Basics of Ratings

(Rating process, rating scales, default recognition, assessing information adequacy, methodology for mapping global scale to Crisil Ratings' scale and various instrument level rating)

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Contents

Section I.

Understanding Crisil Ratings and Rating Scales

Executive summary

Credit ratings by Crisil Ratings on debt obligations are its opinion on the likelihood of the obligation being repaid in full and on time. The ratings indicate the current opinion of Crisil Ratings on the probability of default on the instruments. Crisil Ratings uses a rating watch and an outlook to indicate the likelihood of change in its ratings and the probable direction of that change. The ratings are conveyed using simple alphanumeric symbols for six categories: long-term, short-term, structured finance, credit enhancements, corporate credit rating and debt mutual fund schemes.

Scope

This section[1] enunciates the meaning of credit ratings and the rating scales used by Crisil Ratings for long-term, short-term, structured obligations, credit enhancements, corporate credit rating and debt mutual fund schemes. It also outlines the Crisil Ratings policy for placing ratings on credit watch and assigning rating outlook to provide information to investors about potential rating changes.

Understanding ratings by Crisil Ratings

A credit rating represents a rating agency's opinion on the likelihood of the rated debt obligation being repaid in full and on time. This opinion helps stakeholders perform a comparative assessment of investment options and facilitates the issuer's access to funds.

Rating agencies assign credit ratings using three rating scales: global, regional and national. The essential difference among these is scope: global scale ratings are assigned based on an assessment of the issuer in relation to other issuers globally, regional scale ratings are based on credit risk comparisons within a specific region, and national scale ratings are based on credit risk comparisons in a domestic context.

National scale ratings, including ratings assigned by Crisil Ratings, provide superior credit differentiation among issuers/issues within a country by using the sovereign rating as a benchmark. On a domestic scale, ratings assigned by Crisil Ratings are relative to the sovereign rating of the Government of India, which is assumed to have the highest rating of 'AAA'.

A credit rating by Crisil Ratings indicates its current opinion on the probability of default on the rated instrument. In other words, the credit rating indicates the probability of the issuer not meeting interest and principal obligations on time and in accordance with the terms of the rated instrument. The probability is reflected in the form of an easily understandable alphanumeric scale, with ratings such as 'Crisil AAA', 'Crisil AA', 'Crisil A', or 'Crisil A1' and 'Crisil A2'.

Credit ratings are

- **Relative measures of default probability, not a guarantee against default:** A credit rating does not indicate that payment of interest and principal is completely certain. There are definitive non-zero probabilities of default for any rating category, including the highest, 'Crisil AAA'. For instance, if the default rate for a rating agency's 'AAA' category is 0.1% for three years, it indicates that out of 1,000 'AAA' ratings that the agency has assigned, one has defaulted on paying interest or principal within three years of assigning the rating. The rating only indicates that the rated instrument is less likely to default than instruments rated lower.

[1] *For the previous version of this article, please refer to the link below:*
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/basics-of-ratings/archive/crisil-ratings-and-rating-scales-dec2023.pdf

- **Not a comment on the general performance of the issuer, potential price of its bonds or equity shares or suitability to the investor:** A credit rating should not be construed as an opinion on the issuer's general performance. It is neither an opinion on the likely future price of the rated bonds nor on the potential value of the issuer's equity shares. It is not a recommendation to buy, sell or hold a rated instrument nor a comment on the market price or suitability for a particular investor. Credit ratings are based on qualitative and quantitative analysis of information provided by issuers or rated entities or obtained from other sources considered reliable; they do not constitute audits of issuers or rated entities.
- **Assigned to debt instruments alone and NOT to equity instruments:** Typically, debt instruments such as non-convertible debentures, partially convertible debentures, bonds, fixed deposits, commercial papers, bank loan facilities, short-term debt and structured debentures are rated. Entities issuing these instruments can also be rated on their capacity to meet their debt obligation on time.

A rating agency assigns ratings on the basis of its analysis of the business and financial risks associated with the rated entity and its management. The assessment of business risk includes analysis of the industry that the entity operates in *(refer to 'Criteria and Methodology' on the Crisil Ratings website for detailed sector-specific methodologies)*.

Once a rating is assigned and accepted, Crisil Ratings continuously monitors the credit quality of the rated instrument or entity—as reflected in periodic reaffirmations, upgrades, or downgrades—till such time as the rating is withdrawn. The rating may be changed, suspended, withdrawn or placed on rating watch based on one or more specific events. Accordingly, Crisil Ratings notifies investors of the same from time to time.

Policy for assigning rating outlook

The rating outlook indicates Crisil Ratings view on the direction in which a rating is likely to move over the medium term (defined as **period spanning six months to two years**). Crisil Ratings has been using outlooks since 2003 — more than a decade prior to the regulator requiring it.

While a rating conveys the most likely scenario of creditworthiness based on expected performance of a rated entity, possible alternative scenarios and their impact on creditworthiness drive the outlook. A rating outlook may be 'Positive', 'Stable' or 'Negative'. A 'Positive' outlook indicates the rating may be upgraded; a 'Stable' outlook indicates the rating is likely to remain unchanged, while a 'Negative' outlook indicates the rating may be .

Box 1: A rating outlook may be Positive, Stable or Negative

- A 'Positive' outlook indicates there is a material likelihood (at least one in three) of the rating being upgraded over the medium term
- A 'Stable' outlook indicates the rating is likely to remain unchanged
- A 'Negative' outlook indicates there is material likelihood (at least one in three) of the rating being downgraded

Issue-specific ratings are valid for the life of the instrument. Therefore, as forward-looking opinions on credit quality, the ratings incorporate assessment of future circumstances. The Crisil Ratings rating history indicates that a majority of its ratings have remained relatively stable; a large proportion of the outlooks it has assigned are 'Stable'. 'Positive' or 'Negative' outlooks are, however, assigned when there is likelihood that circumstances could change beyond the extent that has been factored into the ratings.

Outlooks are assigned to ratings of long-term instruments and fixed deposits, barring 'Crisil C' and 'Crisil D' category ratings. These are assigned irrespective of the residual maturity of instruments. Long-term credit enhanced instruments exposed to the credit risks of a single counterparty or a few counterparties are also assigned outlooks. These include ratings based on full or partial guarantees from a single party. Ratings on securitisation transactions do not carry outlooks. Outlooks can be assigned to issuer ratings (referred to as corporate credit ratings) as well. Crisil Ratings does not assign outlooks for its short-term ratings.

An outlook does not necessarily presage a rating change. For instance, a 'Negative' outlook does not indicate that the rating will be necessarily downgraded. By the same token, a rating change is not necessarily preceded by a change in outlook. In other words, all upgrades need not be preceded by a 'Positive' outlook and all downgrades need not be preceded by a 'Negative' outlook. Though rating changes in the direction indicated by the outlook are likely, unexpected events may cause a rating to change before a revision in outlook.

Policy for placing ratings on watch

Crisil Ratings may place a rating on watch if the issuer announces a merger, acquisition or demerger of business, which may impact the credit risk profile of the rated debt instrument. Ratings may also be placed on watch if the credit risk profile of the issuer is impacted by a regulatory action or when the impact of specific events on the credit risk profile cannot be accurately assessed at the point when they occur and additional information may be necessary to fully ascertain the creditworthiness of the rated instrument. The rating may be placed on watch with positive, negative or developing implications ('Watch with Positive Implications', 'Watch with Negative Implications' and 'Watch with Developing Implications', respectively).

Box 2: What does a rating on watch with positive, negative or developing implications convey?

- A rating placed on watch with positive implications indicates that the rating may be upgraded or reaffirmed
- A rating placed on watch with negative implications implies that the rating may be downgraded or reaffirmed
- A rating placed on watch with developing implications indicates that the rating may be upgraded, downgraded or reaffirmed

A listing under rating watch does not imply that a rating will necessarily change, nor is it a prerequisite for a rating change. Ratings placed on watch do not carry outlooks.

Table 1 summarises the differences between a rating outlook and a rating watch

Table 1: Rating outlook vs rating watch

	Rating outlook	Rating watch
Meaning	Indicates possible direction of movement in rating over the medium term based on assessment by Crisil Ratings of key rating sensitivity factors	Indicates uncertainty in rating due to occurrence/possible occurrence of specific events, the impact of which cannot be evaluated without additional information
Types	Outlook may be positive, stable or negative	Rating watch listings can be positive, negative or developing
Time horizon	Covers a duration of six months to two years	A rating watch is typically resolved in about 90 days
Instruments	Applicable to ratings assigned on the long-term and credit enhanced long-term scales	Applicable to all instruments including short-term instruments

Rating scales used by Crisil Ratings

Crisil Ratings assigns ratings under the following six categories:

- **Long-term:** The term 'long-term instruments' indicates bonds, debentures, other debt securities, bank loans and other fund-based facilities with maturity of more than one year. Long-term ratings are assigned on a 20- point scale, from ‘Crisil AAA’ to ‘Crisil D.’ From June 2022, fixed deposit (FD) programmes are rated on the 20-point long-term rating scale. Prior to this, Crisil Ratings assigned ratings to the FD programmes on a 14-point scale.

- **Short-term:** The term ‘short-term instruments’ indicates commercial papers, short-term debentures, certificates of deposit, intercorporate deposits, working capital borrowings and other fund- and non-fund- based facilities with maturity of one year or less. Short-term ratings are assigned on a 9-point scale, from ‘Crisil A1’ to ‘Crisil A4’ and ‘Crisil D’, denoting default.
- Crisil Ratings assigns **dual ratings** (ratings on both long-term and short-term scales) to debt instruments that have maturity of more than one year and a put option exercisable within one year from the date of issue. The first component of the rating, the long-term rating, addresses the likelihood of timely payment of principal and interest over the life of the instrument, while the rating on the short-term scale indicates the likelihood of timely payment on the instrument by the issuer if the put option is exercised. An example of dual rating is ‘Crisil AA+/Crisil A1+’.
- **Structured obligation ratings (SO):** Crisil Ratings assigns ratings to long- and short-term structured finance instruments by using the suffix SO. These ratings are assigned only to securitised or asset-backed transactions having credit enhancement/structure, which leads to the instrument being bankruptcy remote from the issuer/originator. Instruments with maturity of more than one year are rated on the long-term scale, while instruments with maturity of one year or less are rated on the short-term scale. The structured finance rating categories range from ‘Crisil AAA (SO)’ to ‘Crisil D (SO)’ on the long-term scale and ‘Crisil A1 (SO)’ to ‘Crisil D (SO)’ on the short-term rating scale.
- **Credit enhancement (CE) ratings:** Crisil Ratings assigns the suffix CE to ratings on long- and short- term instruments that are backed by explicit credit enhancement that is external (from a third party, parent or group), but the rated instrument is not bankruptcy remote from the issuer/originator. Instruments with maturity of more than a year are rated on the long-term scale while those with maturity of a year or less are rated on the short-term scale. The CE rating categories range from ‘Crisil AAA (CE)’ to ‘Crisil D (CE)’ on the long-term scale and ‘Crisil A1 (CE)’ to ‘Crisil D (CE)’ on the short-term rating scale. The suffix is applied only if the supported rating—after factoring in the explicit credit enhancement structure—is higher than the unsupported rating, implying a credit uplift provided by the structure. The ‘CE’ ratings apply only to instruments and not to the companies issuing them.
- **Corporate credit ratings (CCR):** Crisil Ratings assigns corporate credit ratings to issuers on a scale ranging from ‘Crisil AAA’ to ‘Crisil D’. These ratings indicate the degree of safety of the issuer or the rated entity with regard to timely servicing of debt obligation. Crisil Ratings also assigns these ratings to insurance companies to indicate their financial strength or ability to meet policyholder obligations.
- **Debt mutual fund scheme ratings:** Crisil Ratings assigns ratings to debt mutual fund schemes on a scale ranging from ‘Crisil AAAmfs’ to ‘Crisil Cmfs’ on the long-term scale, and ‘Crisil A1+mfs’ to ‘Crisil A4mfs’ on the short-term scale. The long-term scale is applicable to all open and close-ended schemes with original contracted maturity of more than a year. The short-term scale is applicable only for close-ended schemes with original contracted maturity of up to a year.

Box 3: Crisil Ratings rating scales

Long-term rating scale	Short-term rating scale	Structured finance rating scale		Credit enhancement rating scale		Corporate credit rating scale (CCR)	Debt mutual fund scheme rating scale	
Symbol (Rating category)	Symbol (Rating category)	Long-term SO instruments (Rating category)	Short-term SO instruments (Rating category)	Long-term CE instruments (Rating category)	Short-term CE instruments (Rating category)	Symbol (Rating category)	Long term debt mutual fund schemes (Rating category)	Short term debt mutual fund schemes (Rating category)
Crisil AAA	Crisil A1	Crisil AAA (SO)	Crisil A1 (SO)	Crisil AAA (CE)	Crisil A1 (CE)	Crisil AAA	Crisil AAAmfs	Crisil A1mfs
Crisil AA	Crisil A2	Crisil AA (SO)	Crisil A2 (SO)	Crisil AA (CE)	Crisil A2 (CE)	Crisil AA	Crisil AAmfs	Crisil A2mfs
Crisil A	Crisil A3	Crisil A (SO)	Crisil A3 (SO)	Crisil A (CE)	Crisil A3 (CE)	Crisil A	Crisil Amfs	Crisil A3mfs
Crisil BBB	Crisil A4	Crisil BBB (SO)	Crisil A4 (SO)	Crisil BBB (CE)	Crisil A4 (CE)	Crisil BBB	Crisil BBBmfs	Crisil A4mfs
Crisil BB	Crisil D	Crisil BB (SO)	Crisil D (SO)	Crisil BB (CE)	Crisil D (CE)	Crisil BB	Crisil BBmfs	
Crisil B		Crisil B (SO)		Crisil B (CE)		Crisil B	Crisil Bmfs	
Crisil C		Crisil C (SO)		Crisil C (CE)		Crisil C	Crisil Cmfs	
Crisil D		Crisil D (SO)		Crisil D (CE)		Crisil D		

Crisil Ratings may apply '+' (plus) or '-' (minus) sign to its long-term ratings from 'Crisil AA' to 'Crisil C', long-term ratings for structured finance instruments from 'Crisil AA (SO)' to 'Crisil C (SO)', long-term ratings for credit enhanced instruments from 'Crisil AA(CE)' to 'Crisil C(CE)', corporate credit ratings from 'Crisil AA' to 'Crisil C', long-term ratings for debt mutual fund schemes from 'Crisil AAmfs' to 'Crisil Cmfs', to reflect comparative standing within each category.
Crisil Ratings may apply '+' (plus) sign to short-term ratings from 'Crisil A1' to 'Crisil A4', short-term ratings for structured finance instruments from 'Crisil Á1 (SO)' to 'Crisil Á4 (SO)',short-term ratings for credit enhanced instruments from 'Crisil A1(CE)' to 'Crisil A4(CE)' and short-term ratings for debt mutual fund schemes from 'Crisil A1mfs' to 'Crisil A4mfs' to reflect a comparatively higher standing within a category.
The plus and minus signs are used to indicate finer distinctions within a rating category. The minus symbol associated with ratings has no negative connotations whatsoever.

The Crisil Ratings methodology for recognition of default

The Crisil Ratings criterion for the lowest rating, default, is normally event-specific; delay in payment of interest/principal of the rated debt will result in a rating revision to 'Crisil D' or the corresponding symbol if the rating is assigned on a different scale. Crisil Ratings applies this definition strictly to all rated debt instruments; even a day's delay on the rated debt will result in a downgrade to the default rating ('Crisil D'). For further details, please refer below section III: Crisil Ratings methodology for recognising default.

Ratings for structured obligations

Crisil Ratings uses the suffix SO in parenthesis for ratings of securitised or asset-backed transactions having credit enhancement/structure that leads to the instrument being bankruptcy remote from the issuer/originator. Structured obligation ratings apply only to instruments and not to the companies issuing them.

Typical instruments/facilities for which 'SO' ratings are assigned include:

- Asset-backed securitisation (ABS)
- Mortgage-backed securitisation (MBS)
- Collateralised debt obligation (CDO)
- Covered bonds where primary recourse is to pool loans housed in a trust, with secondary recourse to issuer
- Capital protection-oriented fund

Typical capital market instruments/facilities for which the 'CE' ratings are assigned include (but are not restricted to):

- Guaranteed bond; shortfall undertaking backed bond or other such third-party credit enhancement
- Debt backed by pledge of shares or other assets provided by third party
- Commercial mortgage-backed securities (CMBS)
- Partially guaranteed bond
- Standby letter of credit (SBLC)-backed securities
- Covered bonds with primary recourse to issuer
- Guaranteed pooled bond issuance (PBI), not through a trust
- Debt backed by payment waterfall, escrow or debt service reserve account (DSRA), but with full guarantee or DSRA replenishment guarantee from a third party
- Debt backed by letter of comfort

Typical bank loan/facilities for which 'CE' ratings are assigned include (but are not restricted to):

- Guaranteed bank loan facilities complying with the 12-point framework
- Loans backed by letter of credit, shortfall undertakings issued by central/state governments, provided these are legally enforceable, irrevocable and unconditional
- SBLC-backed facilities
- Guaranteed pooled loans issuance (PLI), not through a trust
- Debt backed by payment waterfall, escrow or DSRA, but with full guarantee or DSRA replenishment guarantee from a third party

Rating for instruments carrying non-credit risk

The Crisil Ratings long-term rating scale addresses credit risk, representing the likelihood of debt not being serviced on time. Crisil Ratings also rates debt instruments such as equity-linked debentures, which carry non- credit risks (such as market risks). It does not attempt to estimate variables such as future stock prices or commodity prices, and therefore, does not factor such risks into the ratings it assigns. In the case of principal-protected market- linked debentures, Crisil Ratings prefixes such ratings with the symbol 'PP-MLD'. The terms of such instruments indicate that while the issuer promises to pay back the face value/principal on the instrument, the coupon rate on these instruments is not fixed and is linked to one or more external variables such as commodity prices, equity share prices and indices.

Validity of ratings

The ratings by Crisil Ratings are under continuous surveillance over the life of the rated facility. In principle, all ratings assigned by Crisil Ratings address the credit risk associated with the rated facility till such time as the entire facility is redeemed in full. Ratings are subject to change at any point in time based on changes in the business or financial risk profile of the issuer or the prospects for the industry in which the issuer operates. Therefore, Crisil

Ratings does not mention a fixed validity date in its rating communication, including rating letters, rating rationales and credit rating reports. Any change in rating is published by Crisil Ratings on its website on real-time basis. The Crisil Ratings website contains latest information on all its outstanding ratings.

Withdrawal of ratings

Debt instruments or facilities rated by Crisil Ratings are under continuous surveillance over the life of the instrument. Certain conditions have to be met for withdrawal of the ratings. For details on the Crisil Ratings withdrawal policy, please refer to the article, **Policy for withdrawal of ratings**, which can be accessed at www.crisilratings.com. The Crisil Ratings withdrawal policy is in line with the Securities and Exchange Board of India (SEBI) guidelines applicable for all credit rating agencies.

Section II.
The Rating Process

Executive summary

The rating process[2] of Crisil Ratings is designed to ensure that all ratings are based on the highest standards of independence and analytical rigour. Analysis of each credit is carried out by a multi-member rating team and is based on information obtained from the issuer and on an understanding of the business environment in which the issuer operates. It is conducted within the framework of clearly delineated rating criteria. The analysis is then presented to a rating committee, comprising members with professional experience and expertise to meaningfully assess the credit. The rating committee approach entails credit assessment of an entity by a group of experienced professionals, thereby ensuring objectivity of the rating.

Once ratings are assigned, they are communicated to the issuers. The issuer has an option to appeal against the rating decision. The ratings that are accepted by the issuer are disseminated to the subscriber base and media sources of Crisil Ratings, and uploaded on its website in the form of a detailed rationale. Crisil Ratings also publishes unaccepted ratings on its website, in line with the Securities and Exchange Board of India (SEBI) guidelines.

For accepted ratings, Crisil Ratings continues to monitor the ratings on the basis of the performance of the issuer and the economic environment in which it operates. Ratings may be withdrawn on fulfilling certain conditions, which have been elaborated in the *Crisil Ratings policy on withdrawal of ratings*, available on its website.

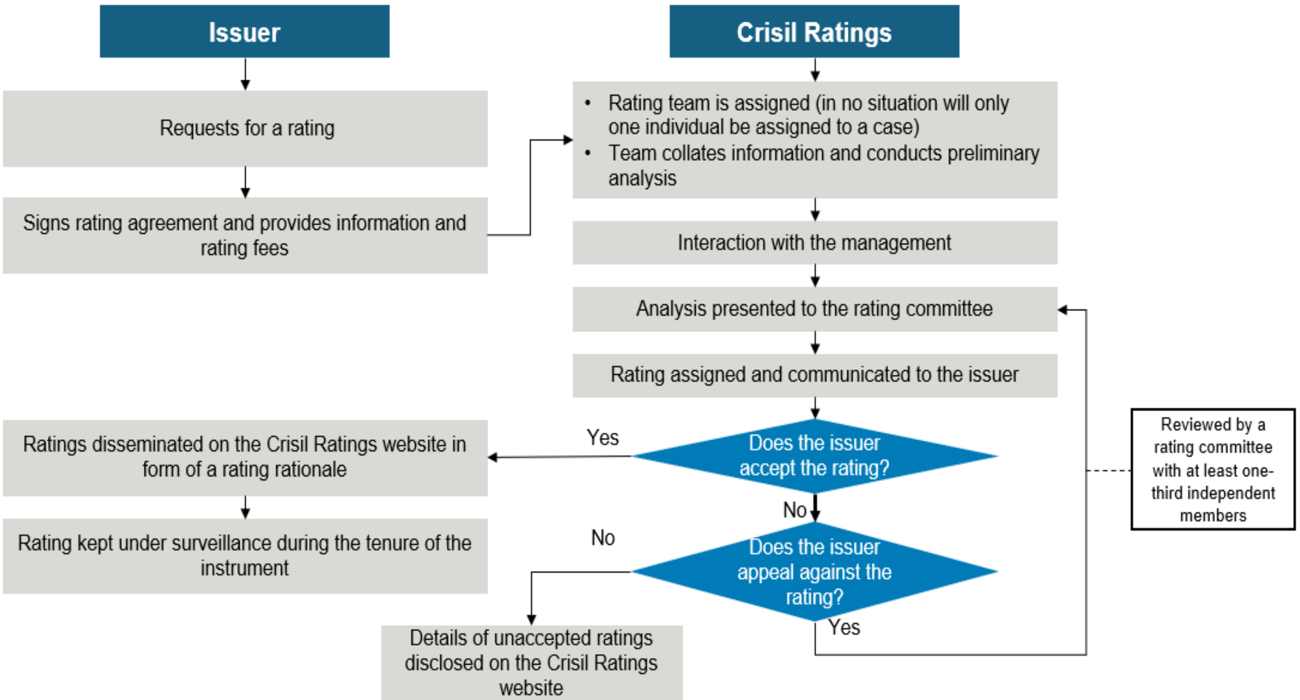
Crisil Ratings monitors its ratings on a continuous basis. In case of non-cooperation by an issuer, Crisil Ratings will rate the instrument on the basis of best available information. Please refer below section V on "*Assessing information adequacy risk*" for details on how Crisil Ratings approaches ratings with limited information. Crisil Ratings maintains confidentiality of the information obtained as part of the rating exercise by enforcing appropriate process safeguards.

