism and can be utilised only in case of any shortfall in servicing that particular debt instrument. Thus, DSRA is considered for the liquidity assessment of only the instrument(s) for which it is available, not as a general liquidity support for the entity. More details on ICRA's approach for liquidity assessment can be referred from the methodology document titled 'Rating Approach – Liquidity Analysis (Non-Financial Sector)' available on ICRA's website.

³ Commercial mortgage-backed securities

Key attributes of various structural features

The presence of structural features enhances the credit profile of a debt instrument; however, only if the features have a utility in substance rather than being available just in form. The attributes which may be associated with the various structural features are described below:

Escrow mechanism

- Cash flow waterfall

An escrow mechanism prevents co-mingling of an entity's cash flows, stemming from some identified assets or revenue sources with the other cash flows of the entity. As the escrow account is monitored by the lender or the investor or the trustee, and withdrawals by the borrower are generally allowed either after the former's consent or as per the defined sequence in which the cash flows can be utilised, the discretion available with the borrower with regard to utilisation of cash flows is limited. Thus, an escrow mechanism, characterised by the presence of a pre-determined sequence for the utilisation of cash flows (cash flow waterfall) such that these are first utilised for incurring the necessary operating expenses and debt servicing before being available for other purposes (including distribution to shareholders), provides comfort that the necessary expenditure and debt servicing are prioritised over other sundry requirements and shareholder payouts.

- Cash trap

In addition to defining the sequence in which the cash flows can be utilised, the cash-flow waterfall terms could also include a mechanism to ensure that either by default or in situations when certain financial covenants are breached, the surplus cash flows are mandatorily utilised for the creation of a liquidity reserve for meeting future contingencies. Such a mechanism enables pre-emptive cash preservation following the first signs of weakness in the cash flows.

- Cash sweep

The cash-flow waterfall could also include a mechanism to ensure that the surplus cash flows, after meeting the defined sequence of cash flow utilisation, are used for mandatory debt pre-payment to ensure that the surpluses are only used for debt servicing. This mechanism ensures that the amortisation of the debt is accelerated during periods when the surpluses are strong, thereby paring down the debt servicing obligation (due to faster run-down of the debt) in years when the surpluses are subdued.

Security/ asset back-up

- Security/asset cover

The higher is the security / asset cover in relation to the debt obligations (beyond 1.0 times), better are the prospects of realising the value equivalent to the debt on monetisation/utilisation of the security. The security cover is seen in conjunction with the volatility in the value of the security, as a high volatility would necessitate a higher cover and vice-versa – to achieve a similar volatility-adjusted factor of safety.

- Liquidity

The better the liquidity of the security, better are the prospects of monetising/utilising the security in a timely manner at a value closer to its assessed value. Liquidity is generally a function of the asset class to which the security belongs (a liquid balance like a fixed deposit versus an investment in real estate, an illiquid asset class), the demand-supply dynamics, and the cost of monetising the security.

- Granularity

Granularity refers to the ability to monetise the security/asset in tranches/piece-meal rather than as a whole. The higher the granularity, higher is the flexibility to monetise the asset at a value closer to its fair value, given the option to attract a wider set of buyers for the various sub-parts and the option to gradually monetise the asset, which would reduce the cost of monetisation.

- Cushion between the due date of debt servicing and initiation of security monetisation

The cushion between the date when the monetisation of the security is contractually stipulated to be initiated by the lender or investor and the due date for debt servicing should be such that it provides adequate time for enforcement of the lenders' or investor's right to monetise the security. The adequacy is assessed by considering the nature of the security in terms of its liquidity, besides considering the procedural time estimated for monetisation. The higher the above cushion, greater is the likelihood of the structure supporting timely debt servicing.

- Mechanism for initiation of security monetisation

Comfort can be derived from a given structure only if there is a time-bound mechanism for mandatory monetisation of the security before the due date. In the absence of such a mechanism, the timely monetisation of the security remains at the discretion of the lender or investor, which may result in delays in debt servicing and thus, limiting the utility of such a structure.

- Credit profile of the financial institution maintaining the security/ asset or the underlying fixed income security (in case the security is a non-equity financial instrument)

The efficacy of the security lies in its adequacy and timely availability to ensure timely debt servicing in full. As a result, in case the security is a financial instrument such as cash or fixed deposit, the credit profile of the financial institution, which holds the security, is an important determinant for assessing the timely availability of the security. This is because any distress at the financial institution could limit the access to such security. In case the security is in the form of investments in fixed-income securities, the credit quality of the investments is important to ensure realisation of the full value of the underlying investment. Thus, the credit rating of a debt instrument backed by some security cover, is linked to the rating of the financial institution maintaining the security (*cash balances or fixed deposit*), or the rating of the security itself (*when the security is in the form of investments in fixed-income securities*). In case the cash balance/fixed deposit is held with different financial institutions, or the back-up held is in the form of various fixed-income securities having different credit worthiness, then the lowest credit rating among them is taken as an anchor for credit enhancement.

