Rating of Public Sector Entities

Sector-Specific Criteria

Legal Definition: Indian public sector entities (PSEs) have some form of public-sector ownership, public-sector role or specific public-sector legal status. The different legal forms of PSEs include government agencies, autonomous or non-autonomous public bodies, state-owned companies (central and state government ownership), and divested companies (specifically created entities, both administrative and business oriented) with public-sector ownership.

Wider Definition of PSE: India Ratings and Research (Ind-Ra) definition of a PSE also covers not-for-profit private companies created to fulfil an important public social mission, such as registered social housing and other co-operative societies, and which are tightly regulated.

Extraordinary Support: Not all PSEs are likely to receive the same level of extraordinary support from upper tiers of government in case of financial stress. In some instances, the central or state government may be prohibited from directly supporting a particular category of PSE or a specific activity or business. Ind-Ra has therefore classified PSEs as dependent where extraordinary support is highly likely and non-dependent where the likelihood and timeliness of extraordinary support is less certain.

Top-down Notching Approach: Dependent PSEs are credit linked to the sponsor with a three-notch floor from the rating of its public-sector stakeholder because Ind-Ra considers that these entities are an integral part of their public-sector owners and therefore the likelihood of extraordinary support would be high.

Dependent PSE: For a PSE to be considered dependent, it must be highly integrated into the government apparatus, its activities must be tightly controlled and, it must be undertaking public service activities. Majority government ownership and regular grant inflow are not the determining factors for a dependent PSE. Even if the government holds less than 50% stake but the same is a controlling stake in a PSE, and the PSE is fulfilling a policy objective of the government, the criteria will apply.

Bottom-up Notching Approach: Where there is doubt about the timeliness and the extent of financial support from its public stakeholder, Ind-Ra classifies the PSE as non-dependent and follows a bottom-up approach to the rating. In this case, the focus is primarily on its standalone profile of the issuer for the assessment of its rating. Ind-Ra will not factor in extraordinary support from the sponsor but the link to its public sector sponsor would act as a credit enhancement. However, the rating uplift would normally be limited to three notches.

Multi-Disciplinary Approach: Where necessary, Ind-Ra uses a multi-disciplinary team including expertise from financial institutions or corporate analysis to assess the standalone credit quality of the PSE. This takes account of ongoing government support (e.g., regular operating subsidies, transfers or capital injections) but not extraordinary support. Where the entity operates on a strictly commercial basis in a liberalised sector and government support is at arm's length, Ind-Ra may use its corporate parent and subsidiary rating linkage methodology to rate the entity.

Variations from Criteria

Ind-Ra's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on an instrument-by- instrument or issuer-by-issuer basis and full disclosure via rating action commentary (RAC), strengthens Ind-Ra's rating process while assisting market participants in understanding the analysis used in the ratings.

Related Research

Revenue-Supported Rating Criteria (December 2021)

Local and State Governments Rating Criteria (December 2021)

Rating Criteria for Partial Credit Guaranteed Debt

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A rating committee may adjust the application of these criteria to reflect the risks of a specific instrument or entity. Such adjustments are called variations. All variations will be disclosed in the respective RACs, including their impact on the rating where appropriate.

A variation can be approved by a ratings committee where the risk, feature, or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but where the analysis described in the criteria requires modification to address factors specific to the particular instrument or entity.

Assessment of Dependence

Ind-Ra initially needs to assess whether it considers a PSE dependent or non-dependent on its stakeholders, as this determines whether it follows a top-down or a bottom-up rating approach. By dependence, Ind-Ra refers not only to a financial or economic link but also to a moral and legal link between the PSE and its public-sector owner, which would result in not only in regular financial support but also timely extraordinary support in a case of need. See Appendix A for a list of general factors Ind-Ra looks at to determine whether a PSE is classified as dependent or non-dependent.

The assessment of economic/financial dependence is straightforward, as the flows from one entity to the other can easily be tracked or assessed. However, a moral link is more complicated, as Ind-Ra needs to assess the purpose and role of the entity, its legal status, the necessity of the services provided and the control mechanisms in place.