[2] *For the previous version of this article, please refer to the link below:*
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/basics-of-ratings/archive/the-rating-process-feb2023.pdf

Process for credit rating assignment

The following flowchart explains the rating process followed by Crisil Ratings for a credit rating instrument. The details are explained in the succeeding section:

Rating process



The surveillance process for a rated client differs from the mentioned process in the following aspects:

- Once rated, the performance of the issuer is regularly monitored, and the rating is kept under surveillance. Therefore, the surveillance process starts from step 3.
- After a rating is reviewed, it is published on the Crisil Ratings website. Therefore, step 6 is generally followed by step 9, unless the client appeals, in which case, step 8 follows step 6. Steps 7 and 11 are not applicable in this case.

Preliminary analysis

The rating process starts with a rating request from the issuer. Thereafter, the rating agreement is signed and the fee collected from the issuer. All interactions with regard to the rating fee are carried out by the business development team of Crisil Ratings, with no involvement of the analytical team. When this process is completed, an analytical team is assigned the responsibility of assessing the issuer's credit risk profile. This rating team (comprising at least two analysts) then collates preliminary information from the issuer to understand its business, management and financial risk profiles.

The impact of security on credit rating

It may be noted that the rating addresses probability of default (PD), one of the four components of credit risk, as identified under the Basel-III methodology. Crisil Ratings does not provide any uplift to the facility rating on account of the underlying security, though asset security may have a significant impact on the loss given default component of credit risk. This is because the presence of security does not prevent default and investors usually enforce their security interests only after default has occurred. Therefore, realisations from enforcement of the underlying security do not influence PD.

Management interaction

Crisil Ratings strongly believes that investor interest is best served if there is an open dialogue between the issuer and Crisil Ratings. This enables Crisil Ratings to incorporate non-public information into its rating decision and helps it arrive at forward-looking ratings.

Management interactions can be carried out telephonically or at any of the offices of Crisil Ratings or the issuer. Discussions during management interactions are wide-ranging, covering competitive position, strategy, financial policy, historical performance, and near- and long-term financial and business prospects. In these discussions, the Crisil Ratings team focuses on the issuer's business risk profile and strategies, in addition to reviewing financial data. The ratings are not assigned based solely on financial projections made by the issuer or on the management outlook. Instead, these serve as a valuable input in the assessment of the issuer's profile as they shed light on the management's assumptions, strategy and contingency plans.

Rating committee and assignment of ratings

After the interaction with the management of the issuer, the Crisil Ratings analysts prepare a report detailing their assessment of the business, financial and management risks associated with the issuer. The report is based on rating methodologies and criteria that are clearly spelt out, published and consistently applied. The report is then presented to the rating committee. This is the only aspect of the process in which the issuer does not directly participate. The rating committee comprises experienced professionals who bring with them extensive experience in credit assessment. The rating committee assigns a rating after thorough discussions on the report prepared by the analysts.

The Rating Committee Meeting (RCM) process ensures objectivity of the rating, as the decision results from the collective thinking of a group of experienced professionals. The process also ensures high quality and consistency of analysis because the reports and discussions are focused on key rating factors that are relevant to the issuer. If Crisil Ratings and the issuer have any common directors, such directors do not participate in the RCM or rating process. A disclosure to this effect is also made with the announcement of the rating.

Communicating the rating to the issuer

On finalisation of a rating at the RCM, the rating decision is communicated to the issuer. Thereafter, a document (rating rationale) highlighting the key reasons for the rating is shared with the issuer. This is to help the issuer understand the key analytical factors that have been assessed for arriving at the rating decision.

If the issuer decides to accept the rating, it can do so by sending a letter of acceptance to Crisil Ratings. If, on the other hand, the issuer disagrees with the rating decision, it can appeal for a fresh look at the rating assigned. In such a case, the issuer needs to submit additional facts, data or new information to the ratings team, to be presented to the rating committee. Such information must be material to the appeal and should ideally address areas that have been highlighted as factors constraining the rating in the rating rationale. Pursuant to SEBI guidelines, an appeal is considered by a rating committee, wherein a majority of the members are different from the one that assigned the rating and at least one-third are independent members. The rating committee then discusses the information submitted. It may or may not change the rating depending on the facts of the case. If the rating is not changed and the issuer continues to disagree with the rating, then the issuer has the option of not accepting the rating. In line with SEBI guidelines, the unaccepted rating is also disclosed on the Crisil Ratings website.

Publication of accepted ratings

The accepted ratings are disseminated to the subscriber base of Crisil Ratings and to local and international media. The rating information is also updated online on www.crisilratings.com, the website of Crisil Ratings, in the form of a rating rationale, which provides information about the company, rated instrument, assigned rating and outlook, rationale for assigning the rating and applicable criteria, among others.

Also, Crisil Ratings, in compliance with the **International Organization of Securities Commission (IOSCO)** code of conduct, publishes a more detailed credit rating report (CRR) on its website, www.crisilratings.com. The publication of the CRR ensures transparency in rating methodologies and assumptions by Crisil Ratings and enables investors to understand how Crisil Ratings has arrived at the rating. In addition, Crisil Ratings publishes credit insights derived from its rated universe through periodic publications called Ratings Roundup (published semi-annually) and Default Study (published annually).

Timeframe

From the initial management meeting to the assignment of rating, the rating process can take up to four weeks, though Crisil Ratings sometimes arrives at rating decisions in shorter timeframes to meet urgent requirements.

Surveillance

All ratings assigned by Crisil Ratings are under continuous surveillance. After a rating has been published, Crisil Ratings continues to monitor[3] the performance of the issuer and the economic environment in which it operates. The surveillance process ensures that the analysts stay updated on current developments and changes in the issuer's plans, and review sensitive areas.

The analysts maintain periodic contact with the issuer and ensure that financial and other information is shared regularly with Crisil Ratings. Moreover, Crisil Ratings endeavours to interact with the issuer's management at least once a year. These interactions essentially focus on developments since the last interaction and the outlook for the coming year.

Withdrawal of ratings

Debt instruments or facilities rated by Crisil Ratings are under continuous surveillance over the life of the instrument. Certain conditions have to be met for withdrawal of ratings. For details on the withdrawal policy of Crisil Ratings, please refer to the article titled '**Policy for withdrawal of ratings**', which can be accessed at www.crisilratings.com. The Crisil Ratings withdrawal policy is in line with the SEBI guidelines applicable for all credit rating agencies.

Non-cooperation by issuers

Crisil Ratings monitors its ratings on a continuous basis. However, monitoring of a rated entity may become difficult because of non-cooperation by the entity. If the rated entity does not share information with Crisil Ratings on a regular basis, or does not provide access to its management or discuss quarterly/annual results, or does not pay fee for conducting surveillance, that entity can be classified as non-cooperative. Crisil Ratings rates the non- cooperative issuer on the basis of best available information. However, the aspects of non-cooperation are highlighted in the rating rationale

[3] *As per Reserve Bank of India guidelines (Master Circular - Prudential Guidelines on Capital Adequacy and Market Discipline-New Capital Adequacy Framework [NCAF]), rating agencies should review each bank loan credit at least once in 15 months*

disseminated on the Crisil Ratings website. In such cases, the rating symbol will be accompanied by 'Issuer did not cooperate; based on best available information'. This is in accordance with SEBI guidelines.

Confidentiality

A substantial portion of the information shared by the issuer is confidential and is provided only for the purpose of arriving at the rating. Such information is kept strictly confidential by the analyst team and is not shared with other divisions or group companies of Crisil Ratings. Crisil Ratings does not disseminate confidential information about the entities it rates.

All employees of Crisil Ratings are required to sign a confidentiality agreement. Crisil Ratings does not disclose issuer-specific confidential information that it has obtained for the purpose of credit rating to anyone (other than to market regulators or law enforcement authorities, if required). For further details on the Crisil Ratings confidentiality policy, please refer to the section under highlighted policies on the website.[4]

[4] https://www.crisilratings.com/content/dam/crisil/investors/corporate-governance/confidentiality-policy.pdf

Section III.

Crisil Ratings methodology for recognising default

Executive summary

Crisil Ratings believes a rating agency should articulate its definition of default clearly to ensure transparency in its operations, and should strictly adhere to its stated policy on default to ensure credibility of its default statistics.

The performance of a credit rating agency (CRA) is best judged through its default and transition statistics, which hinge on the 'event of default' on the rated debt and the manner of default recognition.

It must be noted that investor tolerance varies between the bond market and the loan market. While bond investors prefer to have default recognised instantly, investors in the loan markets exhibit more forbearance due to their relationship-oriented nature.

The Crisil Ratings norms for default recognition are in line with the best practices in the international bond/loan market as well as the expectations of domestic bond/loan investors. **Crisil Ratings recognises default on the first instance of a missed payment on a rated instrument.**

Scope

This section[5] outlines the default recognition principles of Crisil Ratings for ratings assigned to all financial instruments, long-term and short-term debt, bank loan ratings, fixed deposits and structured finance instruments, as well as corporate credit ratings (CCR).

Rating systems and their place in assessing credit risk

The utility of rating systems in assessing credit risk associated with debt or bank loan instruments is recognised universally. This is evident from the critical role that rating agencies have played in the debt security and bank loan markets over decades, and the fact that the Bank of International Settlements, which serves as a bank for central banks, encourages banks to use rating systems to assess credit risk. The Reserve Bank of India (RBI) recognises Crisil Ratings as an external credit assessment institution for bank loan ratings, and banks use ratings assigned by Crisil Ratings to assign risk weights to their loan exposures. Given the growing importance of rating systems, how default is defined has a serious import on the reliability of ratings.

Default definition and its place in rating systems

Default definition in a rating system impacts all aspects of its interpretation, including:

- **What each scale point in the system means:** The interpretation of a rating of 5 on 10 in a system that defines default as a single day's delay on a payment obligation will vary significantly from a rating of 5 on 10 in a system that factors a grace period into its definition, or a system where default is not clearly defined. All other things remaining equal, an early recognition of default is critical from an investor's perspective.
- **The magnitude of post-default recovery:** Early recognition of default will support higher levels of post- default recovery as the sooner the creditors are able to move against a defaulting borrower, the better will be their chances of realising their dues. Therefore, unless all creditors to a defaulting borrower exercise identical forbearance, the longer a creditor delays the proceedings, the lesser are the chances of recovery. Even the Insolvency and Bankruptcy Code, 2016, which aims to resolve insolvencies in a time-bound manner, recognises

[5] *For the previous version of this article, please refer to the link below:*
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/basics-of-ratings/archive/crisil-ratings-approach-to-recognising-default-jan2025.pdf

default as non-payment of debt, in part or whole, once it is due. As per the provisions, creditors (whether financial or operational, secured or unsecured) can initiate insolvency proceedings on default.

- **The default statistics:** Clarity on definition of default and consistency in its application have a direct bearing on the reliability of default statistics generated by the system. To generate credible default statistics, a rating agency must have a transparent and objective definition of default, and apply it consistently. A credible, high- quality rating system tends to generate stable default statistics over time.

Default definition in bank loan and bond markets

Across the world, the loan market has traditionally included a period of forbearance after the scheduled payment date in its understanding of default. This is perhaps considering the larger role that client relationships (extending beyond the outstanding loan) play, and the confidence of the lender in realising value from the available collateral.

The lenders' perspective on default is reflected in by the RBI definition of non-performing assets (NPAs), where banks recognise an account as an NPA when it remains unpaid for over 90 days past the due date.

On the other hand, the definition of default by S&P Global Ratings (a leading global rating agency) reflects the view of the bond market. It refers to default as a missed/delayed payment, filing for bankruptcy, or a coerced note exchange, causing an economic loss to investors, whichever occurs earliest. Thus, the bond markets favour instantaneous recognition of default, in contrast with the forbearance that is the norm in the loan market.

Incidentally, Indian regulators have also stressed the need for timely recognition of default.

The RBI, in its circular 'Guidelines on new capital adequacy framework', states that ratings on bank facilities should reflect 'timely payment of principal and interest'.
(Master circular: DBOD.No.BP.BC.4./21.06.001/2015-16/section 6.2.3 dated July 1, 2015).

The Securities and Exchange Board of India (SEBI) also emphasises that default be recognised at the first instance of a delayed payment. It has provided instrument-wise default recognition to be adopted by all CRAs. Crisil Ratings believes these regulations emphasise the need for timely recognition of default, which is the cornerstone of any rating system.

Accordingly, Crisil Ratings recognises default on the first instance of a missed payment on a rated instrument. At the same time, we understand that at times operational challenges may lead to delay in payment. However, the delay due to operational challenges, reflects neither the ability nor willingness[6] of the company to service its debt on time. These are typically very rare and are immediately remedied, hence are clearly not an indicator of the credit worthiness of the issuer/ rated instrument.

The approach for recognizing default for different types of rated debt instruments is covered in detail below.

Please refer Annexure I of this section for the instrument/facility-wise default definition followed by Crisil Ratings.

The Crisil Ratings policy on recognising default

The Crisil Ratings policy on recognising default in various instances, outlined below, is in line with the SEBI and RBI guidelines.

[6] *It may be noted that global CRAs also do not recognize such operational delays as defaults*

- **Default recognition for debt securities :** The outstanding rating is revised to 'Crisil D' at the first instance of the first rupee of default, regardless of the extent of default (what portion of the debt service obligation is not met) or the period of default (for how many days has the debt service obligation not been met).

  However, the rating may not be revised to 'Crisil D' if non-payment of debt (principal and/or interest) arises due to reasons beyond the control of the issuer, namely, failure to remit payment due to absence of correct information or due to incorrect or dormant investor account furnished by the investor(s) or due to notice/ instruction received from a government authority to freeze the account of investor(s).

  For the abovementioned reasons, Crisil Ratings shall confirm and verify the availability of adequate funds with the issuer and also confirm and verify:

  1) The proof of failure of the required payment of debt (principal and/ or interest),
  2) The reasons for failure being as specified above, and
  3) The required amounts being duly paid into a separate escrow account maintained with a scheduled commercial bank by the issuer on the due date of payment.

- **Default recognition for bank loans[7]:**
  - For bank loans with defined repayment schedule, failure to repay in full on the due date is construed as a default on the rated facility.
  - For working capital facilities such as cash credit and overdraft, which do not have scheduled maturity/ repayment dates, Crisil Ratings recognises default if the facilities remain continuously overdrawn for more than 30 straight days, without the express written consent of bankers. Though over-utilisation of a facility by a few days may not necessarily indicate stress on the credit quality of the borrower, facilities overdrawn for more than 30 days indicate weakness. Incidentally, banks need to classify such exposures under the Special Mention Account category SMA-1.
    - Similar terms apply for some non-fund- based facilities such as bank guarantees and letters of credit.
  - Typically, banks classify non-fund-based facilities that remain overdue beyond 30 days as SMA-1. Crisil Ratings deems non-fund-based facilities to be in default if the devolved amount remains unpaid for more than 30 days.
  - Crisil Ratings also follows a similar methodology for recognition of default on working capital facilities such as packing credit and bill discounting. This is in line with the RBI guidelines for recognising default on bank loan facilities.

  As part of the rating process, Crisil Ratings may seek feedback from the banker to ascertain whether the delay was on account of operational lapses on part of the lending bank or on account of liquidity issues of the borrower.

- **Default recognition for other debt instruments (such as CPs, CDs and FDs) with defined repayment schedule:** For these instruments, default is recognised at the first instance of the first rupee of default, provided the non-payment is not on account of operational issues or issues beyond the control of the issuers. Feedback from a relevant independent third party (such as IP&A/ trustee) or investor(s) may be sought to ascertain the reasons for the delay.

- **Default recognition for CCR:** Crisil Ratings assigns corporate credit ratings to issuers indicating the degree of safety of the issuer or the rated entity with regard to timely servicing of debt obligation. It also assigns these ratings to insurance companies to indicate their financial strength or ability to meet policyholder obligations. Crisil Ratings

[7] *Crisil Ratings formulates its policies for default recognition in line with regulatory directives.*

recognises default depending on the nature of the debt. However, it may not downgrade the CCR to default category if the delay is on account of operational issues or issues beyond the control of the issuers.

- **When the rated instrument is rescheduled:** If investors in a rated instrument grant a formal consent for revision in the terms of repayment sufficiently before the repayment date, unless the same is done to avoid default or bankruptcy, Crisil Ratings will factor in the revised schedule in its analysis, along with the (presumably adverse) factors that necessitated the rescheduling.
  - Crisil Ratings follows the same principle for bank loan facilities that have been rescheduled. Until lenders formally approve the request for restructuring, default would be considered from the original repayment dates.
- **When issuers default on unrated instruments:** When issuers with outstanding ratings on instruments default on external debt/loan facilities not rated by Crisil Ratings (such as vehicle loans availed from financial institutions), it is very likely that the outstanding rating will be lowered to near-default status. This is because factors that cause an interruption in servicing debt on one instrument have a very strong likelihood of interrupting debt servicing on other instruments.
  - This holds for a majority of defaults that have occurred in the rating history of Crisil Ratings. Therefore, it takes very strong mitigating factors, such as the presence of external credit enhancements, for Crisil Ratings to conclude that default on one instrument will not be followed by default on other instruments.
- **When the instruments backed by guarantee are in default:** Instruments backed by guarantee from a third party should have a document describing the payment mechanism. The document should state that if the issuer is unable to make the payment as per the terms outlined in the payment mechanism, the guarantor will clear all the dues on the guaranteed instrument within the stipulated time when the trustee/banker invokes the guarantee.
  - If the instrument is not serviced within the timeline mentioned in the payment mechanism, Crisil Ratings will downgrade its rating on the guaranteed instrument to the default category.
- **Default recognition principle for hybrid instruments:** Crisil Ratings rates both hybrid instruments and conventional debt instruments on the same scale. Ratings on hybrid instruments reflect the likelihood of timely servicing on the instrument. Hence, if the issuer skips or defers payment on the instrument, the rating on the hybrid instrument will be downgraded to 'Crisil D', even though it may be permitted to do so as per the terms of the instrument.
  - The key point to note for hybrid instruments is that transition from one rating to another can be significantly sharper vis-à-vis other debt instruments. This is because a hybrid instrument usually offers the issuer flexibility to defer payments.
- **Bankruptcy filing or coerced exchange:** The insolvency resolution process may be initiated against a company by its financial creditors, operational creditors, or by the company itself
  - If the corporate insolvency resolution process is initiated by financial creditors or the company itself, the latter would have already defaulted on its debt obligation. Hence, Crisil Ratings would shift its rating to the default category.
  - However, there may be instances where a company has not defaulted on its debt obligation, but its operational creditor has initiated the insolvency resolution process as payments are pending. In such cases, even if the insolvency resolution application is admitted by the adjudicating authority, Crisil Ratings may not shift the rating to default category. This is considering the evolving nature of judicial proceedings in such cases, as there have been instances where the appellate authority or the Supreme Court has rendered invalid the insolvency resolution application initiated by an operational creditor and admitted by the adjudicating authority. Hence, Crisil Ratings may place the rating on 'Rating Watch' in such cases, and closely monitor the judicial proceedings and debt servicing by the company. The rating will be taken to the default category only if a default on the company's debt obligation has been ascertained.

– In case of coerced exchange, where the investors need to take a haircut, Crisil Ratings will take the ratings on instruments of such entities to the default category.

- **Default recognition for past defaults:** Crisil Ratings periodically monitors the credit quality of all its outstanding ratings. However, there may be a rare instance where there has been a delayed payment on a rated instrument in the past without the knowledge of Crisil Ratings, but the account has since been regularised and demonstrates a sufficiently long track record of timely repayment. In such cases, Crisil Ratings shall downgrade the rating of the entity to the default category while simultaneously upgrading the rating to a level that considers the track record of timely repayment.

Curing period post default

Once a default is cured and the loan is regularised, Crisil Ratings monitors whether the entity has cleared overdue amounts, regularised payments, and is meeting debt and interest obligations in a timely manner for at least 90 days (from the date of regularisation) before upgrading the rating. Generally, the rating would move to the non-investment grade category after the default is cured.

The rating may be upgraded to investment grade, generally after 365 days from the date of regularisation.

The rating upgrade could be driven by –

- Sustainable improvement in the business risk profile
- Sufficient liquidity to manage working capital requirement and debt obligation
- Improvement in the financial risk profile, indicating comfortable debt coverage indicators and balance sheet strength to support business requirements over the medium term

However, Crisil Ratings may deviate from the curing period timelines on a case-to-case basis, if it believes the situation that led to the default may not recur in the near term. Some of the instances that could lead to this conclusion are:

- Change in the management
- Acquisition by a stronger firm
- Sizeable inflow of long-term funds
- Benefits arising from a regulatory action
- Force majeure event leading to default
- Restructuring of loans, as long as the business risk profile of the company remains strong
- Delay in debt servicing on account of operational or non-credit reasons

The reasons mentioned above are indicative and not an exhaustive list.

