Guarantee and its impact to debt instrument rating

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PEFINDO views that guarantee given to a debt instrument may enhance its credit profile, resulting in higher rating given to the guaranteed debt instrument compared to the issuer's rating. The existence of guarantee may not significantly affect the instrument's probability of default, however it may increase the recovery prospect under the event of default, through the execution of claim mechanism to the guarantor. Guarantee is a legal contract in which a third party (guarantor) agrees to fulfill the obligations of another entity (obligor), if the obligor fails to fulfill its guaranteed debt instruments. For the obligor, guarantee can enhance creditworthiness of debt instrument issued, provide access to broader investor base, and lower cost of financing. For the investors, they will benefit from a stronger recovery prospect of their investment in the guaranteed debt securities issued by low-rated obligors.

In order to be eligible by PEFINDO to provide a credit enhancement of a debt instrument, a guarantee must fulfill the following conditions:

1. The guarantee can be in the form of a corporate guarantee, standby letter of credit (SBLC), or pledged cash collateral. PEFINDO does not consider other form of collaterals such as personal guarantee, marketable securities, fixed assets, receivables, or inventory as eligible guarantees given those types of collaterals are exposed to valuation and liquidity risks. PEFINDO will add the suffix $_{(cg)}$, $_{(bg)}$, or $_{(cc)}$ if the type of guarantee is corporate guarantee, standby L/C from a bank, or cash collateral pledged in a bank, respectively.
2. The party that issues the guarantee must be an entity with a superior financial capability. PEFINDO views that with superior financial capability, there is a very high probability that the guarantor will be able to fulfill the claim on timely basis.
3. The guarantee must be irrevocable and unconditional, including under the bankruptcy of the obligor.
4. The guarantee must also contain the clear and reasonable timeframe for claim mechanism to the guarantor.
5. The seniority of the guaranteed debt instrument should be at least equal to the guarantor's senior unsecured obligations.
6. Value of guarantee should be clearly stated in the contract, which covers portion of the debt instrument and coupon payment
7. The right of the guarantor to offset, subrogation and right of participation against the obligor is waived.
8. The guarantee document is legally enforceable.

Rating assessment of a guaranteed debt instrument will be anchored based on the rating assessment of the obligor. After PEFINDO assigns the rating of the obligor, then PEFINDO will conduct the analysis of the guarantor, to ensure that the guarantor has superior financial capability as required to be an eligible guarantor. PEFINDO views that with its superior financial capability, the risk of the guarantor failing to fulfill its guarantee obligation timely can be minimized. PEFINDO will also incorporate the contingent liability of the guarantee issuance to the guarantor's overall creditworthiness.

Degree of notching up depends on how much coverage of the debt instrument being guaranteed. If the guarantee covers 100% of the principal amount of the debt instrument and interest payment (full guarantee), then the debt instrument rating will be raised to the same rating as the guarantor's rating.

PEFINDO considers sufficient coverage of partial guarantee may enhance the rating of debt instrument above its obligor's rating, as there will be substantial recovery portion to be received by the investors should the guarantor fulfills its guarantee obligation under the default status of the obligor. In determining amount of partial guarantee required to enhance the debt instrument rating, PEFINDO is using statistical data based on PEFINDO's default study, comprising of over 500 entities during the past 20 years of PEFINDO's establishment. PEFINDO considers at least 20% of total debt guaranteed by a superior guarantor should provide additional 1 notching above obligor's rating for the guaranteed debt instrument. Substantially higher portion of partial guarantee coverage may enhance the rating further, however degree of notching up will be assessed by also incorporating the rating of the obligor and the guarantor. Partial guarantee application will also be limited only to long-term senior debt instruments. PEFINDO will not incorporate partial guarantee for short-term debt instrument, subordinated debt instruments, and structured finance products such as project finance bonds and asset-backed securities.