This assessment is also dynamic – a PSE can shift from being considered dependent to non-dependent by Ind-Ra (and therefore subject to a change in the rating approach). For example, a weakening of state shareholding, change in legal status or a more commercial role for the PSE could result in Ind-Ra re-classifying the PSE from dependent to non-dependent and taking the appropriate rating action. However, if the government continues to accord priority to PSE to fulfil its objective, it would continue to be rated under this criteria. The opposite could also happen, although this would be rarer.

Dependent Public Sector Entity

A dependent PSE is an entity directly or indirectly majority-owned or tightly controlled by the centre/state (the stakeholder), or with equivalent special public status. Its activities fulfil a public-sector mandate in a non-competitive sector, where forms of state subsidy or grant from the stakeholder comprise significant revenue for the PSE, or the PSE receives ongoing capital injections that are material to its existing and prospective financial profile. The likelihood of ongoing and extraordinary support by the sponsor would be considered very high to ensure that the PSE is able to service its financial obligations on a timely basis. Such entities do not usually maximise profit, with profitability often determined by the grants or subsidies, which could be budget balancing items.

In some cases a PSE may have a separate legal status; it is in effect an inseparable arm of its public-sector owners. It can be funded and controlled by its stakeholder or its legal status may be linked more to the public than to the corporate sector. For a PSE to be considered dependent it needs to be highly integrated into the government apparatus, with its activities tightly controlled by the latter. It must be undertaking key public-service activities (normally falling under the responsibility of the centre/state/subnational). Such a PSE can either be rated at the same level as its public-sector owner or notched down from the rating of the stakeholder. Statutory or specific pre-default guarantees would cause the rating of a PSE to be automatically equalised with that of its public-sector guarantor.

In many instances, entire expenditure of a PSE is a charged expenditure on the central/ state/subnational budget, which is approved by the parliament/legislature every year. If the borrowing by a PSE is approved by the sponsor and debt servicing is a charged expenditure on budget, Ind-Ra would equalise the rating of PSE and its debt instrument to that of rating of the sponsoring government.

Statutory Guarantee

A statutory guarantee is usually included either in the statute of the PSE or in certain laws passed by its owner in relation to its PSEs. Where a statutory guarantee is unclear, Ind-Ra normally relies on a legal opinion to ascertain the degree of support in the underlying instrument. Ind-Ra also includes in this category implicit statutory guarantees, as is the case for those covering the industrial and commercial entities, state power utilities (SPUs), state financial corporations (SFCs), state co-operative societies or other state owned entities (SoEs). The legal status of SPUs, SFCs and SoEs implies full or nearly full ownership and tight supervision by the government.

However, Ind-Ra understands that some SPUs or SoEs may lose their protective legal status (mainly because they may be privatised or because the market where they operate will be significantly liberalised) and will therefore not rate all SPUs and SoEs the same as its public sector sponsor. However, if the government continues to accord high priority to PSEs to fulfil its objectives, they will be rated closer to the sponsor's rating.

Specific Guarantee

The equalisation of a PSE's rating with that of its stakeholder is also possible where there is a specific debt guarantee rather than a statutory guarantee.

An explicit guarantee would need to include the following characteristics:

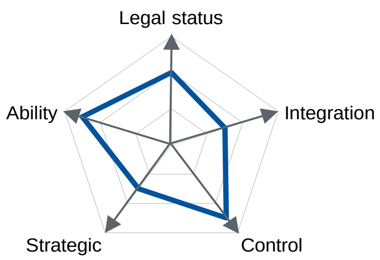
- enforceable – that the guarantee is not ultra vires;
- irrevocable – cannot be changed or cancelled once it has been granted;
- unequivocal – it specifies the guaranteed amount;
- unconditional – with a clear definition as to the extent of the guarantee;
- on demand – there has to be no question as to timeliness;
- general – it must cover all obligations (present and future); and
- indefinite – it should have no time limit (unless it is a guarantee for a specific bond issue)

Moreover, a pre-default guarantee with timelines for support/fund infusion for timely debt servicing will equate the issue rating to the guarantor's rating. Ind-Ra also needs to assess the track record of the government in honouring past guarantees and the legal environment in which it operates.