Box 1: How NPA recognition by banks is different from recognition of default by Crisil Ratings

Crisil Ratings assigns ratings to bank loans as per the terms of the facility, with respect to both, the repayment amount and date. Consequently, any failure to honour debt obligations as per the terms of the facility is construed as default on the rated facility. This is distinct from banking norms, where an account is recognised as an NPA when it remains unpaid for over 90 days after the due date. All facilities in default will carry a rating in the default category, which will continue until the arrears are cleared and a track record of at least three months of timely repayment is established.

Implications of the Crisil Ratings policy on default recognition

The policy that governs analytical treatment of default by Crisil Ratings has far-reaching implications for the interpretation of all its ratings by users, especially investors. Key points to note are:

- **Ratings are an opinion on the likelihood of the first-rupee default:** CRISIL Ratings benchmarks all instruments on its ratings scale, based on their likelihood of full and timely payment of interest and principal as per the pre-decided repayment reschedule. Therefore, rated instruments that are in default will always carry a rating in the default category, regardless of recovery prospects. Moreover, rated instruments that are likely to default in the near term (within 2-3 months) based on the current information, will also carry a 'near default' rating ('CRISIL C' or 'CRISIL D').

- **Ratings by CRISIL Ratings on a particular rating scale mean the same for all instruments:** CRISIL Ratings rates all bond instruments and bank loan facilities on its rating scale, representing the likelihood of full and timely payment of interest and principal. This policy does not, however, prevent CRISIL Ratings from factoring in post-default recoveries, if any, into its ratings on structured finance instruments such as collateralised debt obligations and partially guaranteed instruments. Such recoveries are considered for sizing credit enhancement levels, but only if CRISIL Ratings believes such recoveries are possible within the maturity of the rated instruments. Investors, therefore, need not interpret the ratings of CRISIL Ratings on structured finance instruments or guarantee-backed instruments any differently from its ratings on corporate bonds/bank loans.

- **The CRISIL Ratings default statistics are free from the effects of subjective interpretation:** The CRISIL Ratings definition of default does not include any acceptable grace period for the rated bonds. The resulting default statistics are, therefore, devoid of subjective factors that are open to varying interpretation. This allows the CRISIL Ratings default statistics to be used as a purely objective, and therefore, useful input for credit pricing.

Annexure I: Default definition followed by Crisil Ratings

Facilities	Ratings scale	Definition of default
Fund-based facilities with pre-defined repayment schedule		
Term loan	Long term	Delay of one day even of Re 1 (of principal or interest) from the scheduled repayment date
Working capital term loan		
Working capital demand loan		
Debentures/bonds		
Certificate of deposits/fixed deposits	Short/long term	
Commercial paper	Short term	
Packing credit (pre-shipment credit)	Short term	Overdue/unpaid for more than 30 days
Buyer's credit	Short term	Continuously overdrawn for more than 30 days
Bill purchase/bill discounting/foreign bill discounting/negotiation	Short term	Overdue/unpaid for more than 30 days
Fund-based facilities and no pre-defined repayment schedule		
Cash credit	Long term	Continuously overdrawn for more than 30 days
Overdraft	Short term	Continuously overdrawn for more than 30 days
Non-fund-based facilities		
Letter of credit	Short term	Overdue for more than 30 days from the day of devolvement
Bank guarantee (performance/financial)	Short term	Amount remaining unpaid for 30 days from invocation of the facility
Other scenarios		
When the rated instrument is rescheduled		Non-servicing of the debt (principal as well as interest) as per the existing terms in anticipation of a favourable response from the creditor for restructuring application/proposal shall be considered as a default. Rescheduling of the debt instrument by the lenders prior to the date of payment will not be treated as default, unless the same is done to avoid default or bankruptcy
Curing period		90 days for upgrade to speculative grade and generally 365 days for upgrade to investment grade

Section IV.

Crisil Ratings Bank Loan Ratings – process, scale and default recognition

Executive summary

A bank loan rating (BLR) by Crisil Ratings reflects its opinion on the likelihood of the financial obligation (arising from the rated facility) being serviced on time and in full, as specified in the terms of the facility.

The Crisil Ratings process for assigning ratings to bank loans is similar to that followed for rating bonds and debentures. Ratings are assigned on the long- and short-term scales, depending on the original maturity of the facility. Default on term loans is recognised on the first instance of a missed payment. For working capital and non- fund-based facilities, default is recognised if the facility remains overdrawn or irregular for more than 30 days continuously.

Crisil Ratings has been assigning BLRs since June 2007, following the announcement of prudential guidelines by the Reserve Bank of India (RBI) for implementation of the new capital adequacy framework for banks in April 2007. These guidelines require banks to link the capital they maintain on credit exposures to external credit ratings on these exposures.

The RBI has recognised Crisil Ratings as an eligible external credit assessment institution. Banks can, therefore, use ratings assigned by Crisil Ratings to compute the capital levels they need to maintain on rated credit exposures.

Scope and methodology

Crisil Ratings assigns ratings to fund and non-fund-based facilities extended by banks.

This section[8] describes the methodology of Crisil Ratings to rating bank loans—the process followed; the ratings scale used for, and the recognition of default on, each type of bank loan facility; the policy for withdrawal of ratings; and the treatment of security. It also provides an overview of the processes used for assigning ratings. It does not address detailed methodologies and industry-specific parameters used in the assessment of credit risk, which are provided in the section, Criteria and Methodology, on the Crisil Ratings website.

Significance of rating bank loans

As per the RBI guidelines for implementation of the new capital adequacy framework, banks operating in India have adopted the standardised approach for credit risk.

In the Basel-II and Basel-III approaches, which are an improvement over the Basel-I approach, the credit risk of an exposure is governed by four parameters: the probability of default (PD), the loss-given default (LGD), the exposure at default (EAD) and maturity. The BLRs assigned by Crisil Ratings address the first, that is, the PD component.

The BLR reflects the opinion of Crisil Ratings on the likelihood of the financial obligations (arising from a rated facility) being serviced on time and in full, as specified in the terms of the facility.

The Crisil Ratings process for BLRs

The process is similar to that followed for rating capital market debt instruments such as bonds, debentures and commercial paper. Chart 1 illustrates the rating process for BLRs.

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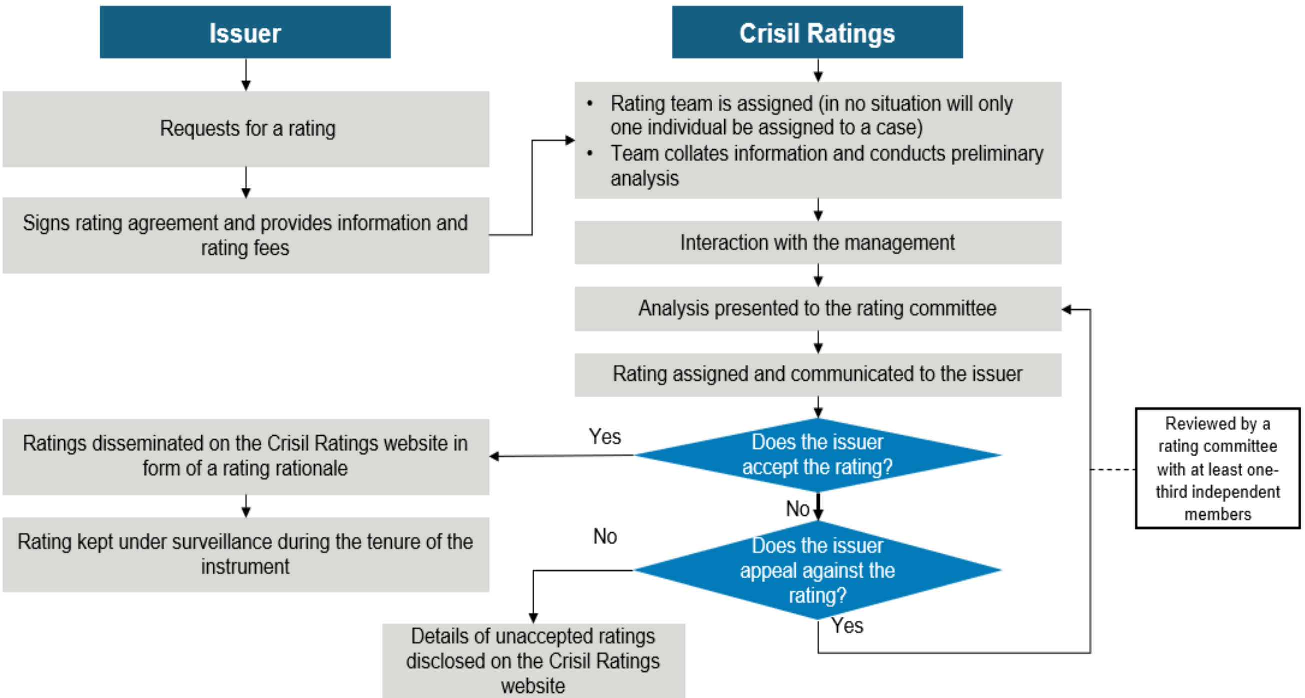
[8] *For the previous version of this article, please refer to the link below:*
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/basics-of-ratings/archive/crisil-ratings-bank-loan-ratings-process-scales-and-default-recognition-nov2024.pdf

Chart 1: The Crisil Ratings process for BLRs



The surveillance process for a rated client differs from the above process in the following aspects:

- Once rated, the performance of the issuer is regularly monitored and the rating is kept under surveillance. Therefore, the surveillance process starts from step 3.
- After a rating is reviewed, it is published on the Crisil Ratings website. Therefore, step 6 is generally followed by step 9, unless the client appeals, in which case, step 8 follows step 6. Steps 7 and 11 are not applicable in this case.

Dissemination of ratings by Crisil Ratings

Ratings assigned by Crisil Ratings are disseminated through its publications and various other media. The RBI guidelines require ratings on bank loan facilities to be available in the public domain to be eligible for risk-weighting.

Additionally, the Securities and Exchange Board of India (SEBI) guidelines require rating agencies to adhere to the International Organisation for Securities Commissions (IOSCO) Code of Conduct, which stipulates that rating agencies publish the ratings along with a report that explains the rationale for the rating opinion. SEBI also requires CRAs to publish unaccepted ratings on their website.

Crisil Ratings publishes ratings for bank facilities on its website and updates the rating list in real-time, in addition to providing the detailed rating report on the website

The impact of security on BLRs

The BLRs address PD, one of the four components of credit risk, as identified under the Basel-III approach.

Lenders usually enforce their security interests only after default has occurred. Therefore, realisations from enforcement of the underlying security does not influence PD. For instance, for availing a letter of credit (LC) facility, a company may offer

10-20% of the facility limit as a cash margin to the bank. However, the cash margin does not help the bank prevent default by the company.

Crisil Ratings, therefore, does not provide any uplift to the rating on the facility on account of the cash margin, though asset security does have a significant impact on the LGD component of credit risk.

The presence of unencumbered liquid assets on a company's balance sheet does, however, add to its financial flexibility. Crisil Ratings factors this additional financial flexibility into all its ratings.

Rating scale for BLR

Bank loans are rated on the same scale that Crisil Ratings uses to assign ratings to capital market debt instruments, including bonds, debentures and commercial paper. The rating symbols employed by Crisil Ratings to represent its different scales are covered in the article titled 'Crisil Ratings: Ratings and ratings scale', which can be accessed at www.Crisilratings.com.

Long versus short-term ratings scale

The scale used in assigning a rating to a term loan depends on the loan's original maturity as specified in the terms of the facility. It is in line with the Crisil Ratings methodology for assigning ratings to debentures. Also, the RBI guidelines specify that a bank facility's maturity is the original contracted maturity, and not residual maturity. Therefore, a term loan with an original contracted maturity of seven years, for instance, will be rated on the long-term scale, even if the residual maturity is only eight months.

Some fund-based facilities such as cash credit and working capital demand loans are sanctioned for one year. However, these facilities are often rolled over and are thus akin to long-term exposures from the bank's perspective. Crisil Ratings, therefore, usually assigns ratings to these facilities on the long-term scale. In fact, the RBI guidelines specify that banks use long-term ratings to compute capital requirement on such exposures. Other fund-based facilities such as packing credit, post-shipment credit, and bill discounting have maturity of less than a year, and are, therefore, rated on the short-term scale.

Crisil Ratings usually assigns ratings to non-fund-based facilities such as LCs or bank guarantees on the short- term scale.

When a bank guarantee is invoked or an LC devolves on the borrower, the bank makes a payment to the third party on behalf of the borrower. The borrower is required to make good this payment to the bank as per the terms of the facility within a short timeframe. As the period available for the borrower for repayment is short, these facilities are rated on a short-term scale.

Table 1: Types of credit facilities and ratings scale applicable

Fund-based facilities	Rating scale
Packing credit	Short term
Cash credit	Long term
Working capital demand loan	Long term
Purchase bill discounting	Short term
Bill purchase/discounting	Short term
Factoring/forfaiting	Short term
Post-shipment credit	Short term
Short-term loan	Short term

Fund-based facilities	Rating scale
Foreign-currency non-resident loan	Long/Short term*
Term loans	Long term
External commercial borrowings (ECBs)	Long term
Mortgage loan facility	Long term
Vendor financing	Short term
Non-fund-based facilities	**Ratings scale**
Bank guarantee	Short term
LC	Short term
Foreign exchange forward contract limit	Short term^

** Based on tenure of loan*

^ Crisil Ratings rates the credit exposure limits sanctioned to companies for covering the mark-to-market fluctuations of the foreign exchange forward contracts that the company has entered into. Default is recognised on the facility if crystallised losses are not repaid within 30 days.

Banks often sanction credit limits to borrowers and allow them the flexibility to draw down the limits as one of several pre-determined facilities. In other words, these facilities are fungible between those usually rated on the long-term scale (referred to as long-term facilities) and those rated on the short-term scale (short-term facilities). In such instances, in line with the RBI guidance, the portion of the facility that can be drawn down as a long-term facility is assigned a rating on the long-term scale, while the remaining portion is assigned a rating on the short-term scale.

Recognition of default on bank loan facilities

The Crisil Ratings methodology for default recognition is in line with regulatory guidance.

Crisil Ratings recognises default at the first instance of delayed payment for instruments/facilities with scheduled payment. For term loans, failure to repay in full on the due date is construed as a default on the rated facility. For working capital facilities such as cash credit and overdraft, which do not have scheduled maturity/repayment dates, default is recognised when the facility remains continuously overdrawn for more than 30 days without the express consent of the bankers.

As part of the rating process, Crisil Ratings may seek feedback from the banker to ascertain whether the delay was on account of operational lapses on part of the lending bank or on account of liquidity issues of the borrower.

Recognition of default on bank loan facility backed by guarantee: Bank loan facility backed by guarantee from a third party should have a document describing the payment mechanism. The document should state that if the borrower is unable to make the payment as per the terms outlined in the payment mechanism, the guarantor will clear all the dues on the guaranteed instrument within the stipulated time when the banker invokes the guarantee.

If the instrument is not serviced within the timeline mentioned in the payment mechanism, Crisil Ratings will downgrade its rating on the guaranteed instrument to the default category

Curing period post default

After a default is cured and the loan regularised, Crisil Ratings monitors whether the entity has cleared overdue amounts, regularised payments and is meeting debt and interest obligations in time for at least 90 days (from the date of regularising the default), before upgrading the rating. Generally, the rating would move to the non-investment grade category after the default is cured.

The rating may be upgraded to investment grade, generally after 365 days from the date of regularising the default.

The rating upgrade could be driven by:

- Sustainable improvement in the business risk profile
- Sufficient liquidity to manage working capital requirement and debt obligation
- Improvement in the financial risk position with comfortable debt coverage indicators and balance sheet strength to support medium-term business requirement

However, Crisil Ratings may deviate from these curing period timelines if it believes that the situation that led to the default is unlikely to recur in the near term. Some of the instances that could lead to this conclusion are:

- Change in management
- Acquisition by a stronger firm
- Sizeable inflow of long-term funds
- Benefits arising from a regulatory action
- Force majeure event leading to default
- Restructuring of loans so that the business risk profile of the company remains strong
- Delay in debt servicing on account of operational or non-credit reasons

The reasons mentioned above are indicative and not an exhaustive list.

Treatment of restructured and rescheduled debt

Crisil Ratings expects entities that have requested restructuring or rescheduling of their debt to continue to meet interest payment and principal repayment obligations on time and in full, until the lenders formally approve such requests. If borrowers fail to meet debt obligation on time and in full pending approval of the request, Crisil Ratings will treat such failure as default on the rated facilities. Crisil Ratings will use the revised repayment schedule in its analysis and recognition of default only upon receiving formal lender consent to the restructured terms.

The guidelines regarding default recognition are covered in greater detail in the above section III titled 'Crisil Ratings methodology for default recognition', which can be accessed at www.Crisilratings.com.

Withdrawal of ratings

A Crisil Ratings BLR is not a one-time exercise, but is under continuous surveillance over the life of the rated facility. The Crisil Ratings policy for withdrawal of ratings stipulates that ratings on securities/facilities that have scheduled repayment dates (such as bonds or term loans) may be withdrawn only on redemption/maturity of the rated facilities. The ratings may also be withdrawn if the debt is pre-paid by the borrower, with the lender's consent, before maturity. In such instances, Crisil Ratings relies on confirmation from the banks or auditors or any other independent sources on whether the obligations have been met in full.

BLRs can also be withdrawn by Crisil Ratings after receiving a request for withdrawal from the borrower along with a no-objection certificate from all the lending banks and on clearance of fees due (if any) to Crisil Ratings.

For further details on the Crisil Ratings withdrawal policy, please refer to the article titled 'Crisil Ratings: Policy for withdrawal of ratings', which can be accessed at www.Crisilratings.com.

Section V.
Assessing information adequacy risk

Executive summary

A credit rating by Crisil Ratings represents its opinion on the likelihood of a debt obligation being paid in full and on time. The rating indicates the current opinion of Crisil Ratings on the probability of default on the instrument, considering public and non-public information about the firm to provide a forward-looking assessment of credit quality.

Crisil Ratings believes that investor interest is best served if there is open and transparent information sharing and dialogue between the issuer and Crisil Ratings. This enables Crisil Ratings to incorporate non-public information into its rating decision and helps arrive at an independent, forward-looking assessment. Crisil Ratings would like to emphasise that information sharing is not a one-time exercise, but an ongoing and continuous process that is critical to rating surveillance.

For issuers who do not share information or engage in interactions with Crisil Ratings, the rating decision is based only on public information, and that too, only to the extent this information is available to Crisil Ratings. Hence, the rating is based on past performance, lacks a forward-looking flavour and may not reflect the robustness of ratings based on full management cooperation.

Crisil Ratings endeavours to elicit cooperation from issuers for the rating surveillance process to the best possible extent. In this context, Crisil Ratings seeks information required for surveillance on an ongoing basis. If an issuer fails to respond to requests for information, Crisil Ratings categorises the issuer as non-cooperative. This may mean that Crisil Ratings lacks adequate information to rate the issuer, and in such instances, the rating will reflect this information adequacy risk.

Scope

This section[9] details the methodology for arriving at credit ratings for issuers that do not share the necessary information and/or confirmation of timely debt servicing. The scope also covers issuers whose ratings may already be under issuer not cooperating (INC) classification, besides other issuers.

Assessment of information adequacy

As per the Securities and Exchange Board of India (SEBI) guidelines, credit rating agencies (CRAs) are required to continue to rate non-cooperative issuers on a best effort basis. To highlight the non-cooperation of issuers, SEBI regulations require that all such ratings should have the suffix 'Issuer not cooperating' (INC), with a footnote '*Issuer did not cooperate; based on best-available information'.

Crisil Ratings believes investors, lenders and all other market participants should exercise due caution when using ratings assigned/reviewed with the INC suffix. This is because these ratings lack a forward-looking perspective as they are arrived at without any management interaction and are based on best available or limited or dated information about the firm.

<u>In line with SEBI guidelines, Crisil Ratings may classify a rating as INC under following scenarios:</u>

- **Non-receipt of minimum information –** Crisil Ratings believes that for market participants to have sufficient confidence in higher rated entities, ample information about credit risks should be available and incorporated into the ratings. In the absence of such information, the confidence of investors and lenders in the credit quality of such issuers wane, indicating higher credit risk. If Crisil Ratings does not receive information necessary to carry out the rating exercise from the issuers (including non-cooperative issuers), it may mark the rating as INC.

[9] *For the previous version of this article, please refer to the link below: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/basics-of-ratings/archive/crisil-ratings-assessing-information-adequacy-risk-march2023.pdf*

Such ratings are unlikely to be in high safety category or above and may be downgraded to sub-investment grade in the absence of reasonable confidence regarding debt servicing ability.

This approach also applies to reviews of ratings that are already carrying an INC suffix. Such ratings shall continue to carry INC suffix in absence of receipt of information required for review and may be downgraded further depending on availability of information and reasonable confidence on debt servicing ability.

The ratings may be maintained in the investment grade category with INC status on a case-to-case basis, after analysing factors such as stability of the cash flow, ability to service debt in a timely manner and satisfactory feedback from the banker/lender.

- **Non-receipt of No-default Statement (NDS) for three consecutive months –** In particular, if NDS is not received for three consecutive months, the ratings shall be migrated to INC in case Crisil Ratings is unable to validate timely debt servicing through other sources like banker interaction. The rating will be migrated to INC status within a period of 7 days of three consecutive months of non-submission of NDS. However, if Crisil Ratings receives feedback from banker(s)/lender(s) or debenture trustee regarding timely debt servicing, then such a move may not be warranted.

  The approach to INC classification for non-receipt of NDS shall not be applicable to ratings that are already classified as INC or are at D.

