# GUARANTEE AND ITS IMPACT TO DEBT INSTRUMENT RATING

PEFINDO views that a 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 the 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, a 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 that those types of collaterals are exposed to valuation and liquidity risks, which could affect the value and ease of the guarantee claim. PEFINDO will add the suffix $_{(cg)}$, $_{(bg)}$, or $_{(cc)}$ if the type of guarantee is corporate guarantee, SBLC from a bank, or cash collateral pledged in a bank, respectively.

2. After the guarantee agreement has been signed, the guarantee must be irrevocable and unconditional. There may be terms and conditions to be fulfilled by the obligor to make the guarantee effective. Certain exceptions in claiming the guarantee (if any), must be clearly stated in the published guarantee statement.

3. The guarantee must also contain the clear and reasonable timeframe for claim mechanism to the guarantor.

4. The seniority of the guaranteed debt instrument should be at least equal to the guarantor's senior unsecured obligations.

5. Value of the guarantee should be clearly stated in the contract, which covers the debt instrument principal and coupon payment.

6. The right of the guarantor to offset, subrogation and right of participation against the obligor is waived.

7. The guarantee document is legally enforceable, including when there are filing for bankruptcy of the obligor.

Rating assessment of a guaranteed debt instrument will be anchored based on the obligor's rating. After PEFINDO assigns the rating of the obligor, PEFINDO will conduct the analysis of the guarantor. PEFINDO will also incorporate the contingent liability of the guarantee issuance to the guarantor's overall creditworthiness. If PEFINDO considers that the guarantor's credit profile is at the same level as the obligor, there will be no credit enhancement given to the guaranteed debt instrument.

The degree of a rating notching up may depend on how much coverage of the debt instrument being guaranteed. If the guarantee fully covers 100% of the principal amount of the debt instrument and interest payment, the debt instrument rating will be the same rating as the guarantor's rating.

PEFINDO considers the eligible partial guarantee may enhance the rating of debt instrument higher than its obligor's rating, considering that there will be substantial recovery portion of the investment in the guaranteed debt instrument, through the claim mechanism to the guarantor if the obligor fails to fulfill its financial commitment on the guaranteed debt instrument timely and in full. In determining the 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 rated entities during PEFINDO's operation.

For the partial guarantee, PEFINDO requires the guarantor should be a very highly rated entity particularly when issuing the partial guarantee. This is to create a high degree of confidence on the recovery prospect resulted from the claim of the partial guarantee. If the guarantor's rating experiences a downgrade to the level below PEFINDO's minimum requirement, the rating enhancement from the partial guarantee may be nullified, unless the obligor appoints another guarantor that meets the criteria as the partial guarantee provider. The partial guarantee should not only cover the principal, but also the coupon payment of the debt instrument.

The degree of impact of the partial guarantee to the debt instrument rating may be determined by several factors, such as the amount of the partial guarantee, the rating of the guarantor, and the rating of the obligor. If one of those factors does not meet the criteria, there is a possibility that the partial guarantee may not result in the credit enhancement on the guaranteed debt instrument.

As an illustration, if an obligor with a moderate credit profile issues a debt instrument with 20% partial guarantee from a guarantor with a superior credit profile, PEFINDO may consider to assign the debt instrument rating at one notch higher than the obligor's rating.

Partial guarantee application will also be limited only to long-term senior debt instruments, and not to be incorporated for short-term debt instrument, subordinated debt instruments, and structured finance products such as project finance bonds and asset-backed securities.