

CRISIL's criteria for rating instruments backed by guarantees

Legal analysis and payment mechanisms

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Criteria contacts

Somasekhar Vemuri

Senior Director – Rating Criteria and
Product Development
Email: somasekhar.vemuri@crisil.com

Chaitali Nehulkar

Associate Director – Rating Criteria and
Product Development
Email: chaitali.nehulkar@crisil.com

Ramesh Karunakaran

Director – Rating Criteria and
Product Development
Email: ramesh.karunakaran@crisil.com

Wazeem M A

Manager – Rating Criteria and
Product Development
Email: wazeem.a@crisil.com

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

Executive summary

Credit enhancements through guarantees allow entities to raise funds from the capital markets and banks at low interest rates. Investors in guaranteed instruments are protected from any decline in the standalone credit 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 non-banking finance company (NBFC). In rating guaranteed instruments, CRISIL assesses the guarantee deed and related documents for any legal risks, and for adequacy of timelines—for invocation of guarantee, and subsequent payment by the guarantor.

Where the guarantee covers the entire payment obligations on the instrument, the rating of the instrument is equated with the guarantor's rating, and suffixed with the symbol 'CE' (indicating 'credit enhancement'), if CRISIL is convinced that:

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

If partial guarantees satisfy conditions (a) and (b), the rating of the instrument will be between those of the issuer and the guarantor, depending on the extent of coverage provided by the guarantee. The rating will also be suffixed with the 'CE' symbol.

CRISIL may factor in the strength of conditional guarantees in the rating if the probability of breach of covenants is low, or if there are adequate provisions to mitigate the risk of breach, and of termination of the guarantee.

Scope of criteria

This criteria note¹ pertains to instruments that are backed by guarantees from corporates, financial institutions or central or state governments. Credit enhancement in the form of standby letter of credit from a bank for an entity's commercial paper programme may also be included in the purview of the criteria. The focus, however, is on the legal aspects and payment mechanisms that are analysed for instruments with full or partial guarantees. This note does not cover the methodology for rating partially guaranteed instruments.²

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 in case 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 the following critical principles (*see Table 1*) before the strength of the guarantee is factored into the rating:

¹ This article has been updated to include the approach for conditional guarantees, and to incorporate SEBI guidelines on application of 'CE' suffix for ratings of instruments backed by explicit credit enhancement from third party / parent / group company. For the previous version of this article, which was published in July 2018, please refer to the link below:
https://www.crisil.com/content/dam/crisil/criteria_methodology/structured-finance/archive/crisil-criteria-for-rating-instruments-backed-by-guarantees-july-2018.pdf

² Please refer to 'CRISIL's rating methodology for partially guaranteed instruments', available on www.crisil.com

Table 1: Critical principles in a guarantee deed

SI No	Principle	Explanation
1	Unconditional	There should be no conditions attached to the guarantor's performance in honouring its obligations under the guarantee.
2	Irrevocable	The guarantor should not be entitled to revoke the guarantee till all the obligations of the borrower/issuer are fully paid to the satisfaction of the lender/ beneficiary.
3	Continuing	The obligations of the guarantor should continue, and not be terminated till all obligations of the borrower under the underlying loan/facility/NCD is fully paid out to the satisfaction of the lender/ beneficiary.
4	Adequate consideration	Consideration in some form should be passed on to the guarantor for providing the guarantee.
5	Cover entire facility	The guarantee should cover the entire rated instrument, including principal, interest (+) costs, charges, expenses, default interest, any any other payable by the borrower.
6	Guarantee for payment	The obligation of the guarantor should not be to ensure that the borrower pays the obligations or to collect payments from the borrower. Instead, the guarantor should explicitly undertake to pay the amounts payable by the borrower as per the terms of underlying instrument in case the borrower fails to pay.
7	Payment mechanism	The guarantee deed should specify timelines for invocation of the guarantee by the lender/trustee/IPA, and for subsequent payment by the guarantor. In case of NCDs/CPs, the timelines must be specified either in the guarantee, or in the debenture trust deed (DBT), with the guarantee making a specific reference to the DBT regarding timelines.
8	Payment on first demand	The guarantor should make payment under the guarantee on receipt of the first demand or notice from the lender/beneficiary.
9	Payment without deduction	All guaranteed payments are to be made by the guarantor without any set off, counter claim, or other deduction or withholding whatsoever.
10	Rights of suretyship waived	Laws relating to guarantees provide certain rights to the guarantors, including automatic termination of the guarantor's obligations under certain situations. The guarantor must explicitly waive all statutory suretyship rights available to the guarantor, till all dues to the lender/beneficiary are fully paid.
11	Guarantor is primary obligor	The lender/beneficiary is entitled to proceed against the guarantor without waiting to exercise all its remedies.
12	Insolvency & bankruptcy / BIFR	The guarantor should agree to make payments under the guarantee even in case of <ul style="list-style-type: none"> • initiation of insolvency resolution process, including but not limited to enforcement of any moratorium and appointment of resolution professional, against the company under the Insolvency and Bankruptcy Code 2016, or, • liquidation, winding up, bankruptcy or dissolution (or proceedings analogous thereto) of the company, or, • the appointment of a receiver or administrative receiver or administrator or trustee or similar officer of any of the assets of the company.