In line with SEBI regulations, Crisil Ratings shall apply following approach to ratings in investment grade and carrying INC suffix:

- **Continued non-cooperation for six months -** The ratings on instruments of issuers that remain non-cooperative for six months shall necessarily be downgraded to non-investment grade with INC status, if already not rated in non-investment grade. As time passes, with prolonged non-cooperation, the rating may be subject to further downgrades.

Conclusion

Crisil Ratings periodically seeks information from issuers for the rating exercise. If an issuer fails to respond to requests for information, Crisil Ratings categorises the issuer as non-cooperative and reviews them on the basis of best-available or limited or dated information. This means that Crisil Ratings lacks adequate information to rate the issuer and the rating in such instances reflects the information adequacy risk. With each passing year of non- cooperation, past information will become dated and this will get reflected in the rating, while continuing under INC classification.

Section VI.

Mapping global scale ratings onto Crisil Ratings scale

Executive summary

While assigning ratings to subsidiaries, Crisil Ratings assesses the credit linkage of the subsidiary with its parent. The credit rating of the parent is a critical input in this assessment. If the parent is a foreign company, Crisil Ratings considers the rating assigned by S&P Global Ratings (S&P) to the parent company. While S&P assigns ratings to instruments on a global scale, Crisil Ratings assigns ratings on its national scale. Hence, Crisil Ratings maps the global scale ratings on the parent to its own rating scale to assess the parent's credit risk profile.

Scope

This section[10] outlines the need for mapping between the global and national scale ratings. The section also describes Crisil Ratings' approach in mapping global scale ratings assigned by CRAs such as S&P to its own scale. Crisil Ratings' mapping methodology is applied when factoring the credit linkage between a foreign parent and its Indian subsidiary, and is not used to rate a global entity on Crisil Ratings' scale. Few FAQs are also covered in Annexure I (of section VI) that highlight features of both the scales and point out the differences in their use.

Need for inter-scale mapping

In an increasingly globalised investment environment, investors seek clarity on how credit ratings by global CRAs may be mapped to ratings on the domestic scale. Credit ratings of domestic CRAs such as Crisil Ratings are not directly comparable with the global scale ratings assigned by CRAs such as S&P, even though the scales appear similar. While global scale ratings are assigned based on an assessment of the issuer in relation to other issuers globally, Crisil Ratings benchmarks the issuer against other domestic issuers.

Over the past two decades, multinationals have increased their presence in India, thereby creating the need for such inter-scale mapping. Credit ratings of the domestic arms of multinationals are influenced, to varying degrees, by the credit quality of their parents, as indicated by their outstanding ratings from global CRAs such as S&P. In rating these domestic entities, Crisil Ratings factors in parent-subsidiary linkages in a calibrated manner on the basis of objective and comprehensive framework. If the parent provides explicit guarantee for the rated debt, which is supported by an appropriate and enforceable payment structure, the rating by Crisil Ratings depends solely on its assessment of the credit quality of the guarantor. In instances where there is no explicit guarantee, Crisil Ratings assesses the strength of relationship between the parent and the subsidiary from a credit perspective, which is factored in addition to the Indian entity's standalone rating to arrive at the overall rating. In both instances, the foreign parent's credit quality is assessed after mapping its global scale rating on to Crisil Ratings' scale.

Crisil Ratings' approach to inter-scale mapping

The underlying principles guiding Crisil Ratings' mapping methodology are the following:

- The default rates of the global scale rating being mapped on to the Crisil Ratings scale should be comparable with the default rates of the mapped Crisil Ratings' rating. For instance, the global scale rating[11]being mapped to 'Crisil AA' should display similar default rates, in line with the performance of 'Crisil AA' ratings.

[10] *For the previous version of this article, please refer to the link below:*
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/criteria-research/archive/mapping-global-scale-ratings-to-crisil-scale-oct2024.pdf

[11] *Crisil Ratings considers the global scale local currency rating for mapping with the Crisil Ratings scale*

- The mapped rating on the Crisil Ratings' scale corresponding to the global scale rating on an entity should have been the rating that Crisil Ratings would have assigned to the entity, based on its own independent credit assessment.

Crisil Ratings' mapping methodology

Crisil Ratings' methodology for mapping global scale ratings to its own domestic scale is a blended approach of comparing:

- Default rates of global scale and domestic scale
- Comparison of global scale ratings on entities to that of Crisil Ratings' direct credit assessments of these entities.

Each of these approaches has its own advantages and limitations, thereby warranting a blended approach to mapping. These are highlighted below:

- **Comparison of historical default rates:** Ratings express credit risk in terms of probability of default. Hence, Crisil Ratings compares default rates when arriving at the mapping between two rating scales.

  However, inter-scale mapping based on default rates may vary with changes in default rates over time as global companies and domestic companies may be subject to different stress levels during different time periods. For instance, global companies were subject to higher stress compared to Indian companies during the global financial crisis of 2008. Conversely, the stress on Indian companies was higher during the Asian crisis of 1997.
- **Direct credit assessment:** Ideally, ratings assigned to foreign entities on the global scale are to be compared with probable ratings that would have been assigned to these entities on the national scale, based on an independent assessment of their credit risk profiles as per the rating methodologies governing the national scale ratings. However, considering the different economic and credit environments in which the foreign and domestic entities operate, this exercise becomes difficult.

  Hence, as a proxy for direct credit assessment, Crisil Ratings compares global scale ratings of Indian entities with ratings on its own scale. Global scale ratings of 'Indian companies' assigned by global CRAs such as S&P are based on their proprietary rating methodologies and benchmarking with international peers. On the contrary, Crisil Ratings' ratings on these Indian companies are based on its own rating methodologies and benchmarking with domestic peers. Hence, the comparison of these commonly rated companies considers the differences in rating methodologies and provides another input for determining the mapping between the two rating scales.

  Comparison of common ratings of Indian entities is only a proxy for direct credit assessment. Ratings on Indian entities are only a small subset of the portfolio of ratings of global CRAs such as S&P, and hence mapping based on comparison of these ratings may not be fully representative of their entire ratings portfolio. In addition, at low sovereign rating levels, "country risk" tend to dominate global scale ratings.

Crisil Ratings periodically updates the inter-scale mapping based on its methodology, to account for possible changes in the parameters being assessed depending on changes in global and domestic credit environments. Crisil Ratings may also amend its mapping methodology itself, based on its assessment of the relevance of the parameters considered for arriving at the mapping, and the availability of data to make meaningful interpretations.

Mapping global scale ratings to Crisil Ratings' scale

According to Crisil Ratings' mapping methodology, a global scale rating assigned by global CRAs such as S&P tends to map to a rating on the Crisil Ratings scale which is typically 6 to 7 notches higher than the global scale rating.

For instance, a rating of 'BBB+' on the global scale would map to either a 'Crisil AAA' or 'Crisil AA+'. A rating of 'BB+' on the global scale would map to either a 'Crisil AA-' or 'Crisil A+'. The difference between the two rating scales tends to reduce towards the lower end of the rating spectrum. For instance, a global scale rating of 'B' would map to either a 'Crisil BB+' or 'Crisil BB'. To arrive at the exact mapping level, Crisil Ratings also factors in the outlook on the parent's rating, the industry/economic scenario, and the recent history of rating actions on the parent.

Any change in the rating of the parent impacts the parent-linked ratings of its Indian subsidiaries. Changes in global scale ratings may, therefore, affect the credit quality of Indian companies rated by Crisil Ratings. This is an inevitable fallout of mapping between global and national rating scales.

Conclusion

While assessing the credit risk profile of a subsidiary, the credit rating of its parent is a critical input. If the parent is a foreign company, Crisil Ratings maps the global scale rating assigned to the parent by global CRAs such as S&P to the Crisil Ratings scale. Crisil Ratings' mapping methodology is a blended approach of comparing default rates and comparing global scale ratings on Indian entities with their corresponding domestic scale ratings assigned by Crisil Ratings. As per the methodology, a global scale rating tends to map to a roughly 6 to 7 notches higher rating on the Crisil Ratings scale. The difference reduces at the lower end of the spectrum.

Annexure I: FAQs on global scale versus national scale ratings

1. What are the various rating scales and how do they differ from each other?

Investors commonly use three rating scales:

- Global scale foreign currency ratings (typically assigned by global rating agencies)
- Global scale local currency ratings (typically assigned by global rating agencies)
- National scale ratings (assigned by both global and national rating agencies)

All credit ratings are relative assessments of credit risk on a debt issue/issuer within a given frame of reference. A global scale credit rating assesses creditworthiness relative to all other debt issues/issuers across the world and is used primarily by global investors who have the option to invest in any country. A credit rating assigned on a national scale, on the other hand, assesses relative creditworthiness within a country. It is used primarily by domestic investors.

2. Can a national scale rating be compared with a global scale rating?

A national scale rating cannot be compared directly with a global scale rating or even with the national scale rating of another country, because the best credit within a country may not be of a similar quality to the best credit globally; the frame of reference would therefore differ, as would the ratings.

Moreover, in a national scale rating, risk factors that are common to all entities in the country cease to be differentiating elements. For instance, local elements such as political risk or fiscal situation of the sovereign are country-specific, and are likely to uniformly affect all entities within that country. Although these factors are considered for credit analysis, they will not play a significant role in differentiating between credit profiles in that country. On the other hand, such factors may be significant risk elements in global scale ratings, as they can vary widely across countries.

3. What is a global scale local currency rating? How does it differ from a global scale foreign currency rating?

A global scale local currency rating assesses an issuer's ability to service debt obligation in the currency of the country in which it is domiciled. Although this rating is relative to all other debt issues/issuers in the world, it addresses only the ability to generate requisite cash in the local currency. The rating does not factor in the risk of any control on transfer and convertibility of foreign exchange that may be imposed by the sovereign government.

A global scale foreign currency rating, on the other hand, assesses the ability to service debt obligations in globally accepted hard currencies such as the US dollar, British pound, or euro. This rating is also relative to all other debt issues/issuers in the world. Moreover, any risk of control on foreign exchange transfer and convertibility is factored into a global scale foreign currency rating.

S&P states: "S&P's issuer credit ratings make a distinction between foreign currency ratings and local currency ratings. An issuer's foreign currency rating will differ from its local currency rating when the obligor has a different capacity to meet its obligations denominated in its local currency vs obligations denominated in a foreign currency."[12]

4. Why do domestic investors use national scale ratings when global scale ratings are available?

National scale ratings, including those of Crisil Ratings, provide superior credit differentiation among issuers/issues within a country. This is especially true if the sovereign rating of that country is in the low investment or speculative grade. At low sovereign rating levels, 'country risk' elements (such as political and economic risks) tend to dominate global scale ratings.

[12] *Please refer to the section on 'Local Currency and Foreign Currency Ratings' in 'S&P Global Ratings Definitions' at www.standardandpoors.com*

Thus, the global scale ratings of entities in the country will generally be clustered in a few categories around the sovereign rating and will not adequately differentiate credit risk among entities in the country.

Moreover, at any time, only a few entities from any developing country are likely to have global scale ratings; national scale ratings provide a wider coverage of entities in local markets, allowing better peer comparisons. These factors make national scale ratings more meaningful for domestic investors.

5. What are the ratings of Crisil Ratings and S&P on the Government of India?

Crisil Ratings does not have an outstanding rating on the Indian government. However, government securities are risk-free in the Indian context and hence, if rated, would carry the highest rating on the Crisil Ratings scale. Government-guaranteed instruments also carry the highest rating on the Crisil Ratings scale. This is because of the government's ability to raise taxes and print money to meet all its Indian rupee-denominated obligations.

S&P has a long-term rating of '**BBB-/Positive**'[13] on the Government of India, for both local and foreign currency obligations.

6. Why does S&P not rate all sovereigns 'AAA' for their local currency obligations?

According to S&P, "One might ask why sovereign local-currency ratings are not all 'AAA', given sovereigns' flexibility to service their local-currency debt through their extensive powers within their own borders. Although the ability to print local currency gives sovereigns flexibility, heavy reliance on such an expansionary monetary stance may fuel very high inflation, or even hyperinflation, and lead to a breakdown of all domestic currency funding options. This may cause more serious political and economic damage than rescheduling local-currency debt.

More often than not, hyperinflation leads to the downfall of the government. This observation may deter policymakers from running the printing presses at full capacity. Sovereigns may therefore prefer to default on their local-currency obligations rather than risk the more profound economic and social dislocations caused by hyperinflation. In addition, in a distressed debt exchange, a sovereign may tender for both local- and foreign currency government debt (as opposed to foreign-currency debt alone) to achieve greater debt relief."[14]

7. When can a company obtain a global scale rating higher than the rating on its sovereign?

A global scale rating on an issuer will be higher than the sovereign rating only if the entity is not expected to default in the stress scenario likely to accompany a sovereign default. The extent by which the entity's rating can be above the sovereign rating would depend on the sensitivity of the entity's sector to country risk, and the presence of mitigating factors for transfer and convertibility risk.[15] Companies that achieve such ratings typically include those that have considerable foreign currency earnings or earning prospects, and those that are not entirely dependent on the domestic economy for cash flow generation.

8. If an Indian company obtains ratings from both Crisil Ratings and S&P, which of the two should an investor use?

The answer to this depends on the investor's investment objectives. A global investor investing across countries should use the rating of S&P, which provides an assessment of the relative creditworthiness of the rated entity in relation to all other debt issues/issuers in the world. However, an investor investing predominantly in India will find the rating of Crisil

[13] The rating is as on October, 2024. Please visit www.standardandpoors.com for the rating outstanding as on date

[14] Please refer to S&P's article on "What's New in S&P Global Ratings' Updated Sovereign Rating Methodology?" at www.standardandpoors.com

[15] For more details, please refer to S&P's article on "Ratings above the Sovereign--Corporate and Government Ratings: Methodology and Assumptions"

Ratings more useful, as it provides the investor with a finer gradation of the entity’s creditworthiness in relation to other Indian issues/issuers.

9. If S&P changes its rating on an entity that is also rated by Crisil Ratings, will the latter follow suit?

Crisil Ratings’ ratings are determined under separate criteria that are not harmonised with S&P’s rating criteria. Also, S&P does not issue local scale Indian ratings. Hence, rating changes by S&P and Crisil Ratings are independent of each other. However, in some instances, the primary factors that drive credit quality may be similar for the ratings of S&P and Crisil Ratings. This can result in changes in a similar direction in both ratings, but not necessarily of the same magnitude.

Crisil Ratings

Section VII.

Meaning and applicability of ‘SO’, ‘CE’ symbols

Executive summary

Crisil Ratings used to apply an 'SO' suffix (indicating Structured Obligation) for instruments that were backed by credit enhancement structures or mechanisms. The 'SO' suffix was used to highlight the credit uplift enjoyed by the instrument over and above the rating of the issuer, due to the presence of the credit enhancement structure. Such credit enhancement supporting the payment of interest and principal on the instrument may have been internal, emanating from structural covenants inbuilt in specific transaction structures, or external, emanating from explicit contractual commitments for support from third parties.

However, the SEBI guidelines in June 2019 restrict the use of 'SO' suffix to instruments having credit enhancement/structure around cash flows that leads to the instrument being bankruptcy remote from the issuer/originator. SEBI guidelines mandate the use of 'CE' suffix (indicating Credit Enhancement), for the rating of an instrument backed by credit enhancement mechanism that is external (or from a third party / parent / group company), but the instrument is not bankruptcy remote from the issuer / originator.

The SEBI guidelines also stipulate the following:

- Disclosure of unsupported rating, without factoring the explicit credit enhancement, along with the supported rating, after factoring the explicit credit enhancement, to enable investors understand the extent of credit enhancement provided by third party/parent/group company.
- Development of models for assessment of adequacy of credit enhancement structures under various scenarios, including stress scenarios. Such an assessment should be articulated in the rating rationale.

In line with the SEBI guidelines, Crisil Ratings applies the 'CE' suffix to the rating of an instrument backed by explicit external credit enhancement from a third party / parent / group where the instrument is not bankruptcy remote from the issuer / originator. However, the 'CE' suffix has been applied only if the credit enhancement mechanism results in a credit uplift for the instrument over and above the unsupported rating of the issuer.

In April 2022, the RBI issued a guidance note (GN) to the credit rating agencies (CRAs) on assigning CE ratings for bank loan facilities. This was followed by a set of FAQs on CE ratings for bank loan facilities that the RBI shared with CRAs in July 2022.

The GN and FAQs have laid down certain conditions based on which CRAs can draw credit enhancement comfort. These are as follows:

- CRAs can rely only on explicit guarantees extended by rated external entities (including parent/group companies or by financial institutions like banks and NBFCs).
- CRAs shall not rely on other forms of diluted and non-prudent structures, viz, letter of comfort (LOC), letter of support/undertaking/responsibility/acknowledgement, obligor-co-obligor structure, etc for deriving rating comfort while assigning CE Ratings.
  - However, LoCs issued by Central/State Governments and "shortfall undertakings", which are legally enforceable, irrevocable, and unconditional in nature may be treated as valid supporting structure.
- CE Ratings shall not be assigned on the basis of credit enhancement derived through pledging of shares.
- Going forward, new CE ratings can be assigned to guaranteed bank loan facilities only when they are backed by a guarantee that is in compliance with a 12-point framework[16] as prescribed in the RBI GN. For existing bank loan

[16] *Please see the Annexure-I (of section VII) for the 12 points specified in the RBI guidance note dated April 22, 2022*

ratings backed by guarantee, RBI has permitted grandfathering the rating approach until the residual tenure of the rated instrument

Scope

This section[17] outlines the guiding principles behind the application of 'CE', 'SO' suffixes, the types of instruments which may be assigned 'CE' or 'SO' ratings. In case of 'CE' ratings, the distinction between supported and unsupported ratings are outlined in the section.

Guiding principles behind application of 'SO', 'CE' suffixes

The application of 'CE' or 'SO' suffix to a rated instrument will be driven by the following principles:

Sr. No.	Instrument type	Application of suffix to rating
1	Instrument having no explicit credit enhancement or payment mechanism /structure	No 'CE' or 'SO' suffix
2	Instrument having internal credit enhancement mechanism (due to payment mechanism/structure around cash flows), but the instrument is not bankruptcy remote from the issuer/originator	No 'CE' or 'SO' suffix
3	Instrument having credit enhancement / structure that leads to the instrument being bankruptcy remote from the issuer / originator	'SO' suffix
4	Instrument having credit enhancement that is external (or from third party), but the rated instrument is not bankruptcy remote from the issuer / originator	'CE' suffix
5	Instrument having external credit enhancement through guarantees or other structures, but the CRA believes that the structure does not enhance the rating of the instrument (over and above the issuer's credit profile)	No suffix

Typical application of 'SO' or 'CE' suffix for bank loan facilities, commercial papers and instruments backed by securitisation

SO suffix – securitised, asset backed transactions with credit enhancement structures that lead to the instrument being bankruptcy remote from the issuer/originator	CE suffix – instruments backed by external credit enhancement from third party / parent / group company, but instrument not bankruptcy remote from the issuer/originator
• Asset Backed Securitisation (ABS) • Mortgage-Backed Securitisation (MBS) • Collateralised Debt Obligations (CDO)	• Guaranteed loan facilities complying with 12-point framework • Loans backed by LOC, Shortfall undertakings issued by Central/State Governments provided these are legally enforceable, irrevocable and unconditional • SBLC backed CPs or other instruments/facilities • Guaranteed pooled loans issuance (PLI), not through a trust • Debt backed by Payment Waterfall /Escrow, DSRA etc., but with Full Guarantee or DSRA Replenishment Guarantee from a third party

[17] *For the previous version of this article, please refer to the link below:*
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/structured-finance/archive/meaning-and-applicability-of-so-ce-symbols-feb2023.pdf

Typical application of ‘SO’ or ‘CE’ suffix for bonds and other capital market instruments

SO suffix –credit enhancement structures that lead to the instrument being bankruptcy remote from the issuer/originator	CE suffix – instruments backed by external credit enhancement from third party / parent / group company, but instrument not bankruptcy remote from the issuer/originator
• Covered bonds where primary recourse to pool of loans housed in a trust, with secondary recourse to issuer • Capital protection-oriented funds	• Guaranteed bond, Shortfall undertaking backed bond or other such third-party credit enhancement • Covered bonds which have to be serviced primarily by the issuer (i.e., primary recourse to issuer), with secondary recourse to the cash flows from the pool of loans housed in a trust • Partially guaranteed bond • Commercial Mortgage-Backed Securities (CMBS)-like structures • Standby Letter of Credit (SBLC) backed securities • Debt backed by pledge of shares or other assets provided by third party. • Guaranteed Pooled bond issuance (PBI), not through a trust • Debt backed by Payment Waterfall /Escrow, or DSRA etc., but with Full Guarantee or DSRA Replenishment Guarantee from a third party • Letter of comfort

The ‘CE’ suffix is used only if the presence of the credit enhancement structure or mechanism results in a credit uplift for the instrument over and above the unsupported rating of the issuer.

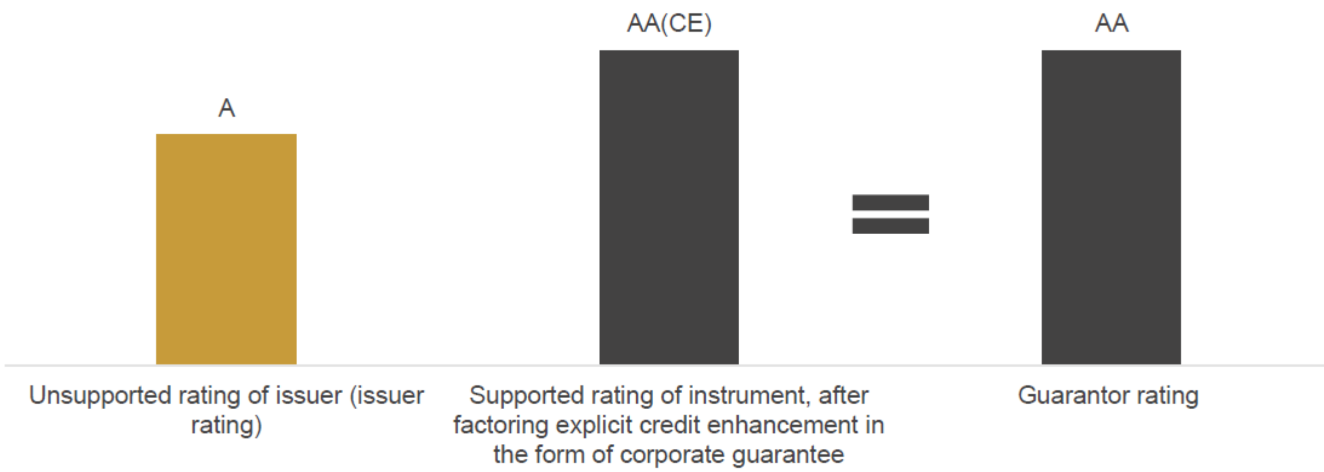
Supported vs unsupported ratings for ‘CE’ structures

Supported ratings factor in the explicit credit enhancement. Unsupported ratings do not factor the credit enhancement from third party. Though explicit external credit enhancement is not factored in the unsupported rating, any implicit support from, say, a parent or group company, will be factored in.