- Bankruptcy remoteness

A security which is directly held by the entity would not be available to support debt servicing in case the entity enters bankruptcy proceedings because of default on other debt. This is because upon the initiation of bankruptcy, the security would be considered as a part of the entity's estate and its utilisation could be put under a moratorium as per insolvency law. As a result, the efficacy of such a security would be limited, which would constrain the extent of credit enhancement for the debt instruments backed by such securities. However, as an example, consider a security that is owned and provided by a third party. If such a security would be available to be utilised even on initiation of bankruptcy proceedings against the rated entity or the terms of the rated debt structure involve mandatory squaring-off of the debt outstanding against the security before the initiation of the bankruptcy, irrespective of the debt falling due, such a security would ensure timely debt servicing. Such a structure could thereby typically result in a higher credit enhancement.

Approach to assess the credit profile of debt instruments backed by structural features

ICRA's approach to assess the credit profile of the debt instruments backed by structural features is described below:

Escrow mechanism

In cases where the cash flows relating to an asset are ringfenced through an escrow mechanism, the business and financial profiles of such an asset are analysed independent of the overall entity⁴. Attributes such as cash trap and cash sweep, if applicable, are also assessed for analysing the financial profile in terms of their impact on debt coverage, leverage, and liquidity. ICRA also evaluates the adherence of the structure to the contractual terms over the tenor of the instrument and the lack of adherence is a rating sensitivity factor.

However, in case there are operational and financial creditors at the entity-level outside of the escrow mechanism—which could be a source of bankruptcy risk—the extent of rating notch-up/credit enhancement for the debt supported by an escrow mechanism would be limited against the base rating. In such cases, the rating of the escrow mechanism-supported debt instrument would be closer to the base rating of the entity, even if not equal.

Assessing the entity's base rating when the surpluses from the escrow could be distributed for meeting any sundry expenses/requirements at the entity level: For evaluating the entity's base rating, a consolidated analysis of the entity is done by including the assets whose cash flows are escrowed, while excluding the DSRA or any other liquidity reserve available only to service a specific debt.

Assessing the entity's base rating when the surpluses from the escrow cannot be distributed for meeting any sundry expenses/requirements at the entity level: The escrowed assets are excluded while evaluating the entity's base rating as the cash flows from such assets are restricted and not freely available at the entity level.

Though theoretically, the rating of the debt instrument based on the analysis of a specific asset whose cash flows are escrowed could be lower than the entity's base rating, the entity's base rating acts as a rating floor for all of the entity's debt instruments (except those that have equity-like features).

Rating approach in the case of contractual-surplus-sharing arrangement between entities: There could be presence of a contractual-surplus-sharing arrangement between various SPVs in a Group, whereby each SPV contributes its surplus cash flows (after adhering to its own specified cash flow waterfall and other features) to support the debt servicing of the other SPVs. In such cases, ICRA consolidates the SPVs in the structure to arrive at a group rating (N1) of the structure. If extraordinary financial support to the group could be expected from the parent/sponsor, then the group N1 rating is notched up based on the likelihood of such implicit support forthcoming, to arrive at the notional N2 rating of the group. The rating of the individual SPVs is then derived by applying the bottom-up approach, whereby the standalone rating of the individual SPVs is notched-up based on the likelihood of support from the group, against the anchor of the notional N2 rating of the group. The rating of the individual SPVs need not be capped at the notional group rating.

Rating approach in case of debt instruments with cross-default linkages: In case of cross-default linkages among the various debt instruments of an entity, then the rating of these instruments will generally be capped at the base rating of the entity.

⁴ The rating of the debt instruments supported by structural features remains linked to the performance of the asset, as the escrow structure only prioritises the debt payments and does not generate additional cash flows

Security/ asset back-up

The debt instruments that are expected to be serviced through security/asset monetisation, are 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 are adequate (in relation to the nature of the security), would it enhance the credit quality of the rated debt instrument. If the security/asset is a financial instrument such as a fixed deposit with a financial institution or a fixed-income security, the rating of debt instruments backed by such security/asset could be theoretically at par with the rating of the financial institution, where the security/ asset is deposited or the credit quality of the underlying fixed-income security. However, even in such cases, the final rating would be typically constrained to remain closer to the entity's base rating. This is because of the bankruptcy-related risks faced by the entity which would curtail the availability of the security/ asset owned by the entity in case of initiation of bankruptcy proceedings against it. But if the security/ asset is bankruptcy remote, either by way of the nature of the security asset or by way of the manner of structuring, the rating of the supported debt instrument could be closer to the rating of the financial institution/ underlying financial instrument.

Summing Up

If a debt instrument has structural features with specific attributes, it reduces the probability of default by preventing mingling of cash flows from a specified asset with an entity's other cash flow streams or through pre-funding the debt servicing through security creation. The various structural features and their attributes along with ICRA's approach to assess the credit profile based on the various structural features are discussed in this document.

However, structural features generally provide credit enhancement to a debt instrument vis-a-vis the entity's base rating, only to a limited extent, unlike the case of a third-party explicit credit support based on which the extent of credit enhancement could be much higher. This is because the credit risk associated with a debt instrument having structural features is not fully delinked from the entity's overall credit risk profile, given the bankruptcy risk, which may arise from default on other operational and financial creditors.

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