CRISIL scrutinises the guarantee deed for any express provisions that violate the spirit of these principles. This is because the mere presence of key words mentioned in Table 1 do not necessarily mean that the guarantee deed adheres to the corresponding principles. In case there are such express provisions in the guarantee, CRISIL may not factor in the guarantee into the rating of the instrument.

Conversely, the absence of any of the specific key words listed in Table 1 does not necessarily lead to CRISIL 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 may obtain independent legal opinions or undertakings from the guarantor to ensure that the guarantor intends to

adhere to these principles. In case the guarantor provides the requisite undertakings and legal opinions, CRISIL could factor in the strength of the guarantee into the rating on the instrument.

Guarantee agreements in case of bank loan facilities are typically drafted by the banks themselves. Hence, in such cases, if it appears that the omission of a particular clause was not intentional, CRISIL may obtain a confirmation from the lender stating that the guarantee has been executed as per the lender's standard format and that, based on the assessment of its legal team, the guarantee is unconditional, irrevocable, valid, binding and enforceable.

Conditionality of guarantees

In case of conditional guarantees, CRISIL may still factor the strength of the guarantee into the rating on the underlying instrument if

- 1) there are sufficient provisions to mitigate the risk of breach of conditions or termination of the guarantee, or
- 2) the probability of such conditions materialising is low.

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

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

- Partial guarantees extended by financial institutions (FIs)
 - The partial guarantees are based on their own credit enhancement policies, and may be subject to conditions, such as the following, failing which the guarantee may be terminated by the guarantor:
 - Payment of guarantee fees to the FI by the issuer
 - Reimbursement of amounts paid by the FI under the guarantee
 - Standalone credit rating of the issuer exceeds a certain threshold
 - CRISIL considers the presence of provisions that can cushion against the breach of such conditions while rating the guaranteed instrument.
- 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 cease to exist in case the ownership of the entity is transferred from the government, unless the guarantee is re-confirmed by the Budget Division, rendering such guarantees conditional
 - CRISIL 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 in the rating of the guaranteed instrument.

Government guarantees

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 executes a tripartite agreement with the issuer and trustee, detailing the payment mechanism. CRISIL assigns ratings to state government guaranteed instruments based on the analysis of the guarantee notification and the tripartite agreement.

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 may factor the guarantee into the rating on the facility even though the guarantee is valid for a limited time. If the guarantee is not renewed on expiry, CRISIL may revise the rating on the facility to reflect the borrower's standalone credit profile, since the guarantee has ceased to exist.

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. In case of foreign guarantees, CRISIL 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:

1. 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?
2. Upon invocation of the guarantee, can the remittances be made from the guarantor's jurisdiction to India as per the existing legal framework in the guarantor's jurisdiction?
3. Should additional approvals be obtained from a regulatory authority for making remittances under the guarantee?

CRISIL factors the strength of foreign guarantees into the rating if the legal counsel confirms that the guarantee is unconditional, irrevocable and 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 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.

Non-fund based bank facilities backed by letter of comfort from financial institutions

Some non-fund-based facilities are backed by a letter of comfort from highly rated financial institutions that cannot sanction non-fund-based facilities. Instead, they extend letters of comfort based on which project developers obtain letters of credit from banks. Such letters of comfort are issued in the normal course of business, and are backed by term loans from the financial institutions, and are worded as unconditional and irrevocable undertakings with sufficient mitigants to overcome deficiencies compared with a guarantee deed. Based on these strengths, the rating on the non-fund-based facility can be equated with that of the entity providing the letter of comfort.

Payment mechanism

Guaranteed capital market instruments

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

1. Issuer transfers the requisite funds to the designated account (account for making payments on NCDs) or the issuer's account with the issuing & paying agent (IPA account - in case of CPs)³
2. If the issuer fails to transfer the requisite funds, the debenture trustee or IPA invokes the guarantee
3. The guarantor transfers the requisite funds to the designated or IPA account
4. Payments are made to investors from the designated or IPA account on the due date

The timelines for invocation of 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 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 to issuers with limited budgetary allocation.

In evaluating the payment mechanism, CRISIL also factors in operational risks that may arise. For instance, in case of CPs backed by standby letter of credit (SBLC) from a bank, the operational risks would be lower if the SBLC provider and IPA bank are the same, as the same entity will invoke and transfer funds. The timelines in such cases may, therefore, be lower than if the SBLC provider and IPA are different entities. *Annexure-I* outlines the timelines that CRISIL believes are adequate for timely payments to investors, based on market practices and empirical assessment of the response time of guarantor and operational risks involved. However, CRISIL may make exceptions on the timelines provided there are sufficient factors to offset risks.