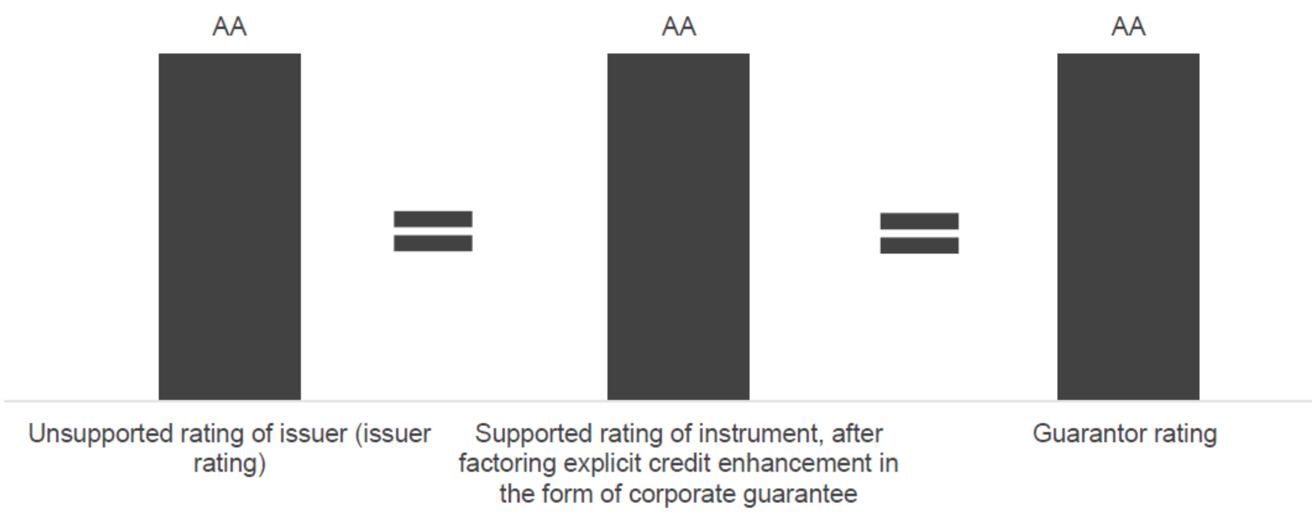
The supported rating on a credit-enhanced instrument will be assigned the ‘CE’ suffix only if it is higher than the unsupported rating of the issuer. In other words, ‘CE’ suffix will be applied only if the external credit enhancement structure provides a credit uplift over and above the unsupported issuer rating. In the absence of any credit uplift, the credit enhancement structure does not add any enhancement to the instrument’s rating.

Illustration: Supported and unsupported ratings for debt backed by corporate guarantee from the parent

Scenario 1: Supported rating > Unsupported rating; CE suffix for supported rating



Scenario 2: Supported rating = Unsupported rating; No CE suffix for supported rating



Assessment of adequacy of 'CE' structures

The financial position of the third party providing the credit enhancement, and the impact of extending payment support to the issuer are assessed to determine the ability of the structure to ensure full debt repayment. Several scenarios, including stress scenarios, are considered.

For instance, in the case of corporate guarantees, the impact of the guaranteed liabilities on the guarantor's credit profile, which, in turn, determines the supported rating of the guaranteed instrument, is considered. Stress scenarios correspond to varying levels of guaranteed debt that are assumed to devolve on the guarantor, and their impact on the guarantor rating. The results of such stress testing are articulated in the rating rationale.

Crisil Ratings also scrutinises contractual agreements underpinning the structure to assess the legal risks involved. Legal opinions are obtained, wherever required, in order to confirm the adequacy of the legal provisions in the transaction documents.

For more details, please refer below to section XI "Crisil Ratings methodology for rating instruments backed by guarantees".

Conclusion

Crisil Ratings applies 'SO' suffix to securitization or asset backed transactions backed by credit enhancement structures that lead to the instrument being bankruptcy remote from the issuer/originator. On the other hand, 'CE' suffix is applied to the ratings of instruments backed by explicit credit enhancements that are external, or from third parties / parents / group companies, but the instrument is not bankruptcy remote from the issuer/originator. The 'CE' suffix is applied only if the supported rating after factoring the explicit credit enhancement structure is higher than the unsupported rating without factoring the structure, thereby implying a credit uplift provided by the structure. The adequacy of the 'CE' structure to ensure full and timely debt repayment is evaluated under various scenarios, including stress scenarios.

Annexure I: 12-point framework to assess the strength of the guarantee

It should be unconditional: The support extended should be unconditional in nature in honouring the obligations under the guarantee.

It should be irrevocable: The support provider should not revoke the guarantee till all the obligations of the borrower are fully paid to the lender.

It should be enforceable: The support extended should be legally enforceable at any time during the tenure of rated facility.

The support should be for the facility in its entirety: The support should cover the entire facility being rated as applicable, including principal, interest or any other amounts payable as per the terms of the facility. In case of partial guarantees, the rating comfort derived shall be restricted to the extent of partial guarantee provided.

Guarantee for payment: The obligation of the support provider should be to pay the guaranteed amount without demur as per the sanctioning terms in case of default by the borrower and not merely ensure repayment by the borrower.

Payment mechanism: The guarantee deed should specify timelines for invocation of the guarantee by the lender, and for subsequent payment by the support provider.

Payment on first demand: The support provider should make payment under the guarantee on receipt of the first demand or notice from the lender as per the terms of the guarantee.

Payment without deduction: All guaranteed payments are to be made by the guarantor without any deductions.

Rights of Support provider to be Waived: The Indian Contract Act, 1872 provides certain rights to the guarantors, including automatic termination of the guarantor's obligations under certain situations (such as change in the terms of contract without the guarantor's consent as per Section 133). Hence, in case of any change in the terms of the contract, the guarantee needs to be reaffirmed by the guarantor for it to be treated eligible as a valid support for deriving the CE rating.

Guarantor is primary obligor: The lender is entitled to proceed against the support provider without waiting to exercise all its remedies.

Payment should happen in the event of insolvency: The support provider should agree to make payments even in case of any insolvency, liquidation, dissolution or any other analogous proceedings against the rated entity.

Overseas guarantors: If the guarantee is extended by an overseas support provider (foreign parent) in respect of subsidiaries/ group entities/ affiliates operating in India, the foreign guarantor should continuously hold a rating from at least one of the international rating agencies (S&P, Fitch Ratings and Moody's Ratings), which corresponds to a lower risk weight than the standalone rating of the borrower. Further, the CRAs shall assess all the aforementioned features of the guarantee and also ensure if there are no regulatory or legal issues in the guarantor making remittances under the guarantee as per the existing legal/ regulatory framework in the jurisdiction of the guarantor.

Section VIII.

Crisil Ratings methodology for rating short-term debt

Executive summary

Crisil Ratings assigns ratings to instruments with an original contracted maturity of up to one year, such as commercial papers (CPs), on a short-term scale. Such short-term instruments are generally rolled over or refinanced on maturity. The ability to refinance the short-term debt (STD) depends on the long-term credit risk profile of the issuer. Hence, the short-term rating is derived from the long-term rating of the issuer. Crisil Ratings uses a mapping framework for capturing the linkage between long-term and short-term ratings. Liquidity backup, wherever applicable, may be required to address the refinancing risk associated with confidence-sensitive instruments such CPs and short-term non-convertible debentures (NCDs).

Scope

This section[18] covers Crisil Ratings' methodology for arriving at short-term ratings of issuers. It covers the mapping framework for deriving short-term ratings from long-term ratings and analysis of the liquidity of issuers undertaken in conjunction with the mapping framework. It also details the liquidity backup requirements for confidence-sensitive short-term instruments.

Methodology

STD, including CP, is different from long-term debt; while the latter is expected to be repaid out of the internal cash accrual of the business, STD is usually rolled over.

The steps followed for arriving at the short-term rating are:

Step 1: Assess the underlying credit quality of the issuer, as reflected in its long-term rating

Step 2: Assess liquidity and analyse the monthly bank limit utilisation of the issuer

Step 3: Arrive at a short-term rating using a mapping framework

Step 4: Evaluate the liquidity backup[19]

Step 5: Evaluate credit enhancement options, if applicable

Step 1: Assess the underlying credit quality of the issuer

Crisil Ratings' rating on a CP or STD is primarily dependent on its opinion of the issuer's fundamental credit quality. The analytical approach adopted for assigning such a rating is very similar to that for a long-term rating as there is a strong linkage between the two. While the tenure of a CP is 7-365 days, the short-term rating's time horizon extends well beyond this period because even such ratings are expected to endure over time rather than change frequently. Moreover, if the maturity of a CP or STD issue cannot be met through subsequent CP or STD issues (rollover) for any reason, the issuer has to rely on fresh borrowings. In such a case, ability to refinance will largely depend on the fundamental credit quality, as reflected in its long-term rating.

Step 2: Assess liquidity

Once the long-term rating is assessed, Crisil Ratings' rating methodology takes into account the issuer's current liquidity. For non-financial sector entities (non-FSEs), this entails a detailed analysis of the adequacy of internal sources of funds for

[18] *For the previous version of this article, please refer to the link below:*
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/criteria-research/archive/criteria-for-rating-short-term-debt-nov2022.pdf
[19] *Wherever applicable*

covering short-term uses, including working capital requirement. This includes an assessment of the average monthly bank limit utilisation for the past 12 months, as well as of the variations in the working capital cycle of the issuer. Where applicable, assessment of the variations in the drawing power during the past 12 months as a proportion of the sanctioned bank limits serves as additional input for the analysis.

For FSEs, liquidity assessment focuses on the cumulative asset-liability mismatches over various maturity buckets, and the adequacy of liquid assets to cover maturing liabilities. Among FSEs, banks and primary dealers (PDs) enjoy more liquidity than non-banking financial companies (NBFCs) and housing finance companies (HFCs) due to their access to the liquidity adjustment facility (LAF) of the Reserve Bank of India (RBI) and call money markets.

Step 3: Mapping framework

While the short-term ratings are linked to the long-term ratings, the assessment made in Step 2 provides some flexibility in determining the exact mapping of a given long-term rating into the short-term scale. The long-term rating scale has more levels and hence there may not be a one-to–one mapping between the two scales (see Table 1).

The mapping adopted for financial sector companies may be different from that for manufacturing companies, primarily on account of better liquidity and easier access to funds by the former.

Table 1: Mapping between short-term and long-term ratings (ratings within brackets only in exceptional cases)

LT rating	Corporates	Other Fin sector entities (other than banks and PDs)	PDs	Banks
AAA	A1+	A1+	A1+	A1+
AA+	A1+	A1+	A1+	A1+
AA	A1+	A1+	A1+	A1+
AA-	A1+	A1+	A1+	A1+
A+	(A1+) A1	A1+ (A1)	A1+	A1+
A	A1 (A2+)	(A1+) A1 (A2+)	A1+ (A1)	A1+
A-	(A1) A2+	A1 (A2+)	A1	A1+ (A1)
BBB+	(A2+) A2	A2+, A2	(A1) A2+	A1 (A2+, A2)
BBB	(A2) A3+ (A3)	(A2) A3+ (A3)	(A2+) A2	(A1) A2+, A2
BBB-	(A2, A3+) A3	(A2, A3+) A3	(A2) A3+, A3	A3+, A3
BB+	A4+	A4+	A4+	A4+
BB	A4+	A4+	A4+	A4+
BB-	A4+ (A4)	A4+ (A4)	A4+(A4)	A4 + (A4)
B, C categories	A4	A4	A4	A4

Crisil Ratings may deviate from its mapping framework when it has a particular reason to ascribe a stronger (or weaker) short-term credit quality and may assign a higher (or lower) short-term rating. The ratings within brackets in Table 1 indicate the typical deviations that may be taken. The deviations will be based on the analysis of liquidity, wherein Crisil Ratings evaluates the extent of short-term sources of funds vis-à-vis short-term funding requirement.

In some instances, Crisil Ratings may put a ceiling on the allowable quantum of short-term debt based on the maturity profile of the assets and liabilities, liquidity, and refinancing ability.

Step 4: Evaluate the liquidity backup

Liquidity backup is typically provided to confidence-sensitive instruments, on which the issuer may default in times of temporary financial stress. These are instruments that are susceptible to default due to loss of confidence among investors, which may jeopardise the financing options of the issuer as well as other issuers of the same instrument class and lead to a series of defaults. For instance, if depositors lose confidence in a bank, they may queue up for premature withdrawal, leading to a run on the bank's deposits.

Similarly, in the STD market, default by one issuer may cause nervousness among investors about other issuers and may prompt them to not roll over the STD facilities. Therefore, it is essential for the issuers to maintain liquidity backup on STD to prevent such financial contagion. The importance of liquidity backup is reflected in the fact that a majority of CPs are being primarily carved out of working capital limits, despite RBI allowing the issuance of CP as a distinct product. The maintenance of liquidity backup allows issuers to weather wide-spread disruptions in the CP market or lack of investor interest in the CP issued.

Liquidity backup for non-FSEs

Crisil Ratings may not insist on liquidity backup for non-FSE issuers rated 'Crisil AA-'or above on the long-term scale. That's because such highly rated issuers typically have substantial liquidity and high refinancing ability based on their market reputation. However, Crisil Ratings may obtain liquidity backup on a case-to-case basis if it believes that this is warranted depending on the analysis of the liquidity of the issuer, its capital structure, cash flow stability, and the characteristics of the industry in which it operates. While analysing liquidity, Crisil Ratings considers the ability of the issuer to meet short-term uses of funds such as working capital, repayment of maturing debt, and a portion of capital expenditure, without having to resort to additional borrowing. In all cases, however, the liquidity plan articulated by the issuer is evaluated.

Crisil Ratings insists on liquidity backup for corporates rated 'Crisil A+' or below. This is assessed for STD under two options:

- **Liquidity backup to the extent of 100% of outstanding STD:** Crisil Ratings insists on 100% liquidity backup for the value of outstanding STD until its maturity.
- **Liquidity backup for STD maturing over the next few days on a rolling basis:** Stipulation of 100% liquidity backup for the entire outstanding STD of highly rated entities may not be necessary in all cases. That's because many such entities have strong liquidity as they consistently maintain sufficient liquid assets to meet short-term requirements. Hence, Crisil Ratings may stipulate a rolling liquidity backup for total STD (rated and unrated) maturing, say in the next "N" days. The stipulation of the number of days is based on evaluation of the specific liquidity plan and other factors such as gearing, current ratio, debt repayment in the near to medium term, availability of alternative options to meet STD redemptions, and propensity of the issuer to rely on STD.

The various forms in which a corporate can provide liquidity backup are:

- Drawing power available against unutilised bank lines
- Investments in liquid MFs
- Cash/unpledged fixed deposits in a bank, of a similar or higher short-term rating in comparison with the issuer

Crisil Ratings also assesses the quality of the liquidity backup facility while assigning the short-term rating. For issues that are carved out of the existing working capital bank limit, the limit would function as a liquidity backup. For other forms of liquidity backup facilities, Crisil Ratings looks at the nature and commitment of the facility, its tenure, the strength of the relationship between the issuer and facility provider, and the covenants/restrictions affecting the issuer's ability to access the facility. Crisil Ratings does not insist on a liquidity backup for companies that have availed of only bank facilities.

Liquidity backup for FSEs

FSEs typically have better liquidity than those engaged in manufacturing, trading, and infrastructure. Hence, Crisil Ratings may not insist on pre-arranged liquidity backup facilities for all classes of FSEs. Crisil Ratings' analysis of the liquidity of an FSE involves understanding the extent of mismatches in its asset- liability maturity (ALM) profile. Also considered is the liquidity plan presented by the issuer with specific emphasis on its policies regarding maintaining liquid assets, staggering of the debt maturities so as to avoid bunching up of repayments, and ease of access to systemic liquidity.

- **Banks and PDs:** Access to systemic liquidity under the LAF of RBI and access to unsecured borrowing in the call money markets enable banks and PDs to comfortably manage liquidity. Hence, Crisil Ratings may stipulate liquidity backup requirements for such companies only in exceptional circumstances. Lack of access to refinance from the regulator and a low long-term rating would typically necessitate a financial sector issuer to provide liquidity backup for availing rating for its confidence-sensitive STD instruments from Crisil Ratings.
- **Other FSEs (NBFCs, HFCs, FIs):** For such entities, Crisil Ratings may not insist on liquidity backup if the issuer is rated 'Crisil AA-'or above on the long-term scale. That's because such highly rated issuers typically have a prudent ALM profile and have high refinancing ability. However, Crisil Ratings may obtain liquidity backup on a case-to-case basis if it believes that liquidity backup is warranted based on the analysis of the asset quality of the issuer, its ALM profile, and the presence of liquid assets to cover asset-liability mismatches. In all cases, however, the liquidity plan articulated by the issuer is evaluated.

Crisil Ratings insists on liquidity backup for NBFCs, HFCs, and FIs rated 'Crisil A+' or below. The liquidity backup may be a combination of the following:

- Sanctioned and unutilised bank lines
- Sanctioned and unutilised refinance limits from financial institutions such as RBI, National Bank for Agricultural and Rural Development (NABARD), National Housing Bank (NHB), Small Industries Development Bank of India (SIDBI), and Export-Import Bank of India (EXIM Bank).
- Investments in liquid MFs or money market instruments
- Investments in listed equity shares subject to suitable hair cuts
- Finance limits provided by parent/group company (rated in at least the 'AA' category)
- Unpledged fixed deposits
- Loan against shares facility from a 'AAA' rated NBFC, provided it is accompanied by a board resolution and other relevant authorisations required

Although liquidity backup facilities are a pre-requisite for rating a CP, Crisil Ratings does not enhance CP ratings based on the backup. That's because most liquidity backup facilities are technically revocable by the facility provider if the credit quality of the issuer deteriorates during the time when the rated instrument is outstanding. In its purest sense, the liquidity facility's purpose is to cover temporary shortfalls in the issuer's cash flows. This means that even the strongest form of backup does not enhance the underlying credit and does not lead to a higher rating than indicated by the issuer's own creditworthiness. Thus, liquidity backup facilities provide support only in times of market disruption and not when the fundamental credit quality of the CP or STD issuer deteriorates. Crisil Ratings enhances short-term ratings only based on unconditional and irrevocable credit-support facilities, which, if available, are evaluated in the next step of the rating process.

Step 5: Evaluate credit enhancement options

Commercial banks may provide back-stop facilities for credit enhancement, such as a standby credit facility. These are distinct from liquidity facilities and work like guarantees. Corporate entities may also provide guarantees for a CP issue. A standby credit facility or a guarantee is unconditional and irrevocable and is available under all circumstances to meet obligations on the issue if the primary obligor (the issuer) fails to do so. In such cases, the CP/STD rating is generally equated to that of the facility provider irrespective of the issuer's standalone rating. For more details, please refer below to section XI on “Crisil Ratings methodology for rating instruments backed by guarantees”.

Box 1: Ratings for CP issues of IPO Financiers

Crisil Ratings assigns ratings to commercial paper issues which are used for raising resources for financing investors in initial public offerings (IPO) and follow-on public offers. It is to be noted that the rated quantum of commercial paper for IPO financing could be higher than the steady-state business-as-usual requirement given the oversubscription in many of the IPOs. However, appropriate structure is present for the entire IPO process which ensures that the overall process of fund flow is well defined; the bank account of client for application money and the DEMAT account where shares are allotted, are controlled by the lender. Also, an accurate estimation of demand for the IPO makes the debt structure largely self-liquidating.

It is also of a significantly shorter tenor, being linked to the duration of the IPO process. The rating on these instruments will typically be at the same level as that of the regular commercial paper issuance of the issuer. In assigning these ratings, Crisil Ratings factors in the significantly low degree of risks of this product due to the largely self-liquidating structure of IPO financing wherein the amount refunded post allocation of securities covers the quantum funded by the lender. This is ensured through the margin policy of the lender; the margin collected from the client is a function of the expected oversubscription level. Given the operational intensity of IPO financing, in assigning these ratings, Crisil Ratings also factors in the risk management systems and processes of the lender, as well as the experience of the lender in IPO financing.

Conclusion

Crisil Ratings assigns short-term ratings to instruments with original contracted maturity of less than one year, such as CPs and STD. These short-term ratings are derived from the long-term ratings of issuers as per a mapping framework that captures the linkages between long-term and short-term ratings. The mapping is different for FSEs and non-FSEs to account for inherent differences in their liquidity. Crisil Ratings also analyses in detail the liquidity of the issuer to arrive at the exact mapping level as per the mapping framework. Crisil Ratings typically insists on liquidity backup for CPs and STD, except for certain FSEs and highly rated issuers with strong liquidity.

Section IX.

Crisil Ratings methodology for rating fixed deposit programmes

Executive summary

Crisil Ratings rates fixed deposit (FD) programmes floated by banks, deposit-taking non-banking financial companies (NBFCs), and corporates in the non-financial sector. FDs allow companies to diversify their funding profile. Under an FD programme, the issuer accepts deposits of varying amounts and tenure from multiple investors. FDs are usually granular with maturities staggered across time horizons. Also, as a considerable portion of FDs are renewed on maturity, their repayment exerts less pressure on the liquidity of the issuer.

