RATING THE ISSUE

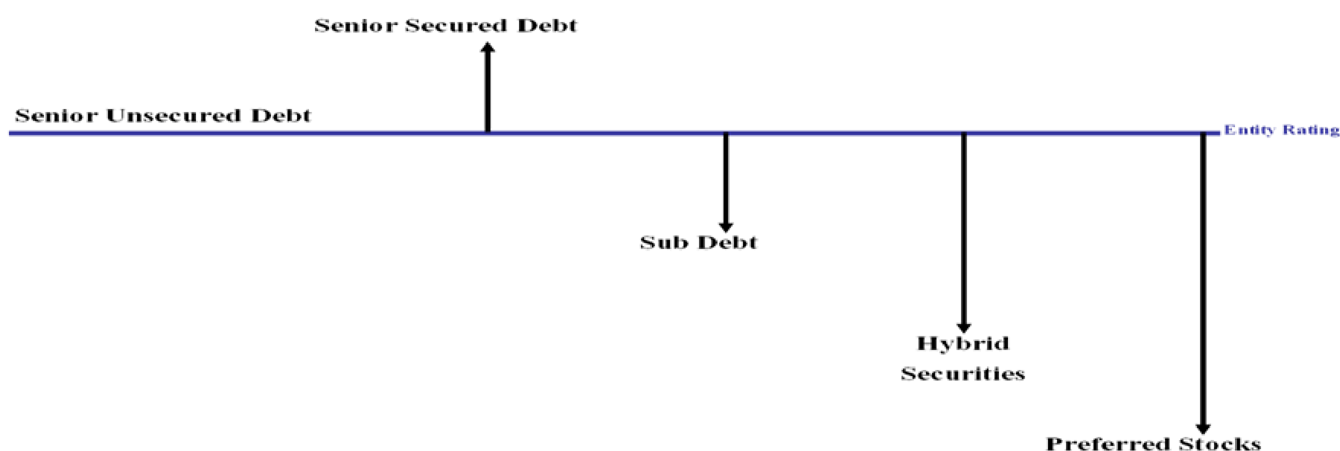
Credit ratings provide an opinion on a company's ability and willingness to meet its obligations on time. VIS Credit Rating Company Limited assigns credit ratings to both issuers and issues. These issuers may include corporations, financial institutions or sub-sovereigns. The issuer ratings take into account the business and financial risk profile of the entity and apply to the senior unsecured creditors. The specific factors that need to be taken into account in case of issuer rating depend on the type of issuer. In case of a corporate issuer, one of the most important factor that may need to be considered is debt service coverage ratio, whereas in case of a financial institution, quality of deposits may be amongst the most critical factor.

The issue specific rating takes into account the relative priority of claim of a particular class of debt vis-à-vis the other outstanding obligations of that particular entity. This means that issue specific rating takes into account both the probability of default on an entity level basis and the recovery prospects associated with a particular debt issue. As a general rule, the set of creditors that will be settled first in a bankruptcy scenario will be assigned the highest ratings, whereas the equity holders have residual claim on a company's assets. This essentially means that VIS will first arrive at the issuer rating and then the ratings of individual debt issues may be determined based on their specific features. Broadly speaking, the following factors must be considered before arriving at issue specific rating:

- Debt specific factors, including security and relevant legal structure
- Relative seniority of the debt issue vis-à-vis other outstanding debt obligations of the issuing entity
- Credit enhancement, if any

Notching Guidelines

The notching guidelines take into account the relative positioning of various classes of debt obligations.



The above chart summarizes the notching guidelines practiced by VIS, in terms of where a particular debt issue will be placed in relation to the entity rating. It is however important to recognize that as the ratings become higher, the reliance on collateral progressively becomes lower. In terms of ratings, this implies that there may be greater differentiation in let's say the entity and subordinated debt ratings of a non-investment grade issuer vis-à-vis an investment grade issuer. In case of an investment grade issuer, the notching down of subordinated debt is generally limited to one notch while it may be up to two notches in case of speculative grade issuers. Similarly, there may be no need to create any differentiation at all between the entity and subordinated debt rating of a 'AAA' rated issuer.

The extent of notching of subordinated/unsecured debt also depends on the quantum of secured or preferred debt carried by a company in relation to the total pool of assets that may be offered as collateral. If a company does not have sufficient assets remaining after satisfying the obligations of secured/preferred creditors, then this could put the subordinated/unsecured debt holders at a disadvantage and may warrant a larger rating differential than may otherwise be warranted.

Moreover, the quality of security also plays an important role in the extent of notching up of secured debt, including its current valuation, nature of charge, probability of obsolescence and the level of enforceability of securities as incorporated in the legal documentation. In case of specialized assets, which do not have sellability or utility outside of the business of the entity, such as those that may be carried by a telecom operator or a refinery, may not necessarily result in any differentiation of the entity and secured debt ratings.

Factoring in Credit Enhancements

Credit enhancement is any form of risk reduction technique that provides protection, in the form of financial support, to cover losses under stressed scenarios; generally, such form of support must be unrelated to the issuing entity to provide the necessary credit uplift.

There can be two types of credit enhancement:

- Third party guarantees
- Cash collection mechanism

In case of the former, the extent of enhancement is a function of the strength of guarantor, amount of guarantee vis-à-vis amount of debt and the timeliness of the guarantee. Moreover, a corporate guarantee carries less weight vis-à-vis a guarantee issued by a financial institution/government. If a particular security is fully secured by a third party, then the counterparty risk will be replaced by the guaranteeing entity. For instance, a debt instrument issued by an entity rated BBB and fully guaranteed by an entity rated A would be assigned rating of A, assuming that the guaranteeing entity is rated by VIS. If VIS does not have an outstanding opinion on the guaranteeing entity, then a shadow rating may be done, and the debt instrument would be rated accordingly.

In certain scenarios, land or financial assets that is not part of an entity's core operations and is available for disposal without recourse to court, can also act as credit enhancement, if such assets are part of the security structure of a particular debt instrument.

Cash collection mechanism which can also be referred to as on-balance sheet securitization, can sometimes also result in a particular debt instrument being rated distinctly from what may be indicated by the issuer rating and notching guidelines discussed above. When captured, one specific revenue stream of the entity, backing a particular liability may result in a better credit quality vis-à-vis the entity rating. The entrapment of revenue in designated accounts however has to be viewed in context of the likely cash requirements for normal business operations. VIS recognizes that cash entrapment mechanism cannot compensate for an issuer's ability to pay if overall entity level debt servicing capacity is considered constrained in general, since an entity that stops making payments on a particular class of debt, may stop payments on all types of debts; this may also be triggered by cross-default covenants in loan documents. If however, there is sufficient legal ring fencing, which would ensure that payments on a particular class of debt will continue even if the entity defaults on one or other liabilities, then the necessary credit enhancement may be built into the ratings of the debt instrument backed by specific cash flows.