

Criteria for notching up standalone ratings of companies based on government support

August 2021

Criteria contacts

Somasekhar Vemuri

Senior Director and Head – Rating Criteria and Product Development

Email: somasekhar.vemuri@crisil.com

Chaitali Nehulkar

Associate Director – Rating Criteria and Product Development

Email: chaitali.nehulkar@crisil.com

Nidhi Mamania

Senior Executive – Rating Criteria and Product Development

Email: nidhi.mamania@crisil.com

In case of any feedback or queries, you may write to us at Criteria.feedback@crisil.com

Ramesh Karunakaran

Director – Rating Criteria and Product Development

Email: ramesh.karunakaran@crisil.com

Neha Sharma

Associate Director – Rating Criteria and Product Development

Email: neha.sharma@crisil.com

Executive summary

CRISIL Ratings may notch up the standalone ratings of government-related entities (GREs) based on the probability and extent of distress support that the government could provide to them. CRISIL Ratings classifies GREs into four categories based on the policy role they execute, and the economic and political implications of their default on the government. Based on the classification, CRISIL Ratings decides if, and the extent to which, notch-up is to be provided to the GRE's standalone rating.

Scope

CRISIL Ratings applies its notch-up criteria to the ratings of public sector undertakings (PSUs) that are majority owned by the Government of India (GoI). The framework may also be applied to entities that are not directly held by the government, but are majority owned by PSUs. GREs, therefore, include the whole gamut of entities that are likely to receive distress support from GoI.¹

Parameters for assessing likelihood of GoI support

CRISIL Ratings may notch up a GRE's standalone rating based on assessment of the policy role played by the entity, the government's moral obligation to support the entity, and the implications of default (see *Chart 1*).

Chart 1: Parameters for assessing extent of notch-up

A. Policy role	B. Implications of default / Moral obligation
A.1. Criticality of sector A.2. Strategic importance	B.1. Domino effect B.2. Political / social implications of default B.3. Public perception of sovereign backing B.4. GoI's stated posture

A. Policy role

CRISIL Ratings evaluates the GRE's role as an instrument of public policy, and the government's intention to retain the policy role with itself or with the public sector over the long term.

The criticality of the sector in which the GRE operates, and the entity's strategic importance within that sector are factors CRISIL Ratings takes into account:

A.1. Criticality of sector: Sectors are classified as strategic or non-strategic to GoI based on the government's disinvestment policy, allocation of funds to different sectors, and discussions with government officials. Sectors such as defence that GoI views as its obligation are considered highly strategic.

¹ This article is being republished following a periodic review of criteria in August 2021, with no major revisions. The previous version of this article, published in August 2018, can be accessed here: https://www.crisil.com/content/dam/crisil/criteria_methodology/criteria-research/archive/Criteria-for-notching-up-standalone-ratings-of-companies-based-on-government-support-aug2018.pdf

A.2. Strategic importance: The extent of private participation in a sector is treated as a proxy for the strategic importance of a GRE within the sector. GREs performing critical government functions and operating in sectors in which the private sector's role is expected to be limited are considered strategically important to the government.

GREs that fulfil functions that GoI views as its obligation, and in which private sector participation is likely to be limited, score high on policy role. For instance, special purpose vehicles (SPVs) set up by GoI to raise resources for projects, such as railways, power transmission and road development, score high on policy role. PSUs in manufacturing industries, however, where the private sector plays a large role, score low on this parameter.

In February 2021, the GoI has announced its policy of **strategic disinvestment of public sector enterprises**. As per this policy, the GoI, intends to have a bare minimum presence in the strategic sectors, and the remaining will be privatized or merged or subsidiarized with other GRE or closed. As strategic disinvestment might take time to implement as suggested by past track record and might take shape in multiple forms – privatization, merger/ subsidiarization with other GREs and/ or closure, CRISIL Ratings will adopt a case-specific approach towards notching its ratings. Such analysis will be depend on the contours of the disinvestment exercise for a specific credit with focus on how the exercise may impact the issuer's functioning as a GRE in the future.

B. Implications of default / Moral obligation

The following parameters help gauge the economic, political, and social implications of default by a GRE in debt servicing:

B.1. Domino effect: This parameter captures the economic implications of default. CRISIL Ratings determines whether the default would have a localised impact or spill over to other entities in the sector. In the financial sector (particularly banks), for instance, default by one entity could lead to loss of confidence, even liquidity constraints, in other entities in the sector.

B.2. Political / social implications of default: GRE's employee strength, the extent of unionisation, and the amount of outstanding retail and foreign currency debt are assessed to determine whether GoI could face political pressures in preventing a default. There would be considerable pressure on GoI to also support GREs that fulfil a social role.

The following parameters reflect moral obligations on the government to support a GRE in distress:

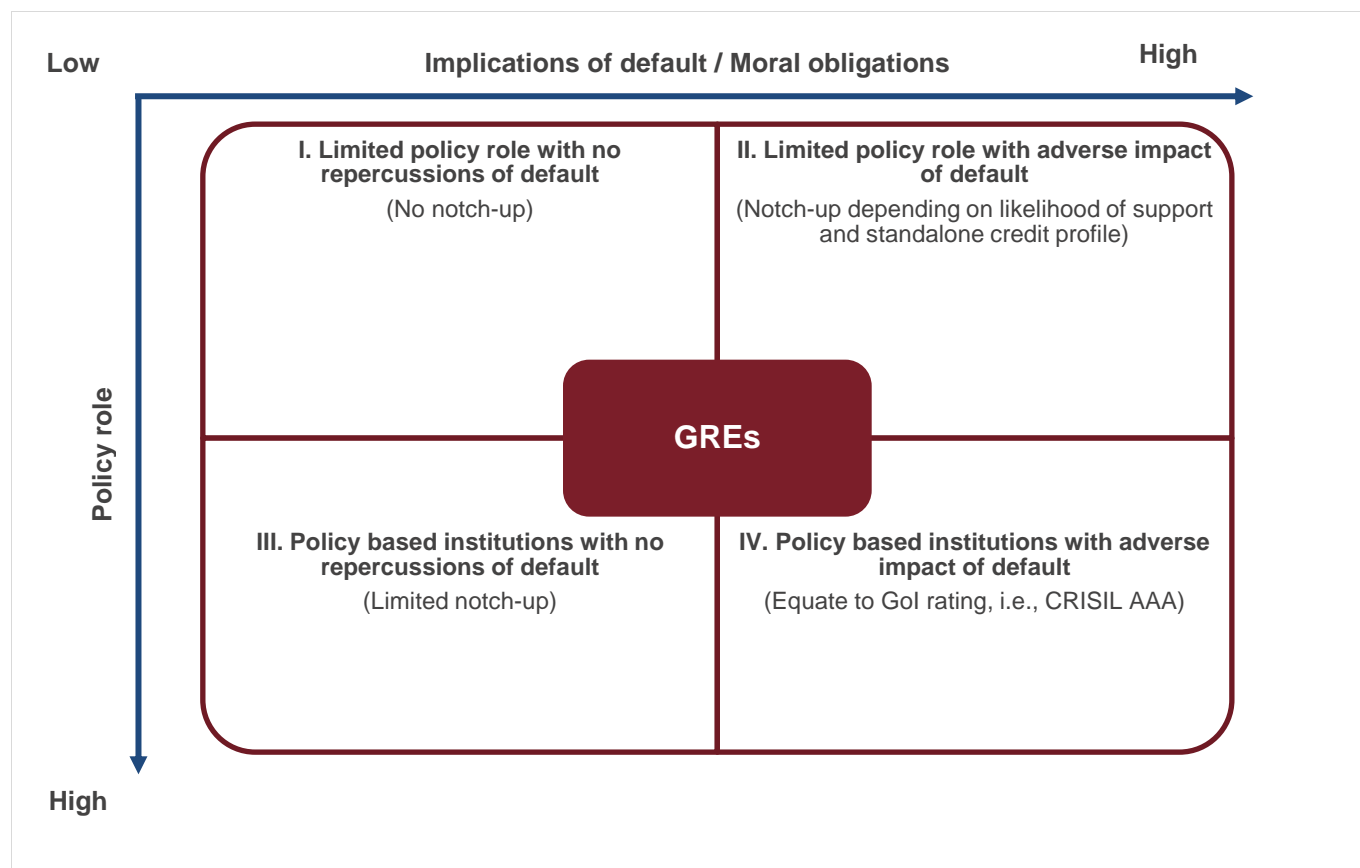
B.3. Public perception of sovereign backing: GoI often needs to intervene and support entities in case there is significant public perception of such support. For instance, GoI has set up SPVs to channelise funds to key sectors. The cash flow of many such SPVs are inadequate to meet the debt obligation. For such entities, resource availability from capital markets is based on a strong assumption of government support.

B.4. GoI's stated posture: Letters of comfort or guarantees from the government for a GRE's borrowing programme or capitalisation support reflect the government's level of commitment towards it. Also, if a GRE is allowed by the government to issue tax-free bonds, there would be significant moral obligation on the government to extend support to the GRE if it falls into distress.

Extent of notch-up

Based on the assessment of these parameters, CRISIL Ratings classifies GREs into four categories (see Chart 2):

Chart 2: Classification of GREs



I. Limited policy role with no repercussions of default: This category comprises GREs that are essentially commercial entities that play a limited policy role and whose default could have low political or economic implications. Such entities have low likelihood of support from Gol. Therefore, CRISIL Ratings does not notch up ratings of such entities, and their ratings reflect their standalone creditworthiness.

II. Limited policy role with adverse impact of default: If an entity plays a limited policy role, but its default could have extreme adverse political and economic implications, CRISIL Ratings believes Gol will intervene in time to avert such defaults. The extent of notch-up over the standalone rating may be much higher for such entities, and driven by the adverse impact of default and the difference between the standalone rating and Gol's rating.

III. Policy-based institutions with no repercussions of default: This category includes GREs engaged in sectors which have received significant government support through equity infusion and loans in the past. CRISIL Ratings believes such support from the government is given to ensure solvency, but not necessarily to ensure timely debt servicing. Hence, CRISIL Ratings may consider a limited notch-up over the standalone ratings of such entities.

IV. Policy based institutions with adverse impact of default: These entities carry out activities that are unlikely to be passed on to the private sector in the foreseeable future. Lack of government support to such entities may lead to funding and liquidity constraints, which, in turn, could impair resource allocation to target sectors envisaged by the

government. CRISIL Ratings, therefore, equates the ratings of such entities to Gol's rating, 'CRISIL AAA'. For instance, regulatory agencies and SPVs established to channel resources (from capital markets) to key social or strategic sectors, and formed under special statutes, belong to this category.

Conclusion

CRISIL Ratings government notch-up criteria factor in the likelihood that Gol extends support to the GRE in time of distress, depending on the policy role and implications of the entity's default on the government. CRISIL Ratings classifies GREs into four distinct categories based on its assessment of the probability and extent of government support. The extent of notch-up to the standalone rating is determined by the category to which the GRE belongs.

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