Crisil Ratings used to rate FDs on a 14-point rating scale (see Table 1) till June 2022. In compliance with the Securities and Exchange Board of India (SEBI) guidelines on standardisation of rating scales[20] and The Reserve Bank of India (RBI) guidelines on minimum investment grade credit ratings for deposits of NBFCs[21], Crisil Ratings now uses the SEBI standardised long term rating scale for rating of FDs as well.

In line with the change in the FD rating scale, Crisil Ratings has revised its mapping framework for assigning FD ratings. Consequently, Crisil Ratings has migrated its existing ratings on FD programmes from the dedicated FD rating scale to the SEBI-standardised long-term rating scale.

This migration has resulted in a change in the rating symbol, which indicates only a recalibration of the rating from one scale to another and does not reflect any change in the credit risk profile of the FD programme. That is, it is neither an upgrade nor a downgrade of the underlying credit risk profile of the FD programme. Crisil Ratings will continue to rate short-term FD programmes on its nine-point rating scale.

Scope

This section[22] explains Crisil Ratings methodology for rating FD programmes floated by companies. It outlines the mapping framework used to derive the rating on the FD programme from the long-term credit rating of the issuer. Crisil Ratings had fine-tuned the framework in line with the shift in the FD rating scale (from 14-point to 20-point) as mandated by SEBI.

This framework is only applicable to FD programmes with contracted maturity of more than a year. Banks may float FD programmes with contracted maturity of up to a year. Such programmes, however, are rated on the short-term credit rating scale of Crisil Ratings based on its ‘Crisil Ratings methodology for rating short-term debt’. These ratings are also derived from the issuer’s long-term credit rating. Crisil Ratings employs different methodologies for assessing the issuer’s long-term credit rating, depending on the sector in which the issuer operates. These methodologies can be accessed at www.Crisilratings.com.

Rating scale

Crisil Ratings will rate FD programmes with contracted maturity of more than a year on the SEBI-standardised 20-point rating scale (‘Crisil AAA’ to ‘Crisil D’). Short-term FD programmes — with contracted maturity of up to one year — offered by banks are rated on the short-term credit rating scale (‘Crisil A1+’ to ‘Crisil D’). For more details on the rating scales, please refer to https://www.Crisilratings.com/ratings/credit-rating-scale.html.

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[20] Refer SEBI ‘OPERATIONAL CIRCULAR’ dated January 6, 2023, section 5.1 on Standardization of Rating Symbols and Definitions

[21] https://rbidocs.rbi.org.in/rdocs/notification/PDFs/37CMIGR37687B27DCA44E1E9019CC2118E0D0F3.PDF. For FDs raised by finance companies, RBI is the regulator and for those raised by non-financial corporates, the MCA is the concerned regulator. Both RBI and MCA now require FDs to be rated at a minimum investment grade for companies to be eligible to raise FDs. Investment grade rating threshold is as specified by the RBI; MCA notification dated June 29, 2016, also refers to the same threshold as defined by the RBI - https://www.mca.gov.in/Ministry/pdf/Rules_30062016.pdf

[22] For the previous version of this article, please refer to the link below: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/criteria-research/archive/crisil-ratings-criteria-for-rating-fixed-deposit-programmes-mar2023.pdf

Table 1: Migrating from the 14-point rating scale to the SEBI-standardised 20-point scale

14-point FD rating scale	
1	FAAA
2	FAA+
3	FAA
4	FAA-
5	FA+
6	FA
7	FA-
8	FB+
9	FB
10	FB-
11	FC+
12	FC
13	FC-
14	FD

Standardised 20-point scale	
1	Crisil AAA
2	Crisil AA+
3	Crisil AA
4	Crisil AA-
5	Crisil A+
6	Crisil A
7	Crisil A-
8	Crisil BBB+
9	Crisil BBB
10	Crisil BBB-
11	Crisil BB+
12	Crisil BB
13	Crisil BB-
14	Crisil B+
15	Crisil B
16	Crisil B-
17	Crisil C+
18	Crisil C
19	Crisil C-
20	Crisil D

Methodology

FDs are floated as programmes. There is a strong linkage between the rating on an issuer's FD programme and its long-term credit rating, which reflects the fundamental credit quality of the issuer, and also factors in the issuer's funding sources (including FDs), debt repayment profile, and liquidity.

In general, the rating on the FD programme will be the same as the long-term credit rating of the issuer as FDs are ranked pari-passu with other senior debt instruments.

For banks[23], Crisil Ratings may map the rating on the FD programme one notch higher than that of the issuer rating. The one notch higher rating is demonstrated by the fact that the investors in fixed deposits of scheduled commercial banks in India have not faced any losses in the past. The mapping framework factors banks' access to systemic liquidity; RBI's regulatory oversight over banks including efforts to safeguard interests of depositors; and deposit guarantee provided by the Deposit Insurance and Credit Guarantee Corporation (DICGC) up to a certain quantum. The mapping framework for banks will also take into account the ownership pattern of the bank (public or private sector banks); and the quality of the FD program reflected in parameters like granularity, and maturity profile of the FD program.

[23] *Scheduled commercial banks*

Conclusion

FD programmes of issuers are rated on the standard 20-point long term rating scale. Ratings are derived from the long-term credit ratings of issuers and in general will be the same as the issuer rating.

For banks, Crisil Ratings may map the rating on the FD programme one notch higher than that of the issuer rating. This is to account for banks' superior access to systemic liquidity, the RBI's oversight over banks including efforts to safeguard interests of depositors, and the presence of deposit insurance. The mapping for banks will also take into account the ownership pattern of the bank and the quality of its FD programme.

Section X.

Crisil Ratings methodology for partially guaranteed instruments

Executive summary

A partial guarantee structure in a debt instrument refers to a mechanism that enhances the credit quality of the instrument by providing a limited external form of credit support. In a typical partial guarantee structure, a guarantor rated higher than the issuer provides guarantee for payment of part of the cash flows payable on an instrument while leaving the rest of the payment liability exposed to the credit risk of the issuer.

Ratings issued by Crisil Ratings on partially guaranteed instruments can range anywhere between the borrower's and the guarantor's ratings, based on the extent of guarantee coverage. The rating indicates Crisil Ratings' assessment of the extent to which the partial guarantee coverage will mitigate the estimated shortfalls in debt service by the issuer, leading to a rating which is higher than the issuer's rating. The key components of Crisil Ratings' process for rating partially guaranteed instruments are:

- **Assessment of issuer's credit quality** (referred to as the issuer rating): Crisil Ratings analyses the credit rating of the issuer based on business and financial risks, management quality, and other relevant parameters.
- **Assessment of guarantor:** Crisil Ratings analyses the credit rating of the guarantor based on business and financial risks, management quality, and other relevant parameters.
- **Linkage of partial guarantee quantum and rating:** Crisil Ratings estimates the weighted average shortfall in debt service on the underlying instrument based on proprietary default statistics and the issuer's credit rating. Crisil Ratings determines whether the quantum of partial guarantee is at a level where these shortfalls are commensurate with a plain vanilla instrument of similar rating.
- **Legal aspects and payment mechanism:** Crisil Ratings undertakes legal due diligence while rating partially guaranteed instruments. The guarantee deed and associated documents are reviewed to validate the terms of the guarantee. Crisil Ratings also analyses the adequacy of payment timelines for timely payment to investors.

Scope

This section[24] explains the methodology adopted by Crisil Ratings in rating instruments that benefit from credit enhancement in the form of partial guarantees from a third party. The section does not cover the ratings of debt instruments that are backed by pools of loans (retail or corporate), which may benefit from credit enhancement not covering the entire debt service on the rated instrument. These debt instruments would be explained in detail in criteria for securitization transactions (kindly refer Crisil Ratings criteria for securitisation transactions).

This section describes Crisil Ratings' methodology to estimate the credit uplift for a given partial guarantee coverage. It does not address the evaluation of legal aspects and payment mechanisms. For more details on the same, please refer below to section XI on "Crisil Ratings methodology for instruments backed by guarantees".

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[24] *For the previous version of this article, please refer to the link below:*
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/structured-finance/archive/crisil-ratings-methodology-for-partially-guaranteed-instruments-feb2023.pdf

Understanding partially guaranteed instruments

Debt instruments fully guaranteed by third-party guarantors have been popular for a long time in the Indian debt markets. There is limited demand in the Indian market for corporate debt with ratings below 'high safety' ('AA') category. Hence, the use of a partial guarantee, to obtain a higher rating and thereby improve its marketability, has the potential to become a handy tool for corporates, financial institutions, and investors.

Crisil Ratings has developed a methodology to assess the credit risk of debt instruments that are partially guaranteed. This analyses the individual probability of defaults of the two entities – the borrower and the guarantor – as represented by their credit ratings. It then assesses other critical parameters of the partial guarantee mechanism, such as the extent of guarantee coverage, cash flow recoveries from the project/company, and timing and nature of the guarantee. The results of these analyses form the basis of Crisil Ratings' credit opinion on the instrument. A partially guaranteed instrument will be assigned a rating with the symbol 'CE' (indicating credit enhancement).

Crisil Ratings' methodology to evaluate partially guaranteed instruments

Prior to development of Crisil Ratings' methodology, the approach for partial guarantees used by rating agencies all over the world was the weak-link approach, where no credit was given for any coverage less than the full debt-servicing obligation on the instrument. Hence, the rating on an instrument with say a 90% guarantee (that is, 90% of interest and principal payments guaranteed) from a higher-rated entity would be identical with the rating on the same instrument without a guarantee. Under this approach, the instrument's rating got no benefit from the partial guarantee.

The methodology pioneered by Crisil Ratings addresses this issue and is an improvement over the traditional approach. Crisil Ratings' methodology factors in the benefits the investor derives from even a partial guarantee. The rest of this section highlights the methodology adopted by Crisil Ratings in rating instruments carrying partial guarantees.

Crisil Ratings' rating methodology is scientifically designed to simulate all the possible default scenarios of the instrument due to default by either the issuer or the guarantor, based on Crisil Ratings proprietary default statistics[25]. This simulated default and corresponding shortfall in debt service on the partially guaranteed instrument is then compared with that of plain vanilla instruments at various rating levels. The rating on the partially guaranteed instrument will be based on the rating of the plain vanilla instrument demonstrating the closest similarity to that of the partially guaranteed instrument.

Illustration: Partial guarantee evaluation - determining the expected shortfall in debt service

For instance, for a three-year bond of an issuer rated 'BBB' with annual debt service (principal and interest) of Rs 10, there are four mutually exclusive and exhaustive scenarios. (For the purpose of this analysis, the default is assumed to be an absorbing state. That is, an issuer in default rate is assumed to remain in default forever.)

The first scenario represents the possibility of the issuer defaulting on the very first installment of debt service. The second scenario represents the issuer successfully servicing the first instalment but defaulting on the second instalment and so on. The last scenario (fourth) represents the possibility of the issuer servicing all three years of debt successfully. Each scenario is associated with a probability that is derived from Crisil Ratings' proprietary default statistics. Also, each scenario represents a particular estimate of the shortfall in debt service on the rated instrument.

[25] *Default rates are critical inputs in assessing the credit uplift for a given guarantee coverage. Partially guaranteed instruments have tenors that could range from 10 to 20 years or more. Observed default rates over such long tenors may not be robust considering constraints on data sufficiency to compute such long-term default rates. Hence, Crisil Ratings extrapolates its observed default and transition rates over medium term to longer tenors*

The table below illustrates the scenario based analysis for the above example for an entity rated 'BBB', with no recoveries assumed post default and no benefit of any partial guarantee.

Scenario #	Probability of Scenario**	Shortfall
1	4%	30 = (3 payments*Rs.10)
2	5%	20 = (2 payments*Rs.10)
3	6%	10 = (1 payment*Rs.10)
4	86%	0
		2.8 (=30*4%+20*5%+10*6%+0*85%) represents 9.3% (=2.8/30) of cumulative debt service obligations on the instrument

*** For this example, the cumulative default rates of BBB are assumed as 4% for year one, 9% for year two, and 15% for year three, solely for illustrative purposes.*

For a partially guaranteed instrument, the scenario- based approach assumes that each debt servicing instalment can exist in one of two states- it is either paid fully on time or there is a default. In the event of default, the shortfall in debt service on instrument depends on the extent of the cash-flow-based recoveries that can be assumed from the issuer and the extent of guarantee coverage available based on the guarantee structure defined upfront.

The weighted average shortfall in debt service across scenarios for the partially guaranteed instrument is benchmarked with that of a vanilla bond (without guarantee) to arrive at the rating of instrument.

The rating on a partially guaranteed instrument can range anywhere between the issuer's and the guarantor's ratings, based on the extent of cash-flow-based recoveries expected from the issuer and the guarantee coverage.

Cash flow-based recovery levels

The recovery rate reflects the expected post-default recovery of cash flows for the defaulted bond or loan. A recovery rate of 30% indicates that in the event of default, although the cash flows generated would not be sufficient to meet the scheduled debt service payments, the issuer would be able to generate enough cash flows from continued operations to service 30% of the scheduled debt payments.

Typically, Crisil Ratings does not give any credit in its analysis for recovery from liquidation or sale of assets post default for most issuers. When an entity is not able to service its term loan obligations in full, it will constrain the entity's continued access to working capital funds from banks, which might reduce their sanctioned limits or refuse to take further exposure. This, in turn, adversely impacts the entity's operations and its ability to generate cash flows. The primary driver of recoveries in such a scenario would be the security that has been provided for the debt. Crisil Ratings' analysis reveals that such recoveries have been very low and quite time consuming in the past. Crisil Ratings ignores recoveries from security enforcement in its rating analysis of partially guaranteed instruments.

However, for infrastructure assets such as toll roads, renewable power projects, ports, or airports in the post commissioning phase, there is very little impact on the asset's ability to continue to generate cash flows even if those cash flows are not sufficient to service the entire debt obligations. For such assets, Crisil Ratings may consider recoveries from the entity's cash flows even after it defaults on its debt obligations.

How do cash-flow-based recoveries differ across industries?

Consider the example of a textile company. A default by the company on its debt obligations will constrain its access to funds and potentially disrupt its entire operations. Hence, for manufacturing companies, the post- default recovery rate for debt holders will be very low.

Similarly, the major expenses of information technology (IT) companies are salaries payable to employees. Hence, default by these companies will be accompanied by insufficient funds to pay salaries and could result in large scale employee exits and consequently, sizeable impact on revenues. Hence, the recovery rate of debt from post default cash flows of IT companies will also be low.

In contrast, consider a default scenario by a player operating in the infrastructure space, say an airport operator. Given the strategic importance of the sector to the government, the slim likelihood of an alternative airport being developed quickly, and lower cash requirement for its operations, the expected post-default recovery rate from the operational cash flows would be much higher than those of manufacturing or corporate service sector industries.

Also, for a wind power project, if there is a default scenario due to a lower plant load factor (PLF), there can be cash flow recoveries from the project due to favourable wind pattern in subsequent years, which may lead to a better PLF and thereby higher cash flows from the asset.

Guarantee coverage

The extent of coverage is the most crucial input in assessing the level of rating enhancement. A higher guarantee cover would take the rating closer to the guarantor's rating; of course, full coverage would equate the instrument's rating with the guarantor's rating.

A guarantee for a specific debt instalment mitigates the default probability of that instalment to the extent that the guarantor's credit risk profile is superior to that of the issuer. Thus, as the extent of guarantee coverage (in terms of the number of instalments covered) increases, a larger number of debt instalments will carry lower default probabilities, thereby reducing the instrument's overall default risk. This has been scientifically measured using Crisil Ratings' proprietary default statistics, which are a crucial input in arriving at the instrument's final rating.

Timing of guarantee

The projected cash flows of a company often carry varying risk levels at different points in time due to company specific reasons such as project implementation and anticipated capital infusions, or industry specific reasons such as cyclicality. A guarantee for debt repayment obligations during the weakest expected period of a company's future cash flows reduces the credit risk more than a guarantee available during a period when the issuer is expected to have strong cash flows and easy access to funds. For instance, in a toll-road project, the initial period might carry the highest risk, whereas in most other companies, the cash flows generated in future years can carry the highest risk of default. Thus, the timing of the guarantee is also important in assigning a rating based on a partial guarantee.

Nature of guarantee

A variant of the partial guarantee, which can effectively address the timing effect, is called a rolling guarantee. A rolling guarantee is one that, if not invoked, rolls over to cover the subsequent repayment obligation. For a given extent of guarantee coverage, a rolling guarantee is far better than a fixed payment partial guarantee. This rolling guarantee will, in effect, address the weakest period in a company's future cash flows, and will provide a curing period for the company to recover and commence regular payments on the instrument. Guarantee can also be in the form of an amortizing guarantee which reduces based on the principal repayment on the instrument.

Conclusion

Crisil Ratings believes the ratings assigned through its methodology for partially guaranteed instruments meet the highest standards of rigor and convey value to investors. With lenders and investors in the Indian markets preferring to invest only in highly rated instruments, Crisil Ratings expects this concept to be a powerful financing tool in the hands of issuers, while adequately addressing the concerns of the investing community.

Section XI.

Crisil Ratings methodology for instruments backed by guarantees

Executive summary

Credit enhancements through guarantees allow entities to raise funds from the capital markets and banks at lower interest rates. Investors in guaranteed instruments are protected from any decline in the credit risk profile of the borrowing or issuing entity.

Guarantees to support the entity's debt may be extended by a related party, such as the parent or a group company, or by a credit institution, such as a bank or a non-banking financial company (NBFC).

While rating guaranteed instruments, Crisil Ratings assesses the guarantee deed and related documents for any legal risks and for adequacy of timelines—for invocation of the guarantee and the subsequent payment by the guarantor.

Where the guarantee covers the entire payment obligation on the instrument, the rating on the instrument is equated with the guarantor's rating and suffixed with 'CE'[26] (indicating 'credit enhancement'), if Crisil Ratings is convinced that:

- The guarantee is unconditional and irrevocable, and
- The envisaged payment mechanism provides enough time to the guarantor to overcome operational risks, if any, to ensure that payments to investors are made on time.

In April 2022, the RBI issued a guidance note (GN) to the credit rating agencies (CRAs) on assigning CE ratings for bank loan facilities. This was followed by a set of FAQs on CE ratings for bank loan facilities that the RBI shared with CRAs in July 2022.

The GN and FAQs have laid down certain conditions based on which CRAs can draw credit enhancement comfort. These are as follows:

- CRAs can rely on explicit guarantees extended by related parties such as parent/group companies or by financial institutions like banks and NBFCs.
- CRAs shall not rely on other forms of diluted and non-prudent structures, viz, letter of comfort (LoC)[27], letter of support/undertaking/responsibility/acknowledgement, etc for deriving rating comfort while assigning CE Ratings for bank loan facilities
    - However, LoCs issued by Central/State Governments and "shortfall undertakings", which are legally enforceable, irrevocable, and unconditional in nature may be treated as valid supporting structure.
- CE Ratings shall not be assigned to bank loans based on credit enhancement derived through pledging of shares.
- Going forward, new CE ratings can be assigned to guaranteed bank loan facilities only when they are backed by a guarantee that is in compliance with a 12-point framework as prescribed in the RBI GN.

For bank loan ratings[28] backed by guarantee, RBI has permitted grandfathering the existing approach until the residual tenure of the rated instrument.

[26] *Please refer to section VII: Meaning and applicability of 'SO', 'CE' symbols*
[27] *For Capital market instruments Crisil Ratings may consider LoC as a valid supporting structure and assign CE Ratings provided LoC is legally enforceable, irrevocable and unconditional in nature*
[28] *Rated before RBI's FAQ letter on Bank loans- credit enhancement (CE) Ratings dated. 26th July, 2022.*

Scope

This section[29] pertains to instruments that are backed by guarantees from corporates, financial institutions (FIs) or central or state governments. Credit enhancement in the form of a standby letter of credit (SBLC) from a bank for an entity's commercial paper programme, LoCs and shortfall undertaking provided by central/state govt. and other unconditional and irrevocable third-party credit support are also included in the purview of the methodology. The section had been revised to include the RBI guidance note on bank loan-CE Ratings.

The focus, however, is on the legal aspects and the payment mechanisms for instruments with full or partial guarantees. This note does not cover the methodology for rating partially guaranteed instruments which is covered above in section X on "Crisil Rating methodology for partially guaranteed instruments".

Legal analysis

Critical clauses in a guarantee deed

An executed guarantee deed forms the legal basis on which lenders and bondholders are entitled to seek recourse to the guarantor if the borrower/issuer defaults on obligations on the guaranteed instrument. It is, therefore, imperative to ensure the guarantee deed confirms that the guarantor is liable for the guaranteed payments on the instrument till it is fully redeemed or repaid. The guarantee deed is evaluated for its adherence to critical principles (see Table 1) before the strength of the guarantee is factored into the rating.

