Rating Criteria for Commercial Paper and Short-Term Debt

CRISIL has been assigning short-term ratings for over 20 years for commercial paper (CP) and short-term debt (STD), and has rated issues made by more than 700 issuers. CRISIL has unmatched coverage in such ratings, having started the process in 1989, even before regulations were introduced for CP issues. CRISIL has been at the forefront in developing criteria for CP and STD, and has been very responsive to market needs and emerging regulatory scenarios. (See box on key regulations governing CP issues.)

CRISIL adopts a unique six-step framework for assigning short-term ratings:

- Step 1: Assess the underlying credit quality of the issuer, as reflected in its long-term rating.
- Step 2: Assess the liquidity position and analyze the monthly cash flows of the issuer
- Step 3: Arrive at a short-term rating, using a mapping framework
- Step 4: Arrive at the quantum of CP/STD consistent with the rating.
- Step 5: Evaluate the liquidity back-up
- Step 6: Evaluate credit enhancement options, if applicable.

This unique framework has helped CRISIL in successfully identifying key credit drivers for STD, which is amply reflected in its rating performance. The six steps in CRISIL's rating criteria are explained in detail below, preceded by a brief background on the CP market in India and why CRISIL adopts an identical approach in rating CP as well as STD.

CP and STD are rated alike

An unsecured money-market instrument, CP is issued by highly-rated companies, financial institutions and primary dealers to raise short-term funds. In India, CP has traditionally been used as low-cost short-term instruments to replace working capital borrowings from the banking system by manufacturing companies. In recent years, highly-rated non-banking financial companies (NBFCs) have also started accessing CP in a large way, as a means to meet their short-term funding needs. NBFCs and financial institutions now account for over 60 per cent of the total CP issued.

Since it was first launched in 1990, the CP market has grown steadily to a substantial size; currently, it is in excess of Rs.1200 billion. CP issues are governed by the Reserve Bank of India (RBI). Earlier, CP issues were a part of the issuer's working capital limits, but now this link has been removed, leaving companies free to issue CP within or outside the bank-sanctioned working capital limit, thereby blurring the distinction between CP and other STD. Therefore, CRISIL adopts identical criteria while rating CP and STD with an original contracted maturity of up to one year.

Step 1: Assessing the underlying credit quality of the issuer

CRISIL's rating on a CP or STD is largely dependent on its opinion of the issuer's fundamental credit quality. The analytical approach adopted by CRISIL for assigning CP and STD ratings is very similar to that of its long-term ratings as there is a strong linkage between the two. While a CP's tenure can range from 15 days to 365 days, the short-term rating's time horizon extends well beyond this period because even short-term ratings are expected to endure over time rather than change frequently. Moreover, if a CP or STD issue's maturity cannot be met through subsequent CP or STD issues (roll-over) for any reason, the issuer has to rely on fresh borrowings. In such a case, the issuer's ability to refinance would largely depend on the company's fundamental credit quality, as reflected in its long-term rating.

Step 2: Assessing the liquidity position

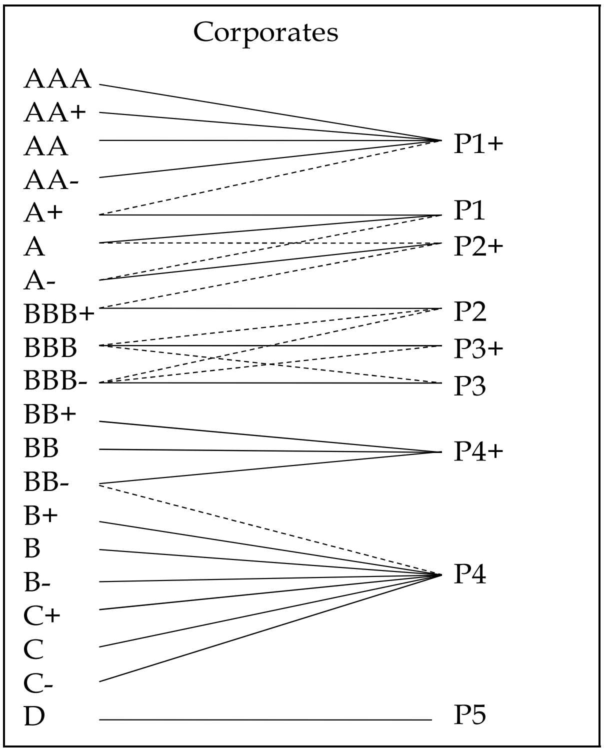
Once the long-term rating is assessed, CRISIL's CP/STD rating methodology will involve taking into account the issuer's current liquidity position and closely analysing monthly cash flow positions. This includes an assessment of the cash flow statements of the past 12 months, as well as an assessment of the future monthly cash flows. Where applicable, monthly bank limit utilisation during the past 12 months also serves as additional input into the analysis.

Step 3: Mapping framework

While the short-term ratings are inexorably 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, Chart 1 illustrates a set of possible outcomes in mapping the two scales, for companies in the manufacturing/infrastructure sector.

For companies in the financial sector, the mapping adopted may be a bit more lenient than for manufacturing companies, primarily on account of better liquidity position and easier access to funds by finance companies as compared to their peers in the manufacturing sector.

Chart No: 1 Mapping of short-term ratings with long-term ratings



CRISIL may assign a rating that is different from the above mapping as an exception (indicated by the dotted lines on the above chart) in cases where CRISIL has a particular reason to ascribe a relatively stronger (or weaker) short-term credit quality. For example, companies that carry large liquid securities may obtain a better short-term rating than that suggested by the mapping.