The conditions of the guarantee must be similar to those of a statutory guarantee, but in these cases it may be for a specific amount, a particular debt issue or a specified period. Ind-Ra also normally obtains a legal opinion on any specific guarantees issued.

Figure 1

Weighting of Parameters of Dependency



Source: Ind-Ra

Rating Not Automatically Equated to Stakeholder

For dependent PSEs that do not benefit from a statutory or a specific guarantee, the key factors in determining the rating are the analysis of the owners' ongoing and potential extraordinary support, whether through a written commitment or not, and the PSE's standalone fundamentals.

Comfort letters, or any other type of written commitment, enable the administration to support a PSE's financing needs without assuming a formal commitment, as would be the case with a guarantee.

Comfort letters are not legally enforceable. When they are provided, Ind-Ra may look at their wording to assess the stakeholder's intention behind the letter and how likely and timely the financial support would be. However, comfort letters are viewed as a mere declaration of intent with no financial obligation on the part of the owner, depending on the explicitness of the declaration. If the statement of intent from the sponsor is unclear or equivocal the agency may decide not to place any significance on the comfort letter. In cases, where the support document has a well-defined pre-default structured payment mechanism monitored by a debenture trustee/bank, Ind-Ra may equate the issue rating to the stakeholder's rating (subject to legal enforceability).

In cases where there is no comfort letter or similar instrument, or where the underlying commitment under the written undertaking is unclear or weak, the assessment of dependence (and therefore rating differentiation) is based on the strength of the factors mentioned below.

- **Control:** This is a key rating issue and includes factors such as management appointments, the controlling ministry/department (whether it is the finance ministry, or any other ministry or sub-ministry), financial supervision (including the approval of accounts and borrowing and budgets reporting), board control, policy design, strategic direction and implementation, and official audits. The tighter the control by the centre/state/subnational of the PSE's decision-making process, the narrower the link between the rating of the PSE and that of its stakeholder. Ind-Ra also expects tightly controlled PSEs to have strong/adequate corporate governance practices such as robust information disclosures, regular reporting of financial performance, and accurate/realistic management guidance on financial performance.
- **Ability:** A subnational may have a strong moral obligation or willingness to support a PSE, but it may not be able to do so on a timely basis because of financial constraints. For example, if the liability of the PSE is significant, in relation to the debt of the centre/state/subnational, it may be difficult for the centre/state/subnational to provide extraordinary support to the PSE in a timely manner. Although Ind-Ra factors in the indirect debt of the dependent PSEs in the rating of the stakeholder, it normally considers these liabilities as subordinated (i.e., the centre/state/ subnational would pay its direct obligations first, before those of its dependent bodies).

  The ease of access of the centre/state/subnational to either bank funding or the capital market is important for Ind-Ra to assess the level of actual financial support that can be raised at short notice. In those cases where the debt of the PSE is significant relative to that of its stakeholder, the rating differentiation is likely to be wider where the rating of the stakeholder is lower than 'IND BBB-'. An assessment of the liquidity position of the sponsor would also be necessary to judge the timeliness of an extraordinary support. Furthermore in cases where the PSE has receivable claims from parent/their dependent entities, an assessment needs to be made on the trend in the collection period. A declining collection period of the PSE due to intervention of a government stakeholder would reflect the significance of the PSE to the sponsor and thereby bridge the link between the two.
- **Legal Status:** Ind-Ra believes that the less corporate the legal status of the PSE, the closer the link with the stakeholder. For example, a ministerial department or a government agency would be rated closer to the stakeholder than a public company. A 100%-owned public company would be more likely to have a narrower rating differentiation with the stakeholder than a majority-owned public company. In the cases where public ownership is under 40%, it is unlikely that Ind-Ra would consider the PSE to be dependent, unless the PSE is providing a social or public good on behalf of its sponsor.
- **Strategic Importance:** The impact of a PSE's default on its effective functioning and its direct or indirect effects on the government's social and political environment are assessed. PSEs may continue to operate or provide the public service, even after default, and accordingly government support could range from merely ensuring continuation of activities while a substitute is found to actively seeking to prevent a default and ensure continued financial viability of the PSE. The more important the PSE's role in fulfilling public services on behalf of, or mandated by, the centre/state/subnational, the greater the likelihood that it will be supported. For example, if the interruption or suspension of a public service (such as electricity, water, food or public transport) has an impact on revenue generation for the subnational or social/political consequences, then the likelihood and timing of support would be higher than if the services provided by the PSE were of secondary importance to the state or subnational.

