

CARE Ratings' criteria for rating of Market Linked Debentures (Including Equity Linked Debentures)



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Background

A market linked debenture (MLD) is a debt instrument that differs from a standard fixed-income security, considering the principal and / or coupon on the instrument is linked to a variable market indicator or benchmarks, such as an equity index, G-Sec, and commodity price such as gold, silver among others.

Market linked debt securities or MLDs that have a promised repayment of face value or principal component while interest / returns depend on movement of one or more underlying benchmarks (such as an index or a combination thereof) are commonly known as principal protected market linked debentures (PP-MLDs). MLDs can be structured in multiple ways either on single index basis or multiple indexes and may include additional features of call, put and other derivative features. Unlike plain-vanilla debt securities, returns on PP-MLD are not pre-determined and will vary on performance of linked benchmark.

The extant SEBI regulation mandates listed market linked issuances to provide principal protection and CARE Ratings Limited (CARE Ratings) prefix "PP-MLD" to the assigned rating to signify principal protection with uncertainty in the interest payment (which could be zero if the underlying benchmark delivers negative returns). CARE Ratings provides credit ratings only for PP-MLDs. Variability in returns on the coupon arising from market risk or other structural features is not considered.

The payment of principal and interest can also be linked to the performance of benchmark, in which case, debt securities may get an amount less than face value / principal, if the linked benchmark delivers negative return. There is no principal protection on these MLDs.

For clarity, CARE Ratings will continue to assign rating without "PP-MLD" prefix to securities that are floating rate instruments, where interest accrues or is paid periodically based on an agreed benchmark, such as MIBOR, T-Bill, or MCLR

Methodology for Credit Rating of MLDs

CARE Ratings' credit ratings of MLDs reflect its opinions on the creditworthiness of the MLD issuer. These ratings specifically assess the credit risk associated with the issuer concerned and do not account for potential fluctuations in returns due to adverse movements in underlying variables. It would essentially be an opinion on willingness and ability of the issuer to meet the obligation per terms of under the MLD issuance. CARE Ratings assumes that the issuer will clearly outline terms of the MLD in the information memorandum/offer document and fully expects investors to understand nature and structure of MLDs. Thus, the market risk sensitivity of the MLDs is expected to be apparent to investors, enabling them to make informed decisions.

As a matter of policy, CARE Ratings does not rate self-referencing products, where returns are linked to performance of the issuer's own equity shares. Inflation is not considered a market risk, and inflation-linked notes, unless they contain additional embedded market risk, are rated without the PP-MLD prefix.

Example of an Equity Linked Debentures (ELD) Credit Rating Assessment

Example 1:

Instrument Structure: Coupon linked to Nifty 10 year benchmark GSec index. In this structure, initial levels, date and final date for redemption are fixed. Underlying performance is tracked basis difference in final levels (official closing levels of Nifty 10-year benchmark GSec Index) at the time of redemption and initial levels, and based on underlying performance, coupon is determined. For example, say if the final level is over 40% of the initial level, then 'Y' coupon is paid, and if the final level is less than 40%, then coupon will be nil.

Example 2:

Instrument Structure: Coupon linked to Nifty 50 index. In this structure, initial levels, date and final date for redemption are fixed. Underlying performance is tracked basis difference in final levels (official closing levels of Nifty 50 Index) at the time of redemption and initial levels, and based on underlying performance, coupon is determined. For example, if the final level is negative to that of the initial level; then a fixed coupon can be paid say "8%", while if the final levels increase beyond initial levels based on underlying performance, the coupon will go on increasing, and on final redemption date, if final levels are 100% of initial level, the coupon can be "20%".

Rating assessment: The issuer with senior debt rating at "CARE A+; Stable" approaches CARE Ratings for rating ELN issue for the two structures mentioned in Examples 1 and 2. CARE Ratings will assign the ELD issue a rating of "CARE PP-MLD A+; Stable", reflecting the issuer's credit risk to pay interest and principal but not reflecting the potential volatility of interest payments, which are linked to market variables.

CARE Ratings' Rating Methodology

Since the rating of the MLDs is ultimately an opinion on creditworthiness of the issuer, the rating methodology would depend on the issuer. CARE Ratings has defined rating methodologies across sectors and appropriate methodologies are applied to MLD issuers based on its industry, which can be accessed from CARE Ratings' website www.careratings.com.

Rating Scale

CARE Ratings uses standardised rating symbols for long-term/short-term ratings on lines specified by SEBI for debt securities. Specifically, for 'Principal Protected Market Linked Debentures', standard rating symbols carry a prefix of 'PP-MLD'. MLDs with the same credit rating and comparable credit risk may have substantially different market risk, depending on their terms.

Ongoing review, monitoring / surveillance and withdrawal of ratings

CARE Ratings would review relevant information on the company being rated on an ongoing basis for the credit risk. CARE Ratings would rely on the information obtained from the issuer and/or from publicly available sources.

[For previous version please refer 'Rating Methodology- Market Linked Notes' issued in [March 2023](#)]

CARE Ratings Limited

Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Phone : +91 - 22 - 6754 3456 | CIN: L67190MH1993PLC071691

Connect :



Locations: Ahmedabad | Andheri-Mumbai | Bengaluru | Chennai | Coimbatore | Hyderabad | Kolkata | Noida | Pune

About:

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