Guaranteed bank facilities

In case of guaranteed bank facilities, there have been several instances when lenders have failed to invoke guarantees, leading to defaults. Hence, for bank loan facilities, CRISIL obtains an undertaking from the guarantor that in case the borrower defaults on a due date, the guarantor will make necessary payments to the lender within a specified timeline, irrespective of whether the lender invokes the guarantee. CRISIL may assign a 'CE' rating to the bank loan facility equated to the rating on the guarantor, based on the collective strength of the guarantee and undertaking, if there is enough confidence in the guarantor's management regarding the intent to honour the timelines as per the undertaking.

For bank loan facilities guaranteed by the central and state governments, CRISIL does not factor the strength of the guarantee into the rating on the underlying facility as the governments may not step in to make payments without invocation of guarantee by the lenders. There have been instances of default due to lenders not invoking government guarantees, and governments not stepping in to prevent such defaults in the absence of an invocation of guarantee.

³ 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

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 guarantee by the trustee in case the issuer fails to fund the designated account. Considering the criticality of the trustee, CRISIL usually obtains an awareness letter from the trustee (*refer to Annexure-II*) to ensure that the trustee is fully aware of its responsibilities. CRISIL may obtain a similar letter from IPAs in case of guaranteed CP issuances.

Provisional ratings

CRISIL may assign provisional ratings 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, duly executed:

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

Details on CRISIL's policy on provisional ratings may be accessed here: "Revision in CRISIL policy for assigning 'provisional' rating", on our website.

Conclusion

In assigning ratings to guaranteed instruments, CRISIL conducts detailed analyses of the legal aspects of the guarantee and payment mechanism. A CE rating equated to the guarantor is assigned only if the guarantee is unconditional and irrevocable, and the transaction's payment mechanism indicates timelines that are adequate to ensure that the investors will be paid in line with the transaction documents. In the case of conditional guarantees, CRISIL may factor in credit enhancement from the guarantee only if risks posed by the conditional nature of the guarantee are adequately mitigated / have low probability of occurrence.

Annexures

Annexure - I: Payment timelines usually adequate, based on empirical research

'T' refers to due date for payment to investors

Guaranteed by →	Guarantee from parent / group company	SBLC backed CPs (Different standby and IPA banks)	SBLC backed CPs (Same standby and IPA banks)	Guarantee from FIs	Govt. guarantees for entities with budgetary support	Govt. guarantees for entities without budgetary support
Timelines ↓						
Trustee / IPA to notify guarantor of upcoming dues	-	-	-	T-15	T-45	T-90
Trustee / IPA to invoke guarantee if 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

The above timelines are for (T – n) payment mechanisms that envisage the issuer making a payment prior to the due date on the instrument (T), 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 recognized on the 'T+x'th day, which is the last date on which the guarantor needs to make payments to the investor as per the envisaged mechanism.

Certain payment mechanisms provide for enhanced liquidity wherein the state government undertakes to fill the shortfall amount in DSRA, in addition to the bond guarantee. Such instruments help mitigate risk of delayed payment from the state government on account of the presence of liquidity buffer. Such payment mechanisms, which 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 accompanying the same. We, in our capacity as Debenture Trustee / Issuing & Paying Agent (IPA) to the captioned transaction, confirm:

1. 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)
2. 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 within 60 days from the date of allotment.
3. We fully understand all the aspects of the said payment mechanism. We also understand our responsibilities thereunder, which includes 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:

1. To inform CRISIL immediately by e-mail of any instance of non-compliance with the payment mechanism.
2. To monitor the designated account for upcoming payments, and if not funded adequately as per stipulated dates, invoke guarantee of the guarantor on time, in accordance with the payment mechanism, and inform CRISIL immediately by e-mail of the invocation of guarantee.
3. To certify to CRISIL, 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 with 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”), by _____ (the “Issuer”).

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

1. All information provided by the issuer to CRISIL regarding the issuance of NCDs, including the operation of the payment mechanism, is true and correct.
2. The payment mechanism (as mentioned in Annexure to this Representations & Warranties) shall operate in the same manner as represented by the issuer to CRISIL.
3. 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,
4. The executants of the legal documentation on behalf of the issuer have been duly empowered and authorized to execute the same and to carry out all necessary actions in accordance with the terms set out therein.
5. The issuer shall satisfy all covenants in connection with the NCD issuance to ensure that the NCDs are fully redeemed in a timely manner.
6. The issuer shall ensure that within a period of 60 days from the allotment of the NCDs
 - a) A Designated Account with a bank is operational for meeting the obligations on the aforesaid debt
 - b) 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
 - c) Submit copies of all the executed transaction documents to CRISIL
7. All the representations and warranties provided by the issuer to CRISIL are true and correct

Authorized Signatory of Issuer <<Signatory Name, Designation, Company Seal>>

Annexure to detail payment mechanism

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

CRISIL Ratings is part of CRISIL Limited ("CRISIL"). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI"). With a tradition of independence, analytical rigour and innovation, CRISIL sets the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 1,10,000 MSMEs have been rated by us.

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