  Ind-Ra assesses the intention and track record of the government regarding continuing services and protecting creditors, e.g., an essential service can continue to operate even if a default has occurred. Ind-Ra would also assess whether the default of a major PSE could have negative consequences for the creditworthiness of its public stakeholder and therefore reduce the stakeholder's access to funding from the capital markets.
- **Integration:** Ind-Ra opines that the tighter the level of consolidation (both budgetary and financial), the more likely the rating will be equalised to that of the centre/state/subnational. The greater the level of ongoing funding of the PSE from the stakeholder, the more dependent it will be and therefore the narrower the rating differentiation. Also, the size of the public sector is important. For example, in states where the public sector is wide (over 80 entities), the likelihood of extraordinary support for one PSE would be lower than in those states where there are only few key PSEs.

Ind-Ra views control and ability to lend financial assistance and strategic importance as the three key areas in deciding whether to align the rating of the PSE to that of its stakeholder – the tighter the control and stronger the ability and willingness to support a PSE, the narrower the rating differential. This is followed by strategic importance, integration and legal status.

Notching Policy for Dependent PSEs

There is no rating differential between the PSE and its public-sector stakeholder where there is a clear statutory or specific guarantee. However, if the guarantee is implicit and there are doubts about the timeliness of support, the PSE's rating may be lower than that of its owner.

Where there is no guarantee, Ind-Ra analyses the factors mentioned above: the legal and institutional framework; any written commitment of support; the degree of integration with the stakeholder; the level of management/financial control; provision in the budget for debt servicing; the record of timely support and the likelihood of privatisation in the short term. The assessment is dynamic and does not only concentrate on past experience; in most cases it involves extensive discussions with the PSE's public owners and other institutions. Ind-Ra looks ahead, assessing whether these conditions are likely to change in the near to medium term (including any change of status, privatisation or weakening in financial support).

The agency applies a top-down approach, with the possibility that up to three notches could be subtracted from the ratings of the stakeholder, depending on Ind-Ra assessment of the level and timeliness of extraordinary support from the sponsor. In most situations the rating of a dependent PSE is likely to be higher than the standalone profile of the entity given its not-for-profit maximisation role.

In those cases where Ind-Ra publishes a sector view, it may decide to assign a broader notching policy (i.e., higher than one rating category for dependent entities), as their aggregate link will be weaker than the link between one single PSE and its public-sector stakeholder. Under circumstances when Ind-Ra feels the link is very weak, the rating differentiation could be wider than three notches.

Figure 2

Notching from Issuer Ratings for Dependent PSEs

Likelihood of extraordinary support	Notching
Very strong	0-1
Strong	1-2
Moderate	2-3
<Moderate[a]	n.a.

n.a. – Not applicable
[a] Use "non-dependent" notching policy
Source: Ind-Ra

Figure 2 above illustrates the notching policy (i.e., how many notches would be subtracted from the rating of the centre/state/subnational), taking into account the different assessments of support. The standalone rating of the PSE is also assessed. If this is stronger than the rating derived from the notching criteria based on support above, the standalone rating would apply. If a weak subnational is highly dependent on a strong PSE for regular dividend payments and/or capital repatriation, the standalone rating of the PSE is depleted by the weakness of its stakeholder. The rating of the PSE would usually not be higher than that of the stakeholder, even if the standalone credit profile of the former is significantly better than that of its public-sector owner.

In cases when the sponsor is composed of more than one central/state/subnational department/organisation, Ind-Ra would normally use a weighted average of the credit profile of the sponsors based on their controlling stakes and/or funding involvement in the PSE. However, if there are a large number of sponsors, the agency may conclude that there are not sufficiently strong links to any small group of sponsors, and may decide not to consider the PSE as a dependent entity.