Table 1: Critical principles in a guarantee deed (as prescribed in the RBI Guidance note on CE Rating)

Sr No	Principle	Explanation
1	**It should be unconditional**	The support extended should be unconditional in nature in honouring the obligations under the guarantee.
2.	**It should be irrevocable**	The support provider should not revoke the guarantee till all the obligations of the borrower are fully paid to the lender
3	**It should be enforceable**	The support extended should be legally enforceable at any time during the tenure of rated facility.
4	**The support should be for the facility in its entirety**	The support should cover the entire facility being rated as applicable, including principal, interest or any other amounts payable as per the terms of the facility. In case of partial guarantees, the rating comfort derived shall be restricted to the extent of partial guarantee provided.
5	**Guarantee for Payment**	The obligation of the support provider should be to pay the guaranteed amount without demur as per the sanctioning terms in case of default by the borrower and not merely ensure repayment by the borrower.
6	**Payment mechanism**	The guarantee deed should specify timelines for invocation of the guarantee by the lender, and for subsequent payment by the support provider.
7	**Payment on first demand**	The support provider should make payment under the guarantee on receipt of the first demand or notice from the lender as per the terms of the guarantee.
8	**Payment without deduction**	All guaranteed payments are to be made by the guarantor without any deductions.
9	**Rights of Support provider to be Waived**	The Indian Contract Act, 1872 provides certain rights to the guarantors, including automatic termination of the guarantor's obligations under certain situations (such as change in the terms of contract without the guarantor's consent as per Section 133). Hence, in case of

[29] *For previous version of this article, please refer to the link below: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/structured-finance/archive/crisil-ratings-criteria-for-rating-instruments-backed-by-guarantees-jan2025.pdf*

Sr No	Principle	Explanation
		any change in the terms of the contract, the guarantee needs to be reaffirmed by the guarantor for it to be treated eligible as a valid support for deriving the CE rating.
10	**Guarantor is primary obligor**	The lender is entitled to proceed against the support provider without waiting to exercise all its remedies.
11	**Payment should happen in the event of insolvency**	The support provider should agree to make payments even in case of any insolvency, liquidation, dissolution or any other analogous proceedings against the rated entity.
12	**Overseas guarantors**	If the guarantee is extended by an overseas support provider (foreign parent) in respect of subsidiaries/ group entities/ affiliates operating in India, the foreign guarantor should continuously hold a rating from at least one of the international rating agencies (S&P, Fitch Ratings and Moody's Ratings), which corresponds to a lower risk weight than the standalone rating of the borrower. Further, the CRAs shall assess all the features of the guarantee and also ensure if there are no regulatory or legal issues in the guarantor making remittances under the guarantee as per the existing legal/ regulatory framework in the jurisdiction of the guarantor.

Adequate consideration: In addition to the above 12 points, Crisil Ratings will check for the presence of “adequate consideration” clause, more specifically when the guarantor is an unrelated entity. Adequate consideration implies that consideration in some form should be passed on to the guarantor for providing the guarantee.

The mere presence of key words mentioned in Table 1 does not necessarily mean that the guarantee deed adheres to the corresponding principles. Hence, Crisil Ratings scrutinises the guarantee deed for any express provisions that violate the spirit of these principles. If there are such express provisions, Crisil Ratings may not factor in the guarantee into the rating on the instrument.

Conversely, the absence of any of the specific key words listed in Table 1 does not necessarily lead to Crisil Ratings considering the guarantee deed as not strong enough to be factored into the rating. If a specific key word is absent, but the language of the deed indicates that the guarantee will adhere to the principles mentioned in Table 1, Crisil Ratings may rely on independent legal opinions or undertakings from the guarantor to ensure that the guarantor intends to adhere to these principles. If the guarantor provides the requisite undertakings and legal opinions, Crisil Ratings may factor in the strength of the guarantee into the rating on the instrument

Guarantees, Letter of Comfort and Shortfall undertakings issued by Central/State govt.

While GoI executes guarantee deeds in favour of public sector entities, state governments typically issue a guarantee notification that unconditionally and irrevocably guarantees the bonds of the issuer, and execute a tripartite agreement with the issuer and trustee, detailing the payment mechanism. Crisil Ratings assigns ratings to central\state government-guaranteed instruments provided guarantee issued are legally enforceable, irrevocable, and unconditional.

Similarly, Letter of comfort and shortfall undertaking issued by central/state govt. may be considered as valid support, provided they are legally enforceable, irrevocable, and unconditional, for assigning credit enhancement ‘CE’ ratings.

Conditional guarantees

In case of conditional guarantees, which typically may arise in government guarantee, Crisil Ratings may still factor in the strength of the guarantee into the rating on the underlying instrument if

- There are sufficient provisions to mitigate the risk of breach of conditions or of termination of the guarantee, or
- The probability of such conditions materialising is low.

In such cases, Crisil Ratings highlights the conditional nature of the guarantee in the rating rationale. The rationale also states the presence of provisions that mitigate these risks or the low probability of manifestation of these risks.

Some examples of conditional guarantees where Crisil analyses the presence of risk mitigants for factoring in the strength of the guarantee are:

Guarantees issued by the central government to public sector entities post the Government Financial Rules 2017(GFR-2017)

- GFR-2017 states that guarantees given by the Government of India (GoI) shall be non-transferable and shall cease to exist if the ownership of the entity is transferred from the government, unless the guarantee is reconfirmed by the Budget Division, rendering such guarantees conditional.
- Crisil Ratings analyses the probability of the entity's ownership being transferred from the government to decide if the strength of the guarantee is to be factored into the rating on the guaranteed instrument.

Working capital facilities guaranteed for limited periods

Working capital bank facilities that do not have a specified maturity date are typically guaranteed for a limited period post which the guarantor, in consultation with the bankers, may choose to either renew or discontinue the guarantee.

In such cases, Crisil Ratings may factor the guarantee into the rating on the facility, provided it satisfies the RBI 12-point guarantee framework, even though the guarantee is valid for a limited time. If the guarantee is not renewed on expiry, Crisil Ratings may revise the rating on the facility to reflect the borrower's standalone credit risk profile.

Foreign guarantees

If a guarantee states that the guarantee and obligations of the guarantor are governed by laws of a foreign country, or that the actions under the guarantee should be initiated in a court outside India, such guarantees will be construed as foreign guarantees. For foreign guarantees, Crisil Ratings may seek the opinion of a legal counsel of the guarantor, or an independent legal counsel domiciled in the place of execution of the guarantee, on the following issues:

- Is the guarantee provided by the guarantor unconditional, irrevocable, valid, and binding as per the terms thereof under the laws of the guarantor's jurisdiction and enforceable in courts in the jurisdiction?
- Upon invocation of the guarantee, can remittances be made from the guarantor's jurisdiction to India as per the existing legal framework in the guarantor's jurisdiction?
- Should additional approvals be obtained from a regulatory authority for making remittances under the guarantee?

Crisil Ratings factors the strength of foreign guarantees into the rating if the legal counsel confirms that the guarantee is unconditional, irrevocable and legally enforceable, and that there are no regulatory or legal issues in making remittances under the guarantee from the guarantor's jurisdiction to India.

For bank loan facilities guaranteed by a foreign entity, Crisil Ratings may alternatively obtain a confirmation from the lenders that they believe the guarantee is unconditional, irrevocable, valid, binding and enforceable, and that there are no regulatory or legal issues in the guarantor making remittances under the guarantee.

Factoring the credit profile of the guarantor while assigning CE Rating:

While evaluating the rating of debt instruments on the basis of a guarantee, Crisil Ratings examines the credit profile of the support provider and ensure continuous surveillance thereof of the support provider, till the tenure of the rating. Any rating downgrade in the support provider's rating shall appropriately be reckoned in the CE rating of the borrower

The following guidelines will be followed while factoring the credit profile of the guarantor. This is in line with the RBI GN:

- If Crisil Ratings already has ratings on the guarantor, then the 'CE' rating can be based on Crisil Ratings' rating of the guarantor.

- If the guarantor does not have an external rating[30] from any of the CRAs (including Crisil Ratings), Crisil Ratings shall arrive at an implicit rating and assign CE rating to the bank loan facility based on the implicit rating.
- If the guarantor does not have a rating from Crisil Ratings, but has an external rating from any of the Other domestic CRAs (OCRA), then the implicit rating of the guarantor is to be arrived at and 'CE' rating assigned shall be capped at the lower of Crisil Ratings' implicit rating or external OCRA's rating.
- Crisil Ratings shall consider only those ratings from OCRAs which are not in the "INC (issuer non cooperative)" category for this purpose. Further, in line with BASEL principles, if there are more than one cooperative ratings for the guarantor from different OCRAs, the second-highest OCRA rating shall be considered for arriving at such as cap.

Payment mechanism

Guaranteed capital market instruments

Payments on guaranteed capital market debt instruments are typically made in the following steps:

- The issuer transfers the requisite funds to the designated account (account for making payments on NCDs) or the issuer's account with the IPA (in case of CPs)[31].
- If the issuer fails to transfer the requisite funds, the debenture trustee or IPA invokes the guarantee.
- The guarantor transfers the requisite funds to the designated or IPA account.
- Payments are made to investors from the designated or IPA account on the due date.

The timelines for invocation of the guarantee and payment by the guarantor as envisaged in the guarantee deed must be adequate, so that investors receive payments within the due date. Hence, Crisil Ratings evaluates the payment mechanism with respect to the response time of the guarantor in making payments on invocation. For instance, the central and state governments take longer than corporates to make payments, given the administrative processes involved in sanctioning funds. In government-guaranteed instruments, the response time will be shorter for issuers that receive regular budgetary support from the government compared with issuers with limited budgetary allocation.

In evaluating the payment mechanism, Crisil Ratings also factors in operational risks that may arise. For instance, for CPs backed by an SBLC from a bank, the operational risks would be lower if the SBLC provider and IPA are the same, as the same entity will invoke and transfer funds.

The timelines in such cases may therefore be smaller than if the SBLC provider and IPA were different entities. Annexure-I of this section outline the timelines that Crisil Ratings believes are adequate for timely payments to investors, based on market practices and empirical assessment of the response time of guarantors and the operational risks involved. However, Crisil Ratings may make exceptions for the timelines if there are sufficient factors to offset risks.

Guaranteed bank facilities

In case of guaranteed bank facilities, the guarantee deed should specify timelines for invocation of the guarantee by the lender and for subsequent payment by the support provider. For bank facilities backed by a central or state government guarantee, Crisil Ratings shall factor in the strength of the guarantee into the rating on the facility only if there is adequate

[30] In cases, where there is an "INC (issuer non co-operative)" rating for the Guarantor in public domain, CRA's may rely on implicit rating- based approach.
[31] Certain payment mechanisms additionally envisage a notification to the guarantor by the trustee /IPA, prior to invocation, in order to alert the guarantor of an upcoming due date on its guaranteed instrument.

track record of timely fund infusion by the government in the entity whose facility is being rated. Moreover, any of the following additional provisions may be considered to mitigate the risk of non-adherence to transaction structures:

- Maintenance of committed liquidity, or
- Soft notice to the government prior to the invocation date highlighting the payments due, or
- Presence of ‘T + n’ structure (refer to Annexure I) where invocation happens post the due date for payment (T)

Role of trustees

Debenture trustees play an enhanced and critical role in the case of guaranteed instruments. The trustee monitors compliance with the payment mechanism in accordance with the terms laid down in the guarantee deed. The performance of the transaction hinges critically on timely invocation of the guarantee by the trustee if the issuer fails to fund the designated account. Considering the criticality of the trustee, Crisil Ratings usually obtains an awareness letter from the trustee (refer to Annexure-II of this section) to ensure that the trustee is fully aware of its responsibilities. Crisil Ratings may obtain a similar letter from IPAs in case of guaranteed CP issuances.

Provisional ratings

Crisil Ratings may assign provisional ratings[32] to instruments backed by corporate guarantees based on analyses of draft guarantee agreements. The provisional rating will be converted to a final rating on receipt of the following documents (as relevant), duly executed:

- Guarantee document
- Debenture trust deed (for NCDs)
- Designated account agreement (for NCDs)
- Debenture trustee/ IPA awareness letter
- Representation and warranties letter from the issuer (refer to Annexure-III of this section)
- Additional documents executed for the transaction

Obligor-Co-obligor groups

The ratings on the obligor-co-obligor group (may also be referred to as restricted group) are driven by the intent of the sponsor in conveying to the lender that the SPVs in the obligor-co-obligor group need to be viewed as one consolidated group. The presence of common sponsor/holding company ensures that the entities belong to the consolidated group. Also, these groups benefit from the presence of legally strong and enforceable agreements/ transaction documents that bind the SPVs together with cross default clauses to which lender(s) is/are party of and ensure that cash surplus co-obligor entities support the cash deficit entities during stress. In these cases, Crisil Ratings may consolidate all the entities as part of its analytical approach to arrive at the rating of the obligor-co- obligor group and thereafter derive the ratings of the individual entities from the group rating. Typically, these ratings will be equal to or close to the rating on the group.

[32] *For details on Crisil Ratings policy on provisional ratings, please visit www.crisilratings.com*

‘CE’ suffix[33] may not be applicable for entities rated as part of the obligor-co-obligor group. This is because, in the case of obligor-co-obligor groups, the group entities share/pool cash flows to support debt servicing abilities of each other and this aspect is factored in duly into the credit profile of each entity which is a part of the group.

Conclusion

In assigning ratings to guaranteed instruments, Crisil Ratings conducts detailed analyses of the legal aspects of the guarantee and the payment mechanism. A ‘CE’ rating equated to the guarantor is assigned only if the guarantee is compliant with the RBI 12-point framework, and if the transaction’s payment mechanism indicates adequate timelines to ensure that the investors will be paid in line with the transaction documents.

[33] *‘CE’ suffix is applicable only in cases where the credit profile of the rated instrument is higher than that of the issuer on account of a third party explicitly providing support such as guarantee.*

Annexure- I

Table 2: Adequate payment timelines, based on empirical research

Guaranteed by → Timelines ↓	Guarantee from parent/group company	SBLC backed CPs (different standby and IPA banks)	SBLC backed CPs (same standby and IPA bank)	Guarantee from FIs	Government guarantees for entities with budgetary support	Government guarantees for entities without budgetary support
Trustee/IPA to notify the guarantor of upcoming dues	-	-	-	T-15	T-45	T-90
Trustee/IPA to invoke guarantee if the issuer fails to make payments	T-2	T-2	T-1	T-3	T-15	T-45
Guarantor to make payments post invocation	T-1	T-1	T-1	T-1	T-1	T-1

'T' refers to the due date for payment to investors

The above timelines are for (T - n) payment mechanisms that envisage the issuer making the payment prior to the due date

(T) on the instrument, failing which the guarantee is invoked to enable payment to the investors by the due date. There could be other payment mechanisms where the guarantee invocation happens after the issuer fails to make the payment by the due date, referred to as (T + n) mechanisms. The adequacy of timelines, as mentioned in Table 2, are applicable even in (T + n) mechanisms, albeit post the issuer missing the payment on the due date. For the purpose of the rating, the due date for reckoning a default on the instrument will be the due date 'T', in case of (T - n) mechanisms. For (T + n) mechanisms, default will be recognised on the 'T+x'th day, which is the last date on which the guarantor needs to make payments to the investors as per the envisaged mechanism.

Certain payment mechanisms provide for enhanced liquidity wherein the state government undertakes to plug the shortfall in the debt service reserve account (DSRA), in addition to the bond guarantee. Hence, the risk of delayed payment from the state government is mitigated by the presence of a liquidity buffer. Payment mechanisms that provide for adequate liquidity buffer may be considered for notch-up from the state government rating.

Annexure- II

Sample awareness letter obtained from trustees

Sub: Confirmation on awareness of the payment mechanism and responsibility to ensure its compliance for the proposed Rs_________crore <<Amount>> Non-convertible debenture ("NCD") issue by ______________ <<Name of Issuer>> ("Issuer") backed by Guarantee from ___________________ <<Name of Guarantor>> ("Guarantor").

We refer to the captioned transaction and the payment mechanism for the same. We, in our capacity as Debenture Trustee/Issuing & Paying Agent (IPA) to the captioned transaction, confirm:

- We are aware that the proposed NCD issue will be guaranteed by the guarantor. We are also aware of the payment mechanism, as proposed by the issuer and guarantor (as mentioned in the Annexure to this Awareness Letter)
- We will ensure that all requisite transaction documents are executed as per the terms and conditions of the information memorandum/term sheet and corporate guarantee, and will be submitted to Crisil Ratings within 60 days from the date of allotment.
- We fully understand all the aspects of the said payment mechanism. We also understand our responsibilities thereunder, which include monitoring the designated account for compliance with the payment mechanism. We also confirm that we shall discharge all our responsibilities mentioned in the information memorandum/term sheet, guarantee agreement and other transaction documents.

In line with SEBI guidelines on communication between trustees and CRAs, we further undertake:

- To inform Crisil Ratings immediately by e-mail of any instance of non-compliance with the payment mechanism.
- To monitor the designated account for upcoming payments, and if not funded adequately as per the stipulated dates, to invoke the guarantee on time in accordance with the payment mechanism, and to inform Crisil Ratings immediately by e-mail of the invocation of the guarantee.
- To certify to Crisil Ratings, at least on an annual basis, about the compliance of the payment mechanism. This will include a specific confirmation that funds are being paid through the designated account on specified dates, as stated in the information memorandum/term sheet, guarantee agreement and other transaction documents.

Authorised Signatory of Trustee <<Signatory Name, Designation, Company Seal>> Annexure to detail payment mechanism

Annexure- III:

Sample representations and warranties letter obtained from issuers

This is in reference to the issuance of listed/unlisted, secured/unsecured, redeemable non-convertible debentures of face value of Rs ______ each, aggregating Rs _______(Rupees _______only), (the “NCDs”), _____________ (the “Issuer”).

The issuer hereby represents, warrants and undertakes to Crisil Ratings as follows:

- All information provided by the issuer to Crisil Ratings regarding the issuance of NCDs, including the operation of the payment mechanism, is true and correct.
- The payment mechanism (as mentioned in the Annexure to this Representations & Warranties) shall operate in the same manner as represented by the issuer to Crisil Ratings.
- The instrument details and the payment mechanism to be incorporated in the final transaction documents will be the same in all respects as the draft transaction documents/term sheet and the Guarantee documents shared with Crisil Ratings,
- The executants of the legal documentation on behalf of the issuer have been duly empowered and authorised to execute the same and to carry out all necessary actions in accordance with the terms set out therein.
- The issuer shall satisfy all covenants in connection with the NCD issuance to ensure that the NCDs are fully redeemed in a timely manner.
- The issuer shall ensure that within a period of 60 days from the allotment of the NCDs:
  - A Designated Account with a bank is operational for meeting the obligations on the aforesaid debt
  - Execute all the requisite transaction documents as per the terms and conditions intimated to Crisil, to enable the Trustee to operate the Designated Account and for the effective operation of the payment mechanism
  - Submit copies of all the executed transaction documents to Crisil Ratings

- All the representations and warranties provided by the issuer to Crisil Ratings are true and correct.

Authorised Signatory of Issuer <<Signatory Name, Designation, Company Seal>> Annexure to detail payment mechanism

Section XII.

Crisil Ratings methodology and capital treatment of corporate sector hybrid instruments

Executive summary

Hybrid instruments combine features of debt and equity. They offer greater flexibility to defer debt servicing than traditional debt, and can benefit investors, shareholders and issuers. Indian companies have been issuing hybrid securities such as preference shares, optionally or compulsorily convertible securities, and foreign currency convertible bonds, for years. Corporates prefer to issue hybrids as this helps optimise the debt-equity mix in their capital structure. The features of hybrid issuances include varying tenures, multiple call options, and flexibility to step up the coupon rate.

For the benefit of issuers, investors, and intermediaries, this section discusses two critical aspects of Crisil Ratings' assessment of hybrids: Crisil Ratings' view on the extent of equity-like features embedded in them (and consequently, their treatment in the capital structure), and the rating framework for such instruments.

Crisil Ratings looks beyond the nomenclature or legal construct of the instrument in its assessment of the equity content and evaluates the overall impact of the instrument's characteristics on the capital structure. The characteristics of equity (Box 1) serve as a guide to assessing the equity content in hybrids. Two factors help identify this: the cushion provided by the instrument to conserve cash in an exigency, and the permanence of the instrument. Typically, hybrids offer greater flexibility to issuers than traditional senior debt in their servicing.

Crisil Ratings' rating for the instrument is based on the assumption that the issuer is a going concern. All payments indicated in the instrument are considered as scheduled payments, despite conditions that enable the issuer to skip or defer regular debt servicing. The rating assigned assesses the risk of default or deferment on all scheduled payments. If, for example, an issuer defers payment because of the breach of a trigger, Crisil Ratings treats the missed payment as a default even if the terms of the instrument indicate otherwise. Given that breaches permit issuers to defer payment, hybrids are, hence, at higher risk of default than traditional debt instruments. Therefore, when a hybrid is likely to miss a payment, the risk will be appropriately reflected with the rating on the hybrid notched down from the rating on senior debt instruments. Furthermore, subordination of the instrument is not a key determinant of the rating given that Crisil Ratings' ratings are based on the probability of default scale.

Scope

This section highlights Crisil Ratings' methodology in determining the equity content (and consequently, their analytical treatment in the capital structure) in hybrids instruments (such as perpetual bonds, optionally convertible securities, compulsorily convertible securities, foreign currency convertible bonds, preference shares etc) issued by non-financial corporates[34]. It also outlines the methodology adopted for rating them.[35]

Methodology

III.1. Assessment of equity content

As hybrids combine the features of debt and equity, a comparison of features is useful in determining the equity content of hybrids. Box 1 offers a quick understanding of the features of equity in the capital structure of a company.

[34] For methodology for hybrid instruments issues by financial entities: a) Banks and FI, b) NBFCs and HFCs and c) Insurance, kindly refer to the respective criteria on Crisil Ratings website under Criteria and Methodology section.

[35] For previous version of this article, please refer to the link below: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/criteria-research/archive/crisil-ratings-criteria-for-rating-and-capital-treatment-of-corporate-sector-hybrid-instruments.pdf

Box 1: Classification of instruments

	Equity	Hybrid	Debt
Permanence	Perpetual	Based on tenure	Based on tenure
Committed obligation to service	None	Subject to no breach of triggers	Yes
Loss absorption capacity	Very high	Moderate	None

Characteristics of equity

- **Permanence in the capital structure:** By definition, equity does not have any scheduled maturity or repayment. Issuers have no obligation to redeem or buy back equity. This feature of permanence fortifies the issuer’s overall capital structure.
- **Absence of committed servicing requirement:** The issuer has no ongoing committed payment in the case of equity, as declaration of dividend is discretionary. Equity holders cannot take the issuer into liquidation for non-payment of dividend. This enhances the issuer‘s ability to absorb losses on an ongoing basis, and the flexibility to conserve cash.
- **Capacity to absorb losses:** In case of liquidation of the issuer, equity shareholders are the last to be paid. Moreover, equity shareholders are to be paid only if there is enough cash left after paying other creditors. This enhances the loss absorption capacity of equity, and provides a cushion to creditors in the case of bankruptcy of the issuer.

