

## **CREDIT ENHANCEMENT AND ITS IMPACT TO DEBT INSTRUMENT RATING**

PEFINDO views that credit enhancement given to a debt instrument may enhance its credit quality, resulting in higher debt instrument rating compared to the issuer's rating. The existence of the credit enhancement may significantly reduce the instrument's probability of default. In other cases, it may increase the recovery prospect under the event of default, through the execution of claim mechanism to the credit enhancement provider.

The followings are types of credit enhancement that may improve debt instrument's credit quality:

- (i) Guarantee;
- (ii) Standby letter of credit (SBLC);
- (iii) Pledged cash collateral;
- (iv) Undertaking towards maintaining bond sinking funds

PEFINDO does not consider other forms 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 may affect the value and ease of the guarantee claim. PEFINDO will add the certain suffices after the rating symbol to indicate that the rating has incorporated any form of credit enhancement.

### **Guarantee**

Guarantee is a legal contract in which a third party (guarantor) agrees to fulfill the financial 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.

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

1. 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.
2. The guarantee must also contain the clear and reasonable timeframe for claim mechanism to the guarantor.
3. The seniority of the guaranteed debt instrument should be at least equal to the guarantor's senior unsecured obligations.
4. Value of the guarantee should be clearly stated in the contract, which covers the debt instrument principal and coupon payment.
5. The right of the guarantor to offset, subrogation and right of participation against the obligor is waived.
6. 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.

The above terms and conditions are also generally applicable for credit enhancement in the forms of SBLC and pledged cash collaterals, with the credit rating of the bank providing credit enhancement is the anchor in determining the debt instrument rating.

### **Undertaking towards maintaining bond sinking funds**

Undertaking towards maintaining bond sinking funds means a third party provides support in terms of funding to ensure that the rated debt instrument has cushion in maintaining bond sinking funds in the event of inadequacy of cash inflows, covering bond principal, coupon, other related expenses, and certain financial ratios covenant in the bond indenture.

The nature of funding is akin to committed credit facilities by banks, allowing the rated entity to drawdown up to certain amount during the entire tenor of bond. The facility will be utilized in the event of inadequacy

of cash inflows to meet the scheduled debt servicing obligations on the bond. We identify that the main risk is when the shortfall of cash inflows is beyond the amount of committed credit facilities/support. There may also be an execution risk, in which for any reasons the rated entity fails to make the sufficient amount of loan drawdown promptly to fill in the cash flow deficit.

Rating assessment of a debt instrument structured by undertaking towards maintaining bond sinking funds will be anchored based on the obligor's rating. After PEFINDO assigns the rating of the obligor, PEFINDO will conduct the analysis of the structures. The degree of impact of the facility to the debt instrument rating may be determined by several factors:

1. Cash flow stress test

We perform stress scenarios to the key assumptions that affect the obligor to generate cash flows. The result of stress test is to determine how much the shortfall of cash flows to debt service payments.

2. Amount of committed credit facilities/support

We examine whether the amount of the facility has sufficient cushion for bond sinking fund during the bond tenor, including for the bond with amortization feature. If the credit enhancement facility amount could cover all of the liabilities related to the bond issuance during the bond tenor, in most cases we may equate the debt instrument rating with the credit enhancer's rating. If the amount of the credit enhancement facility could only cover part of the bond's liabilities, the debt instrument rating may lie between the issuer's rating and credit enhancer's rating. If the credit enhancement facility amount is considered as insignificant compared to bond's liabilities, there is a possibility that the facility may not result in any enhancement to the debt instrument rating.

3. Facility conditions

The facility must be irrevocable and unconditional. There may be terms and conditions to be fulfilled by the obligor to make the facility effective. Certain exceptions in claiming the facility (if any) must be clearly stated in the published facility statement. We also assess particular number of days to disburse the facility. The facility is also treated as junior to the bond issued. It means that if the facility is utilized, the payment of its principal and interest will be deferred until the full repayment of bond. We understand that the facility has higher interest rate compared to the bond as the facility provider has high exposure to the obligor's cash flows.

4. Rating of the facility provider

PEFINDO requires the facility provider should be a very highly rated entity. This is to create a high degree of confidence on the timeliness of facility disbursement.

The final debt instrument rating will be derived from the assessment of a comprehensive structure and legal documentation, not only the amount of facility.

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