Non-Dependent Public Sector Entity

PSEs in this category include those that are operating autonomously and whose control by the centre/state/subnational is more subtle than direct. The centre/state/subnational may only have a minority stake in the company. The PSE may have a profit maximisation function and operate to all intents and purposes as a commercial entity, or there may be near-term prospects of privatisation.

In some instances, if the public entity operates to all intents and purposes as a commercial entity, with profit maximisation goals and strategy in a fully liberalised sector, then Ind-Ra may decide to use its corporate parent and subsidiary linkage methodology to rate the entity.

Notching Policy for Non-Dependent PSEs

For these entities, Ind-Ra uses a bottom-up rating approach and the analysis focuses primarily on the PSE's standalone profile for the assessment of its rating. Ind-Ra will not factor in extraordinary support from the sponsor but the link to its public sector sponsor would lend support to the PSE's standalone credit profile.

This includes aspects such as discretionary funding and subsidies, the role of any regulator of the sector, the regulatory framework and ongoing monitoring (for a more exhaustive list see Appendix C). However, Ind-Ra normally limits the rating enhancement to not more than three notches from the standalone assessment of the PSE. This is because if the enhancement is considered significant, by definition the entity would be dependent on the stakeholder and a top-down rating approach is more appropriate.

Ratings of Debt Instruments of PSEs Referred Under IBC

Ind-Ra generally assigns ratings to the debt instruments of a public sector enterprise (PSE) on the basis of the security features instead of assigning the issuer any rating. Credit enhancers commonly used by PSEs include government guarantees, budgetary support and escrow accounts. Therefore, different instruments of the same PSE can have different ratings, depending on the security feature embedded in the instrument.

Considering PSEs fall under state control and their business plans are largely influenced by the development priorities of the government (central/state/subnational), they receive support in the form of equity, grants, soft loans and others, which are part of the budget (central/state/ subnational). Moreover, as most PSEs have low profitability, they seek state support in the form of guarantees to borrow from financial institutions or the debt market.

After the Insolvency and Bankruptcy Code, 2016, (IBC), came into effect from 1 December 2016, several cases have been referred to the National Company Law Tribunal for resolution under the IBC.

In case a PSE is referred under the IBC for resolution, Ind-Ra will not undertake any rating action as long as the obligation of the guarantor remains intact and debt servicing is timely. Ind-Ra understands that the obligation of the guarantor remains intact and needs to be fulfilled in a timely manner even if the issuer were to be admitted into an IBC process.

Ind-Ra has so far observed that in case of rated debt, debt servicing by PSEs is generally timely, with the extent of delays/defaults extremely low. However, in case of unrated debt and inter-governmental debt, there have been delays.

Figure 3
Rating Correspondence

Long-Term	Short-Term
IND AAA	IND A1+
IND AA+	IND A1+
IND AA	IND A1+
IND AA-	IND A1+
IND A+	IND A1+ or IND A1
IND A	IND A1
IND A-	IND A1 or IND A2+
IND BBB+	IND A2+ or IND A2
IND BBB	IND A2 or IND A3+
IND BBB-	IND A3
IND BB+ to IND BB-	IND A4+
IND B+ to IND B-	IND A4
IND C	IND A4
IND D	IND D

Source: Ind-Ra

Rating Short-Term Debt of PSEs

The short-term rating of PSEs is contingent upon its long-term rating (Figure 3). The liquidity positions of a PSE and its sponsor have a strong impact on the rating level. Apart from working capital, commercial paper (CP) is the most common form of short-term debt. Ind-Ra typically expects investment-grade commercial paper issuers to have full (100%) liquidity back-up available for its outstanding CP and other short-term obligations, regardless of the credit rating of the entity. In case of issuers rated at 'IND AA-'or below, Ind-Ra usually requires CP to be carved out of the entity's fund-based working capital limits. In case of higher rated entities, back-up may not only be in the form of bank commitments but may also include cash and cash equivalents, expected operational cash flow sources, or other alternative forms of liquidity support. However, given the nature of public policy institutions and the support they command from the government, Ind-Ra believes public policy institutions are unlikely to face refinancing challenges for their debt. Hence, Ind-Ra analyses liquidity management policy/liquid investments, and does not look for explicit working capital backup while assigning CP ratings to public policy institutions that are rated higher than 'IND AA'.