Step 4: Assessing the quantum of rated short-term debt

While assigning short-term ratings, CRISIL scientifically assesses the quantum of rated short-term debt that a company can issue based on its business plan. This assessment is based on an analysis of the maturity profile of the issuer's assets and liabilities, its assessment of the liquidity position of the company, and its refinancing ability. In some instances, CRISIL may put a ceiling on the allowable quantum of short-term debt based on the company's cash flow and liquidity position.

Step 5: Liquidity back-up for CP and STD

A liquidity back-up facility is a mechanism that allows CP and STD issuers to draw funds from a pre-arranged line, if they choose not to roll over the CP/STD (or are unable to do so). In the Indian context, the most commonly available liquidity back-up facilities are sanctioned bank lines for working capital. Other examples of liquidity back-up facilities include compensated lines, pre- arranged bank facilities, revolving credit facilities and the like.

Liquidity back-up facilities are essential for assigning ratings to CP programmes. These back-up lines protect against the risk of default under circumstances in which investors are unwilling or unable to roll over the issuer's CP even though the issuer remains creditworthy. For instance, a disruption in the commercial paper market due to banking system's liquidity, or uncertainties regarding the issuer following a specific event (such as a lawsuit or management changes) might trigger the need to utilise the back-up.

Short-term debt markets are highly confidence-sensitive in nature, where investors might be unwilling to bear even a few days' delay compared to long-term debt markets. This underscores the criticality of liquidity back-up facilities, which can be used to make timely payments on short-term debt instruments. CRISIL insists on a liquidity back-up facility to the extent of its rated debt for all its short-term ratings. However, CRISIL may marginally relax this 100 per cent liquidity back-up requirement for highly-rated companies.

For companies in the financial services sector, keeping in mind their easier access to funds and the more liquid nature of their assets, CRISIL may not insist on a pre-arranged liquidity back-up facility. Instead, CRISIL would evaluate the liquidity plan presented by the company over the tenure of STD/CP and also evaluate the alternative options available with the company to meet the redemptions.

Internationally, the concept of having a back-up for CPs came about when the US CP market was disrupted in June 1970 after Penn Central Railroad defaulted on its USD 82 million CP issue. This first ever default of a prime-rated corporate entity increased nervousness among investors so much so that even highly-rated companies found it difficult to roll over outstanding CPs. Today, all CPs issued in the international market are backed by a liquidity facility, though the nature and extent of the coverage varies depending on factors such as the maturity pattern of the CP and other STDs, and the issuer's standalone rating.

CRISIL also assesses the quality of the liquidity back-up facility while assigning the short-term rating. For issues that are carved out of existing working capital bank limits, the same would function as a liquidity back-up. For other forms of liquidity back-up facilities, CRISIL 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 draw funds.

Although liquidity back-up facilities are a pre-requisite for rating a CP, CRISIL does not enhance CP ratings based on a liquidity back-up facility. This is because most liquidity back-up 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. Thus, liquidity back-up facilities provide support only in times of market disruption and not in times of fundamental credit quality deterioration of the CP or STD issuer. Hence, the presence of a liquidity facility does not, per se, enhance the CP's credit rating. CRISIL 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 6: Evaluating credit enhancement options

In its guidelines, RBI has allowed commercial banks to provide back-stop facilities for credit enhancement, such as a standby credit facility. Such facilities provided by banks are distinct from liquidity facilities in that they work like a guarantee. The current guidelines even allow corporate entities to 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 the obligations on the issue, if the primary obligor (the issuer) fails to do so. In such cases, the CP/STD rating is generally equalised to that of the facility provider irrespective of the issuer's standalone rating.

CRISIL assigns the rating of the facility provider for such issues after evaluating the covenants of the stand-by credit facility or guarantee. Thus, CRISIL clearly distinguishes between a liquidity back-up facility and a credit facility based on these covenants, and reflects the same in the rating assigned to the CP. In addition, credit enhancement can be provided by non-bank (corporate) entities through unconditional and irrevocable guarantees to the CP programme of the issuer. Issues guaranteed by corporate entities would be rated on CRISIL's short term rating scale with an '(so)' suffix, with the rating being equated to that of the guarantor.

Box: Key regulations governing CP issues

Commercial paper (CP) issues in India are regulated by the Reserve Bank of India (RBI), which periodically notifies guidelines for such issues. Till October 2000, CP issues were carved out of the working capital limits of the issuer in accordance with the prevalent RBI guidelines. Working capital limits were reduced to the extent of the commercial paper issued and reinstated to original levels on the paper's repayment. Although the reinstatement was not a compulsory obligation on part of the lending bank, this was done almost invariably and, in effect, the bank limits acted as a liquidity back-stop for the CP.

The RBI's guidelines on CP (issued on October 10, 2000) have de-linked them from the working capital limits of a company. In effect, this means that companies now have the freedom to issue CP within or outside the bank's working capital limits, thereby blurring the distinction between CP and any other short-term debt (STD).

In addition, RBI permitted banks to provide 'stand-by assistance/credit back-stop facilities' for credit enhancement of a CP. Furthermore, the credit policy announced by RBI on April 29, 2003 allowed non-bank entities including corporate entities to provide credit enhancement for CP issues through unconditional and irrevocable guarantees.

CRISIL has been assigning CP ratings for over 20 years and its rating criteria for CP have also undergone changes during this period in line with the regulations governing such issues. The criteria presented above are CRISIL's approach to rating CP and STD under the current regulatory regime. CRISIL has been proactive in the past in updating its criteria in line with regulatory changes; any such changes in future would also be immediately factored into CRISIL's rating criteria for CP.

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