Hybrids have a variety of features, each with varying degree of influence on the equity content. Crisil Ratings uses a framework for non-financial companies, classifying equity content in hybrids as high, intermediate, or low. The parameters considered in the framework are:

III.1.1. Level of fixed component of coupon rate

Most hybrids offer a stated distribution or coupon rate (coupon) to the investor. Some hybrids, such as participating securities, have two components in their coupon: fixed (say, 2% per annum) and variable (linked to the entity‘s reported profit after tax; say, 10% of EPS[36]). In such cases, the fixed component on the coupon is payable regardless of the issuer‘s financial performance, while the variable component is linked to profit, and is dependent on the issuer‘s financial performance.

A large variable and small fixed component ensures that the amount paid to service the instrument varies in direct proportion to the company‘s financial performance. Hence, in difficult business conditions, the payout will be low, enabling the company to conserve cash. This feature makes the instrument behave like equity. On the other hand, a high fixed coupon would limit the flexibility available to the issuer in difficult business conditions. The quantum of fixed component in the coupon is, therefore, a key element in evaluating the equity content in the instrument.

Crisil Ratings believes that the fixed component on instruments should be materially lower by at least 5% than a comparable debt market benchmark rate, to be considered for ‘high’ equity treatment. The greater the difference, the lower the debt content in the hybrid.

[36] *EPS= Earnings per share*

III.1.2. Permanence of the instrument

Permanence is a key characteristic of equity *(see Box 1: Characteristics of equity)*. The longer the instrument remains in the capital structure, the higher its equity content. Residual maturity is a measure of the instrument ‘s permanence: **the longer the residual maturity, the lower the debt content in the instrument** *(see Box 2: Crisil Ratings’ evaluation of the replacement capital covenant)*. However, the tenure stated in the terms of the instrument is not the primary factor in determining residual maturity. This is because most issuers can redeem the instrument well before maturity, often in the form of a call option.

In instruments where the issuer has a call option, the date of the first call determines residual maturity. The call option is built into the instrument to provide the issuer with an early exit option and curtails the instrument ‘s permanence. Instruments with a residual maturity of less than 5 years do not, therefore, merit treatment as equity, as the period is too short to provide any cushion to the issuer for losses.

Box 2: Crisil Ratings’ evaluation of the replacement capital covenant

Issuers may structure their hybrids with a legally binding capital replacement clause. This provides senior-debt holders of a company the comfort that cash flow will not be affected by redemption of hybrids. Additionally, debt holders also retain their seniority in the capital structure. While the replacement capital covenant (RCC) may be structured in many ways, a common variant is one that allows for the redemption of the instrument only through issue of common equity, or instruments with similar equity content. Crisil Ratings believes that for the covenant to be effective in helping preserve credit quality, it should force the issuer to replace a hybrid security, if it is called, redeemed, or repurchased, with an instrument of similar or better equity-like characteristics, in terms of payment deferability, permanence, and degree of subordination. The RCC, thus, ensures that even if the instruments are not redeemed, they will stay in the capital structure for as long as the covenant remains enforceable. The RCC, therefore, positively affects the residual maturity of the instrument, thereby reinforcing its permanence. Crisil Ratings, however, factors the RCC into its assessment of equity content only if it substantially extends the instrument‘s residual maturity.

Additionally, ceteris paribus, the RCC ensures that the issuer‘s capital structure will have similar or higher equity content for as long as the covenant remains applicable. It is also important to examine the conditions under which the covenant will be applicable, and the likelihood of its termination. If a termination event occurs making the RCC unenforceable, the equity content of the instrument would diminish to that extent. Crisil Ratings assesses the RCC for its enforceability and the conditions for its termination in evaluating the equity content in the instrument.

III.1.3. Deferability of payment obligation

Typically, hybrid capital instruments have a stated dividend or coupon. However, the payment may be deferred or skipped, contingent on certain pre-specified covenants or threshold, or at the discretion of the management or a regulator (such as the Reserve Bank of India [RBI] for perpetual issuances by banks and non-banking financial companies). If the deferral is for conservation of cash, especially in a difficult business environment, the instrument possesses the characteristic of equity. So a link between the deferral and the entity‘s debt obligation or financial performance may result in higher equity content being accorded to the instrument, provided the deferral is mandatory, and not at the discretion of the management. From an issuer‘s perspective, discretionary flexibility to defer or skip payments is optimal. However, while such deferrals provide sufficient leeway to the management to make payments to investors, non-payment may be viewed negatively by the market, and may constrain the management‘s fund- raising ability in future.

Crisil Ratings believes instruments that enable mandatory deferral have higher equity content. Mandatory deferral binds the issuer to defer payments on the hybrid, and thus eliminates subjectivity from the issuer‘s intent. This feature provides comfort to other debt holders, and compensates for the non-permanence of the instrument to a large extent. In some cases, the deferral is linked to non-payment of dividend on equity shares. In such cases, Crisil Ratings assesses the issuer‘s stance on, and track record in, payment of dividends. It also evaluates the effect that the deferment may have on the issuer‘s capital-raising ability. Crisil Ratings classifies hybrids with a mandatory deferral clause as having higher equity content than instruments which give issuers an option to defer payment.

III.1.4. Relevance of triggers for deferring/skipping payments

Mandatory triggers for deferral do not necessarily merit a case for higher equity content. If deferrals are contingent on the breach of a trigger, Crisil Ratings assesses the equity content by evaluating the likelihood of a breach, in the light of the issuer‘s business and financial performance. Furthermore, the threshold for the trigger must be realistic. For instance, the trigger for deferral for a highly rated issuer cannot be the diminution of net worth by 80%, for such a trigger is unlikely to be breached. Therefore, to qualify for higher equity content, the triggers need to be such that there is reasonable probability of them being breached.

Crisil Ratings believes higher rated entities may opt to pay dividend to their equity shareholders, even in times of poor financial performance, by dipping into their reserves. Instruments wherein payments are subject to dividends distributed to equity shareholders will, therefore, have a relatively lower equity content, than those where payments are subject to a more objective parameter, such as profits earned by the company in a given period.

Additionally, issuers in the international markets have included features such as dividend stoppers or look-back triggers to restrict payments on other instruments. These features are structured to restrict the issuer from making payment on instruments that are equal, or junior to, the hybrids in the capital structure, unless the arrears due to deferral on the hybrids are paid. Such clauses, which give the instrument a debt-like characteristic, restrict the issuer‘s ability to defer dividend.

III.1.5. Cumulation of payments

If a hybrid’s coupon can be deferred, it is a cumulative instrument; if there is no obligation to make up for missed payments, it is non-cumulative. The latter has a higher equity content, as there is no continuing liability on the instrument. Additionally, it is easier for issuers of non-cumulative hybrids than cumulative ones to improve their financial risk profiles. However, the issuer may be more reluctant to defer payments on non-cumulative instruments, given that a missed payment to an investor is not subsequently made up.

III.1.6. Availability and timing of call options

The presence of a call option with the issuer brings the permanence of the instrument into question. The call option enables the issuer to redeem or retire the instrument. The date of the first call, therefore, determines the residual maturity. The presence of a call option raises concerns on whether the instrument will remain outstanding after the initial call date, as it typically allows the issuer to redeem the instrument much before the scheduled maturity. **Therefore, the shorter the period to the call date, the lower is its equity content and shorter would be the period for which the instrument will remain in the capital structure.**

Some instruments may allow issuers to have multiple call dates (typically on an annual basis), and therefore, additional flexibility. The issuer may choose not to call the instrument on the first available date, especially if the market conditions favour a deferral of the call option. Crisil Ratings, however, believes that multiple call dates do not significantly affect the instrument‘s equity content, as the issuer will need to manage investor expectation that the issue will be called at first date.

III.1.7. Presence of a step-up

The call option is usually paired with a provision for stepping up the coupon, whereby the coupon rate on the instrument increases if the call option is not exercised. Such combinations are structured specifically to induce the issuer to call, and thus to avoid a step-up. Coupon step-up options increase the issuers' debt-servicing burden and serve as a strong incentive for issuers to exercise the call option, redeem the instrument, and replace it with a much cheaper debt instrument. Therefore, this feature reduces the permanence of instruments, and hence, lowers the equity content.

However, the inclusion of a coupon step-up does not always mean lower equity content. The quantum of the step- up must be high enough to induce the issuer to call. **Crisil Ratings believes step-up options add debt-like features to hybrids, and that instruments without step-ups have higher equity content than those with step- ups.**

III.1.8. Position in the capital structure

The capital treatment is based on the degree to which hybrids are subordinated to the issuer's debt instruments. The greater the subordination of a hybrid to debt, the higher its equity content will be, for it enhances the cushion available to the issuer in case of bankruptcy. It is, therefore, important to evaluate the nomenclature and regulatory treatment of the instrument. However, mere subordination alone will not mean high equity content for the instrument. Nevertheless, it is unlikely that non-subordinated hybrids will be treated as equity, even if other features warrant such treatment. Additionally, if the terms of the instrument allow investors to initiate winding up proceedings against a company, if the instrument is not serviced for extended periods (2 or more years), it will resemble debt more than equity.

III.2. Assessing the overall equity content

The overall assessment of equity content in an instrument will be based on the interplay of all parameters discussed above. However, the first four parameters in the framework—quantum of coupon rate, permanence, deferability of payment obligation, and triggers for deferability—should be accorded higher weightage when arriving at the overall equity content of the instrument.

Based on the framework discussed, the instrument is classified into one of three buckets, as indicated in ***Table 1.***

Table 1: Classification of hybrids based on quantum of equity content

Classification	Low	Intermediate	High
Equity content	0-25%	26-50%	51-75%

The presence of hybrids benefits an issuer 's capital structure. Nevertheless, Crisil Ratings believes that common equity is the best form of equity capital for issuers. This is because common equity is permanent and enhances the issuer 's loss-absorption capacity at all times. Therefore, issuers with a balanced capital structure and common equity will be viewed more favorably than those with an excessive dependence on hybrid securities. Crisil Ratings limits the total equity content for hybrids for an issuer to 20% of its adjusted net worth.

III.3. Capital treatment of some common hybrid securities

Typically, hybrids issued by Indian companies include optionally convertible securities, compulsorily convertible securities, foreign currency convertible bonds (FCCBs), and preference shares. Crisil Ratings evaluates each instrument 's characteristics in relation to its maturity profile, coupon payments, and loss absorption capacity. Accordingly, it treats such securities as equity or debt when calculating its financial and capital ratios.

Optionally convertible securities are usually considered as debt. However, if they possess equity-like features, the equity content is assessed and classified as either high, low, or moderate.

FCCBs are mostly treated as debt, except in rare instances where the characteristics (such as very low yield, or conversion price less than or within a reasonable range of the current market price) resemble equity, and the intent of the issuer and investor indicate that the instrument is perceived as equity rather than debt.

Compulsorily convertible securities are typically treated as pure equity.

Most preference shares in India are close to debt, despite them being promoter-held because of short maturity and higher interest rate. However, if they do show equity-like features, Crisil Ratings classifies them as low, intermediate, high, or pure equity.

Crisil Ratings evaluates a hybrid in terms of how closely it resembles equity and its impact on the issuer‘s capital structure. This is a starting point for the analysis on whether a particular hybrid is incrementally positive, negative, or neutral for the issuer’s capital structure. Moreover, Crisil Ratings analyses the behaviour of such instruments in a distress situation, especially the liquidity or refinancing risk for servicing the fixed commitments of a hybrid. In general, based on the hybrid securities that have been vogue in India, the following categories are common:

- **Preference shares**
- **Optionally convertible securities**
- **Compulsorily convertible securities**
- **FCCBs**

Crisil Ratings’ treatment of each category of hybrid is detailed below:

III.3.1. Preference shares

These are probably the oldest and most popular form of hybrid securities in India.

Maturity profile: Preference shares have a fixed tenure and have to be repaid at the end of it. In most cases, the tenure is 3-5 years if the investors are institutions, and slightly longer if the investors are promoters. Long-dated preference shares are rare in the Indian context. Also as per current regulations, preference shares cannot be issued with an original maturity of more than 20 years. Thus, in terms of maturity profile, preference shares closely resemble debt. If the preference shares have early call options, their effective maturity reduces. Crisil Ratings considers this reduced maturity in its analysis.

Coupon payment: Typically, preference shares in India are non-participating and have a fixed dividend rate, imparting debt-like characteristic. Furthermore, the dividend rate is typically close to the market rate of debt. However, Crisil Ratings may assign some equity-like character if there is evidence that the instruments have a low coupon rate.

Loss absorption capacity: Deferability and non-cumulation are not usually observed in practice, despite a large number of these being promoter-subscribed. However, if such terms are observed, Crisil Ratings gives some equity benefit. Moreover, if the instruments are not promoter subscribed, conditions on deferral and cumulation shall be viewed critically. However, in such cases, deferral may be treated as default, even if the instrument does not specify so.

Furthermore, the preference dividend is included in calculations of interest coverage and other debt service coverage ratios.

The treatment of preference shares in the capital structure is largely similar to hybrids as outlined in Section III.1 and Section III.2.

III.3.2. Optionally convertible securities

An optionally convertible security gives investors the option of converting the principal amount into the company's equity shares, usually on maturity and at a pre-determined price.

Maturity profile: While these securities have a fixed tenure for repayment, the final conversion itself would be contingent on the underlying share price. Normally, the strike price at the time of issue is higher than the existing price. The liquidity risk of repayment or refinancing is eliminated if investors exercise the option of converting the securities into equity shares. As it is difficult to predict share prices, and hence, there is uncertainty on whether investors will exercise the conversion option, it is prudent to assume that the company will have to repay the principal.

Coupon payment: As the investor has the option of participating in the company's potential gains, the coupon rates on such securities are typically lower than traditional debt. Like traditional debt, however, the securities carry a fixed charge, which needs to be paid with no deferral option.

Loss absorption capacity: For a going concern, loss absorption capacity refers to the ability to defer, suspend, or waive dividend/interest payments on the instrument in case of a loss. As optionally convertible securities mirror traditional debt till such time the investors actually convert them into common shares, their loss absorption capacity is similar to that of debt.

- **How Crisil Ratings treats optionally convertible securities**

Optionally convertible securities resemble debt more than equity, given the uncertainty over their conversion into equity shares. A hybrid is required to provide a cushion in times of distress. But since stock prices would, in all likelihood, be lower than the conversion price in such times, investors are unlikely to exercise the conversion option. Therefore, Crisil Ratings treats such instruments as debt while computing capitalisation ratios. However, if the instrument has more equity-like features (such as extremely low yield to maturity, option to reduce the conversion price, and low differential between current market price and conversion price), and the intent of the issuer and investor indicates that the instrument is perceived as equity rather than debt, Crisil Ratings may treat such instrument as equity.

III.3.3. Compulsorily convertible securities

Traditional debt, wherein the final repayment is through the issuance of common equity to investors based on a fixed conversion rate (or a band), are called compulsorily-convertible securities (given such conversion is without any condition).

Maturity profile: As these securities are compulsorily convertible into the company's equity shares, they fully eliminate the credit risk of repayment or refinancing.

Coupon payment: These instruments would have specific interest payments till the point of conversion and claim a fixed charge out of the company's cash flow.

Loss absorption capacity: With compulsory conversion, these securities have a higher loss-absorption capacity. This capacity increases as the conversion date approaches.

- **How Crisil Ratings treats compulsorily convertible securities**

Given that the only cash outflow in case of compulsorily convertible securities is fixed interest payment till the point of conversion, these securities are more like equity. Crisil Ratings, therefore, treats them as part of common equity while computing capitalisation ratios, in most cases.

III.3.4. FCCBs

Convertible securities issued in foreign currency are termed FCCBs, which are similar to convertible securities.

- **How Crisil Ratings treats FCCBs**

Crisil Ratings has treated most FCCB issues as debt and a handful as equity, given that they typically resemble debt.

The debt or equity characteristics of FCCBs are determined by analysing parameters such as

- yield to maturity
- forced conversion option
- option to reset conversion price downward
- differential between conversion price and current market price
- size of issue
- current dilution in promoters‘ holding on conversion

Crisil Ratings regularly reviews these parameters and takes an appropriate view on debt or equity on that basis. The capital treatment decided upon is included in the calculation of all its ratios.

IV. Assigning ratings to hybrids

Although this note has so far focussed on Crisil Ratings' assessment of the equity content in hybrids, these instruments do possess debt-like characteristics as well. Crisil Ratings, therefore, also assigns credit ratings to such instruments. This section will outline Crisil Ratings' methodology and approach for such ratings.

Crisil Ratings rates hybrids on the same scale as traditional bonds. Crisil Ratings' ratings are an opinion on the probability of default. The subordination of the instrument is, thus, not a key determinant of the rating, as subordination becomes relevant only in the event of bankruptcy, which is a post-default event.

Potential equity treatment for rating analysis: The capital treatment of a particular instrument must not be directly related to the rating accorded to the instrument. This is because, for the assessment of equity content in an instrument, Crisil Ratings also factors in the support provided by the instrument in terms of distress or bankruptcy, as well as permanence. However, Crisil Ratings assigns the rating assuming that the entity is a going concern, and hence, the notch-down of the rating will not necessarily be proportional to the equity content of the instrument. Therefore, it is possible that an instrument with low equity content is also notched down from the rating on its traditional debt, or vice versa.

Likelihood of deferral criterion: Unlike traditional debt instruments, hybrids offer flexibility to issuers to defer payment. As a result, investors are exposed to a greater degree of risk of non-payment on hybrids than on debt. The key to determining the rating, therefore, is Crisil Ratings' view on the likelihood of payment on the instrument being missed (or deferred) on account of a breach of trigger. Crisil Ratings evaluates these aspects on a case-to-case basis after analysing the triggers, and the likelihood of the issuer breaching them in future.

In the case of optional deferrals, Crisil Ratings' approach is governed largely by the issuer‘s stance on, and track record in, deferring payments. In the international markets, optional deferrals are typically linked to profitability. Therefore, in case an optional deferral, issuers with a higher rating on their traditional debt instrument would typically have a lower notch-down (typically 0-1 notch) than issuers with a lower rating. This is because higher-rated issuers will have stronger profitability than those with a low rating, and hence, will be in a better position to service the instrument regularly.

Additionally, if the likelihood of a breach of the deferral trigger is high and the trigger is not discretionary, Crisil Ratings assesses such instruments as having high probability of missing payments. Consequently, the instruments will be notched down by at least two notches. Crisil Ratings also assess all additional features of the instrument that can lead to a default in payment on the instrument.

Conclusion

Hybrids are instruments which have both debt and equity like characteristics. Based on their features, Crisil Ratings classifies hybrids as either low equity (0-25% equity), intermediate equity (25-50% equity), or high equity (50-75% equity). While analysing the equity content of hybrids, Crisil Ratings considers a number of parameters such as the fixed coupon rate, permanence, deferability, triggers for deferral, cumulation, availability and timing of call options, coupon step-up, and position in the capital structure. Crisil Ratings analyses these factors not only from the perspective of the legal and economic structure of the instrument, but also in terms of cash outflow implications on debt servicing by the issuer.

This section also focusses on the rating of hybrids. Once the equity content of the instrument has been determined, Crisil Ratings arrives at the rating by notching down from the rating on the senior unsecured debt of the issuer. Crisil Ratings centrally factors in likelihood of breach of deferral trigger and discretionary nature of trigger while deciding the degree of notch down.

Annexures

Box 3: Essential features of common equity replicated in hybrids

From a lender's perspective, common equity is the best form of capital. As issuers of hybrids try to replicate the essential features of equity, it is appropriate to identify some of the characteristics of common equity that will reveal how successful the replication is. The primary characteristics of equity are:

Capital structure: A company's capital structure, commonly referred to as gearing, leverage, or the debt/equity ratio, reflects the extent of borrowed funds in its funding mix. The equity component in a company's employed capital has no fixed obligation; returns to the investor depend on the profit made by a company. Debt, on the other hand, carries specified obligations of interest and principal, which have to be honoured, irrespective of the vicissitudes in business.

Absence of maturity or principal repayment: Under no circumstance is an issuer required to contractually return common equity to shareholders. Unlike equity, debt needs to be repaid at maturity or in fixed instalments. Common equity does not give the investor a fixed claim on the issuer's cash flow, by way of either gradual or full repayment. In the case of debt, however, the gradual repayment of principal and regular interest outflow places an ongoing fixed demand on the issuer's cash flow. Therefore, the need to fund maturing debt with cash flow from operations, or through refinancing, increases the issuer's credit risk.

The risk is exacerbated if the issuer encounters any type of financial stress that limits cash flow or impedes ability to refinance. Fixed obligations introduce the risk of default, cross-default to other debt, or even bankruptcy. Common stock imposes no such demands. Although many companies have bought back their shares in the recent past, these are mostly discretionary. Moreover, the risk of equity buybacks is mitigated by restrictions on such repurchases, such as a one-year gap between repurchases and limitations on the debt-equity ratio post- repurchase. It must, however, be recognised that the average duration of equity will reduce over the long term and equity need not be perpetual.

Absence of recurring payments: Dividend payments on common equity shares are largely discretionary. The ability to reduce or eliminate fixed payments is a characteristic of common equity, which can provide significant cushion to a company's cash flow. Thus, in a stress situation, or when profits are lower because of a recession in the business cycle, an issuer can choose to either reduce or skip its dividend payouts without triggering an event of default. In the case of new projects as well, an issuer can skip dividend payments until the project begins to generate profits. Such flexibility is not available in the case of traditional debt, where skipping interest payments usually triggers an event of default, which if not addressed, may eventually lead to bankruptcy.

Significant loss absorption: A firm's net worth represents the residual value after paying off all liabilities. As losses and impairment in assets can be written off against the net worth, it provides cushion to reduce the likelihood of a liquidation event. Common equity has the largest loss absorption quality of all financing options available to a company; because shareholders are the last to receive any distribution in a liquidation situation. Thus, equity protects the company from any unforeseen distress situations and allows it to continue its business. In case of distress, equity provides the first layer of loss absorption followed by hybrids, unsecured and secured creditors.

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