Rating Approach for State Owned Enterprises (SOEs) Debt Backed by Escrowed Cash Flows from Specific Tax/Cess or Non-Tax Revenue

SOEs are created to fulfil a specific service which state is supposed to discharge. The user charges of the services, provided by state government, are much lower than the economic cost of delivery of these services and SOEs are generally loss-making or make a marginal profit. Unsupported or standalone ratings are assigned based on the strength of linkage these entities have with the respective governments.

The upper-tier government may commit funds to segregated accounts that can be altered only with its own consent and control, and may earmark them solely for that purpose. Since the pledged cash flows for debt servicing is a revenue source of the state government, the base level rating for the instrument/ transaction is based on Ind-Ra's evaluation of the credit profile of the parent state government. When a specific instrument is being rated, the rating will reflect the nature of the instrument, considering its legal and financial strengths, and any credit enhancements.

Ind-Ra's starting point is assessing the credit profile of the state government. Subsequently, the degree of uplift the instrument rating may receive will depend on the evaluation of performance of pledged revenue, legal and financial strengths of the debt structure, enhancements and how those enable revenues to flow uninterrupted to timely service debt. A deterioration in the credit profile of the parent state government, wherein the pledged revenue is from a upper-tier government, will impact the base rating and, therefore, the rating of the debt instrument.

Rating Factors

To determine the rating of the specific security, Ind-Ra considers the following factors:

- Analysis of the revenue pledged as a source of payment;
- Structure of the financing, and the protection it provides for holders of the security;
- DSCRs and any credit enhancements; and
- Legal protection for creditors.

The characteristics, strengths and weaknesses of each factor are analysed, and no specific weighting of such factors is made to reach a particular rating or for notching above the issuer rating.

Evaluating Pledged Flows

Ind-Ra requests monthly historical information regarding specific tax/cess/non-tax revenue collections or related revenues being pledged. Growth rates in nominal terms for different periods are evaluated, and projections are made considering scenarios. The pledged resources covered under this approach may be collected centrally and then transferred to the SOE by the state government prior to the segregation under the custodial arrangement.

Ind-Ra evaluates demonstration of irrevocability features and notifications of such pledges may favourably affect the rating of a security. Ind-Ra considers the revenue shortfall support provided by the upper-tier government. If there is an interruption of the revenue source or a shortfall in pledged revenue, structures establish an obligation for the state government to cover revenue shortfalls with other resources.

Financing Structure

Ind-Ra reviews the waterfall mechanism of the transaction structure, any segregation into sub-accounts, funding and maintenance of reserve funds, covenants or triggers established, responsibilities and obligations of the trustee, and all factors in general that provide greater financial certainty to creditors and/or investors.

Pledged revenues are transferred to the escrow account, then segregation is made to each account of interest, sinking fund and reserves funds to complete debt service payment. Finally, if excess cash flow remains, funds are transferred to the issuer.

For covenants established in the trust and financing documents, Ind-Ra also considers covenants that limit future borrowing in addition to the usual trigger to maintain a DSCR higher than a required minimum.

Coverage Analysis

Ind-Ra evaluates expected debt service coverage and performance using rating and adverse projection scenarios, with respect to asset behaviour, debt service estimates, credit enhancements and macroeconomic variables, such as market interest rates.

The rating case will consist of a through-the-cycle performance that incorporates a combination of revenue pledged and debt service stresses. These stresses may incorporate a particular scenario of events in which the pledged revenues/receivables are vulnerable to a downturn in economic activity, demand slowdown, a change in tax policy, and/or interest rate volatility.

When analysing debt securities in structures demonstrating strong coverage metrics, Ind-Ra usually limits uplift for the debt instrument at four notches above the base rating. Strong coverage means Ind-Ra generally expects revenues pledged to be enough to cover debt service payments under the Ind-Ra's rating case scenario without using debt service reserve funds.

Generally, a security judged to have a majority of stronger attribute assessment, as per the Appendix D, may be assigned a rating three-four notches above the base rating. A mix of a stronger and midrange attribute assessment would support a rating two-three notches above the base rating, and having some attributes judged as weak would suggest a rating one-two notches above the base rating.

