Criteria for rating instruments backed by guarantees

Legal analysis and payment mechanism

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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 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).

In rating guaranteed instruments, CRISIL 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’ (indicating ‘credit enhancement’), if CRISIL is convinced that:

- The guarantee is unconditional and irrevocable,
- 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.

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

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 the criteria

This criteria note 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, and other unconditional and irrevocable third-party credit support are also included in the purview of the criteria. 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.

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

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1 For the previous version of this article, which was published in September 2019, please refer to the link below: [https://www.crisil.com/content/dam/crisil/criteria_methodology/structured-finance/crisil-criteria-for-rating-instruments-backed-by-guarantees-sep-2019.pdf](https://www.crisil.com/content/dam/crisil/criteria_methodology/structured-finance/crisil-criteria-for-rating-instruments-backed-by-guarantees-sep-2019.pdf)

2 Please refer to ‘CRISIL’s rating methodology for partially guaranteed instruments’, available on [www.crisil.com](http://www.crisil.com)
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

<table>
<thead>
<tr>
<th>Sl No</th>
<th>Principle</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Unconditional</td>
<td>There should be no condition attached to the guarantor’s performance in honouring its obligations under the guarantee.</td>
</tr>
<tr>
<td>2</td>
<td>Irrevocable</td>
<td>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.</td>
</tr>
<tr>
<td>3</td>
<td>Continuing</td>
<td>The obligations of the guarantor should continue, and not be terminated till all obligations of the borrower under the underlying loan/facility/non-convertible debenture (NCD) are fully paid out to the satisfaction of the lender/beneficiary.</td>
</tr>
<tr>
<td>4</td>
<td>Adequate consideration</td>
<td>Consideration in some form should be passed on to the guarantor for providing the guarantee.</td>
</tr>
<tr>
<td>5</td>
<td>Entire facility covered</td>
<td>The guarantee should cover the entire rated instrument, including principal, interest (+) costs, charges, expenses, default interest and any other payable by the borrower.</td>
</tr>
<tr>
<td>6</td>
<td>Guarantee for payment</td>
<td>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 the underlying instrument if the borrower fails to pay.</td>
</tr>
<tr>
<td>7</td>
<td>Payment mechanism</td>
<td>The guarantee deed should specify timelines for invocation of the guarantee by the lender/trustee/issuing and paying agent (IPA), and for subsequent payment by the guarantor. In case of NCDs/commercial papers (CPs), the timelines must be specified either in the guarantee or in the debenture trust deed, with the guarantee making a specific reference to the debenture trust deed regarding timelines.</td>
</tr>
<tr>
<td>8</td>
<td>Payment on first demand</td>
<td>The guarantor should make payment under the guarantee on receipt of the first demand or notice from the lender/beneficiary.</td>
</tr>
<tr>
<td>9</td>
<td>Payment without deduction</td>
<td>All guaranteed payments are to be made by the guarantor without any set off, counter claim, or other deduction or withholding whatsoever.</td>
</tr>
<tr>
<td>10</td>
<td>Rights of suretyship waived</td>
<td>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 it, till all dues to the lender/beneficiary are fully paid.</td>
</tr>
<tr>
<td>11</td>
<td>Guarantor is primary obligor</td>
<td>The lender/beneficiary is entitled to proceed against the guarantor without waiting to exercise all its remedies.</td>
</tr>
</tbody>
</table>
| 12    | Insolvency & bankruptcy/Board for Industrial and Financial Reconstruction | The guarantor should agree to make payments under the guarantee even if:  
  - 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,  
  - Appointment of a receiver or administrative receiver or administrator or trustee or similar officer of any of the assets of the company. |
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 scrutinises the guarantee deed for any express provisions that violate the spirit of these principles. If there are such express provisions, CRISIL 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 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. If 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 for bank loan facilities are typically drafted by the bank. Hence, 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.

**Conditional guarantees**

In case of conditional guarantees, CRISIL 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 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:

- Partial guarantees extended by FIs:
  - Partial guarantees are based on the FI’s 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 exceeding 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 shall cease to exist if 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 into the rating on 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 execute 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 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 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 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 FIs**

Some non-fund-based facilities are backed by a letter of comfort from highly rated FIs 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 FIs, 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 may 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. 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)\(^3\).
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 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 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 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 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 guarantors and the operational risks involved. However, CRISIL may make exceptions for the timelines if there are sufficient factors to offset risks.

\(^3\) 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.
Guaranteed bank facilities

In case of guaranteed bank facilities, there have been several instances of lenders failing to invoke the guarantee, leading to default. Hence, for bank loan facilities, CRISIL obtains an undertaking from the guarantor that if the borrower defaults on a due date, the guarantor will make the necessary payment to the lender within a specified time, 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 facilities backed by a central or state government guarantee, CRISIL shall factor in the strength of the guarantee into the rating on the facility only if there is adequate 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 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 the issuer (refer to Annexure III)
- Additional documents executed for the transaction

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4 For details on CRISIL’s policy on provisional ratings, please visit [www.crisil.com](http://www.crisil.com)
Conclusion

In assigning ratings to guaranteed instruments, CRISIL 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 unconditional and irrevocable, and if the transaction’s payment mechanism indicates adequate timelines 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 or have low probability of occurrence.
Annexures

Annexure I:

Table 2: Adequate payment timelines, based on empirical research

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

‘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:

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 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:

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 the stipulated dates, to invoke the guarantee on time in accordance with the payment mechanism, and to inform CRISIL immediately by e-mail of the invocation of the 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 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”), 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 the 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 authorised 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.

____________________________
Authorised 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 through businesses that operate from India, the US, the UK, Argentina, Poland, China, Hong Kong and Singapore.

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