Legal Considerations

The information Ind-Ra analyses from a legal perspective includes laws and regulations applicable in public debt; government orders and/or agreements of authorization to incur debt, legal authorisation to pledge resources for debt repayment and constitute custodial mechanisms to hold the revenues that support debt service; loan agreements and/or issuance offering memos; trust agreements; irrevocable instructions to pledge resources among other documents particular to a transaction. Where necessary, the constitutional validity of the transaction will also be ascertained by the agency.

The irrevocability features of the structures and actions taken by the state government, either through a decree or legislation or an amendment to existing legislation, to legally pledge revenues to the debt securities, and the legal language of the documents that protect investors and lenders from actions that may affect the assets' performance, are the essential factors assessed in Ind-Ra's review to effectively apply the uplift approach for rating the security. Ind-Ra considers that such irrevocability features are an important protection against political risks, such as changing political agendas or government administration changes, and some financial risks, such as short-term liquidity pressures.

Credit Enhancements by Way of Partial Credit Guarantee (PCG)

Ind-Ra also evaluates additional credit enhancements debt securities may have, which could extend the security rating uplift. When a PCG provided by third parties is incorporated, the additional notching of the security ranges from one to three notches, depending on the strength of the enhancements and PCG extended on the principal amount, assuming the security's first line of defence (assessed in the Appendix D) is depleted or interrupted.

The nature and terms of a PCG can vary. Ind-Ra assesses the presence of the following key elements to provide additional uplift to a security rating:

Repayment of any draws on a PCG must be subordinated to debt service payments on the securities;

The PCG must have a term at least equal to the term of the securities benefited by the PCG;

Reimbursement of a PCG can be made from future excess over debt service on the security; if the reimbursement does not replenish the drawable balance of the PCG, the remaining balance will be used to determine notching uplift;

Timeliness of payment under a PCG will be evaluated to assure draws can occur before default on the benefited securities. Ind-Ra will follow its Partial Credit Guarantee criteria for credit enhancement through PCG.

Appendix A

Characteristics of Dependent and Non-Dependent PSEs – Not All Aspects Have to be Present

Dependent

- The PSE falls under a legal regime, which does not allow it to be liquidated or made bankrupt
- The centre/state/subnational dictates the strategic policy of the PSE
- There is a strong economic/financial link between the centre/state/subnational and the PSE
- The PSE is tightly monitored by the centre/state/subnational
- The PSE is policy oriented and responsible for providing important public services
- There is a precedent of support of similar types of PSEs by the centre/state/subnational
- A default by the PSE would have considerable negative repercussions for the credit perception of the centre/state/subnational

Non-Dependent

- The PSE operates in a commercial environment
- It is profit oriented
- The status of the PSE is likely to change in the short term to a more commercial orientation
- The centre/state/subnational has communicated publicly that it will not financially support the PSE
- There is a precedent of non-support of similar types of PSEs by the centre/ state/subnational

Appendix B

Checklist for Assessment of Dependency for Dependent Entities

Legal Status and Political Framework

- Proximity or legal link to the centre/state/subnational, such as government department, government agency, public entity, fully owned public company, majority-owned public company or minority-owned public company
- Past level of support, or extraordinary support for troubled PSEs
- Assessment of the likelihood of extraordinary support and ongoing financial support by the sponsor
- Political remarks on support
- Overall size of the public sector

Integration

- Degree of consolidation of the budget/accounts of the PSE with the centre/ state/subnational
- Whether debt is considered part of the financial liability of the subnational or the overall general government sector
- Status of employees (e.g. civil servants)
- Level of ongoing funding of the PSE by the centre/state/subnational and the proportion of total revenue that this represents

Control

- Appointment of management of the PSE
- Level of board representation and control
- Decision-making process of the PSE
- Debt authorisation requirement
- Planning and strategic direction decision making
- Intervention of the stakeholder in tariff-setting policies
- Official and unofficial audits and reporting requirements
- Level of corporate governance

Strategic Importance

- Nature of the public services provided by the PSE
- Impact of the disruption of services on the centre/state/subnational
- Importance of dividend payments to the centre/state/subnational

Ability

- Size of the liability of the PSE in relation to the overall indebtedness of the centre/ state/subnational
- Rapid access by the centre/state/subnational to funding (e.g. financial institutions or the capital markets) in case of extraordinary support
- Formalisation of requirements for extraordinary support by the centre/state/subnational (i.e. approval from upper tiers of government)
- The initiatives/steps taken by sponsor to improve the collection efficiency and thereby facilitate liquidity and sustenance of the PSE whose receivables are mostly from parent/their dependent entities.

Appendix C

Checklist for Assessment of Credit Enhancement for Non-Dependent Entities

- The percentage of minority ownership by the centre/state/subnational
- The freedom of the PSE management in governance and decision-making
- Whether the stakeholder can inject capital to the PSE in the event of need
- The PSE operates in a commercial but highly regulated environment
- The role of the regulator
- Whether the regulator monitors the financial situation of the entities in its sector and has the ability and funding to provide extraordinary support or to re-structure entities
- The proportion of the business of the PSE that is public service related and the time horizon of such public service provision by the PSE
- The discretionary funding available to the PSE from its stakeholder. The mechanisms available and conditionality for providing these funds are considered
- Whether the stakeholder is willing to instil a commercial and responsible operating strategy for the PSEs
- The sector the PSE is operating in and the other players e.g., whether it consists of both public and private operating entities
- The importance of the service provided by the PSE
- The time horizon for the PSE to be fully privatised

Appendix D

Figure 4

Notching Guidelines for SOEs Specific Securities

	Asset pledge analysis[a]	Legal, financial and structure strength				Coverage
Proposed notching	**Asset performance**	**Legal foundation[b]**	**Trustee monitoring**	**Interest rate risk**	**DSRA**	**DSCR**
Stronger attribute (three to four-notch uplift)	Stability in asset performance, resilient behaviour under downturn economic cycles. Historical positive growth rate.	Robust legal foundation, fully compliant with regulation, enforceable and irrevocability features	Pledged revenues are set apart and monitored by trustee and/or escrow bank. Revenues are sufficient for debt servicing.	Fixed interest rate, additional stress for variable interest rate	Upfront DSRA: More than or equal to one quarter for BLR, 1 year for NCDs	Minimum DSCR equal to or higher than 1.2x in the rating case scenario
Mid-range attribute (two to three-notch uplift)	Asset performance closely linked to economic cycles.	Sound legal foundation with some contingencies	Pledged revenues are set apart and monitored by trustee/escrow bank. Revenues are sufficient for debt servicing	Variable interest rate	Upfront DSRA: Less than 1 quarter for BLR; Less than one-year for NCDs	Minimum DSCR between 1x and 1.2x in the rating case scenario
Weaker attribute (one-notch uplift)	Uncertain asset performance. frequent negative growth rates.	Sound legal foundation with some contingencies	Weaker structure and monitoring	Variable interest rate	No DSRA	Minimum DSCR equal to at least 1x in the rating case scenario

[a] Pledged revenue could be from SOE's own revenue source or from upper-tier of government
[b] Based on external legal opinion
Source: Ind-Ra

Appendix E

Key Aspects While Evaluating Non-Bank financial PSEs

- Trends in the gross non-performing assets (NPA) ratio, net NPA ratio, net NPA/equity ratio and the capital to risk adequacy ratio. The said ratios are defined as follows
    - Gross NPA ratio: Loans where income has either stopped accruing or the receivable is deemed otherwise impaired to period-end loans
    - Net NPA Ratio: Gross NPAs less provisions to period-end loans
    - Net NPA/Equity: Gross NPAs less provisions versus equity
    - Capital Adequacy Ratio: Total capital (tier 1+tier 2) to risk weighted assets
- Asset liability management practices put in place to prevent uncovered mismatches between assets and liabilities

Key Aspects While Evaluating Non-Dependent PSEs

- Movement seen in net leverage (net debt/EBITDA), gross interest coverage (EBITDA/gross financial expense) over the years
- Trend seen in the cash flow from operations