Guarantee and Extraordinary Support Methodology

Fedafin's methodology for evaluating guarantees and extraordinary support
within the credit rating process of an issuer or issue

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1 General Remarks

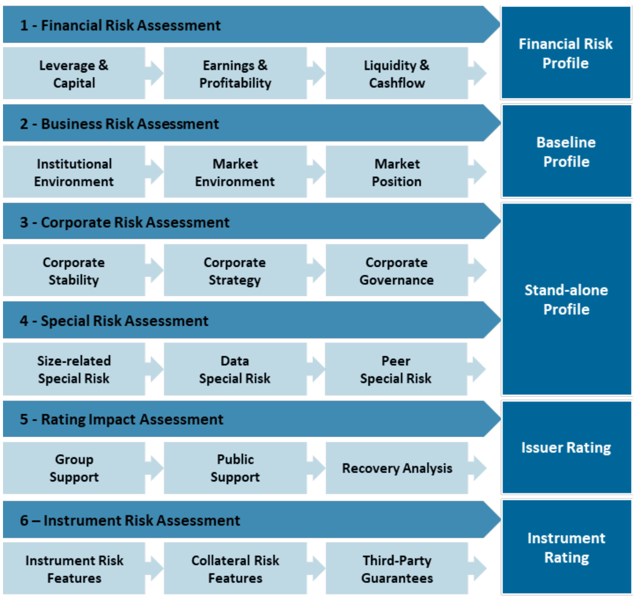
This rating methodology describes the general principles and guidelines for the qualitative assessment and evaluation of guarantees and extraordinary support. If an entity receives extraordinary support or guarantees are activated, the respective credit risk is transferred at least in part to a third party. As supporters provide liquidity or other assistance to bridge financial emergencies, they contribute to reducing the credit risk of the beneficiary issuers or debt instruments.

The provision of guarantees and extraordinary support is very common in the economy. Guarantees can be granted to both debt instruments and issuers, while extraordinary support applies only to issuers. The methodology distinguishes between public support and group support. Entities benefitting from public support include, for example, regional bus and rail companies, hospitals and care facilities, cantonal banks, energy suppliers or waste disposal and sewage treatment plants. Often, these companies are considered too important to fail, as a discontinuation of their services would have severe negative effects on the economy or the population. Similarly, private sector companies such as very large banks might be judged as too big to fail if their default would pose a systemic risk for financial markets and the real economy, with contagion risk extending to public sector budgets and affiliated entities.

Group support is common between different entities of corporate or banking groups. Examples are relationships between holding companies and operating companies, or between financing subsidiaries and other members of the group.

Figure 1 shows the general rating framework for private and public sector corporate ratings. The starting point for a rating classification is usually the financial risk assessment. This is augmented by an analysis of business risks, corporate risks and other specific risks, which leads to a stand-alone profile (SAP). The SAP reflects the creditworthiness of a company independent of extraordinary support or guarantees. In contrast, ordinary support from third parties is an element of the institutional environment of an issuer and is thus included in the SAP. Examples of such ordinary and recurring support are the specific financing systems of local public transport or of nursing homes.

Figure 1: General rating framework corporations



It is possible that an issuer benefits from both group support and public support. In this case, we would first establish the influence of group support on the creditworthiness of the issuer, before analyzing the impact of additional public assistance. However, most often only one type of support is relevant. Given the crucial importance of public support on government-related entities, this document first sets out our public support methodology in Section 2. Section 3 then turns to intra-group support mechanisms.

Evaluating extraordinary support or guarantees generally involves five steps: (1) identify the provider(s) of support and their respective creditworthiness; (2) determine the anchor rating; (3) determine the relevance of explicit guarantees or extraordinary support; (4) assess the extent of risk mitigation; (5) assign the issuer credit profile.

2 Public Support

For government-related entities (GREs) and other issuers potentially benefitting from extraordinary support, the first step is to determine the relevant support providers. This might be a municipality, a canton or a state, or a combination of several of these. Crucially, although it is often the case that we consider the public owners of a GRE as the likely support providers, there are cases where we think other third parties might also be compelled to provide financial relief (e.g. in the case of transport companies). Which entity is the de facto guarantor or support provider must therefore be assessed on a case-by-case basis.

When determining the anchor rating, we use the credit ratings of the guarantors or support providers as a starting point.[1] If several support providers are present or several owners issue per quota guarantees, we typically calculate the weighted average of the individual credit ratings. However, it is also possible that we consider the credit rating of only one guarantor or support provider as the relevant measure. In terms of seniority characteristics, if the financial support to a GRE or another firm is viewed as having the same rank as senior unsecured obligations of the support provider, its senior unsecured rating is considered as the relevant credit rating. If the financial support is deemed subordinated, however, we use the corresponding subordinated debt rating of the support provider.

To arrive at the anchor rating, it is possible to adjust the ratings calculated above by several notches. For instance, if an expected support payment is so high as to become detrimental to the supporter's own creditworthiness, we can make a deduction of one or more notches. Similarly, if we view changes in the pool of support providers or of their credit ratings as probable in the near future, we might incorporate a corresponding adjustment in the anchor as well.

In a next step, we consider whether explicit guarantees or extraordinary support will be relevant for the determination of a GRE's issuer credit profile. This distinction is not always clear. Even if explicit guarantees are present, it is often unlikely that they will actually come into effect. Guarantors might be induced to provide support to an entity in order to prevent guarantees from being activated. In these cases, we would normally apply the extraordinary support methodology, but regard the existence of explicit guarantees as a very strong supportive factor when evaluating the willingness of providing support.

The following subsections set out the rating methodologies for explicit guarantees and extraordinary support, respectively.

2.1 Explicit Guarantees

Explicit guarantees are usually set out in writing (law, contract, partnership agreement). They can either apply to the majority or all liabilities of an issuer or only to specific issues. Here, we discuss mainly the former, but the principles apply similarly to the latter. The evaluation of guarantees is then based on two criteria: (1) the extent of the risk transfer between the issuer and the guarantor and (2) their timeliness and enforceability.

[1] If fedafin does not assign its own credit rating for a guarantor or support provider, the credit ratings of other recognized credit rating agencies can also be used. Such use will be disclosed on the respective credit rating documentation.

The extent of the risk transfer can be judged integral, strong, or limited. If statutory guarantees encompass all liabilities of an issuer, the corresponding risk transfer is normally considered integral. In the case of limited guarantees with a binding cap, analysts would likely judge the resulting risk transfer as weaker.

The timeliness and enforceability of a guarantee is categorized as integral, strong, or limited, depending on how well the following criteria are met: whether the guarantee is direct or subsidiary; if legal enforceability is unproblematic or limited; if payments are timely or delayed; how easily the guarantee can be terminated or substantially altered; and if it has a fixed duration.

Figure 2 shows how the two criteria are combined to determine the guarantee risk profile. This can take one of five assessments: excellent, strong, fair, limited, or weak.

Figure 2: Guarantee assessment

GUARANTEE RISK MITIGATION ASSESSMENT			
	integral risk transfer	strong risk transfer	limited risk transfer
integral enforceability	excellent	strong	fair
strong enforceability	strong	fair	limited
limited enforceability	fair	limited	weak

This qualification of the guarantee risk profile then translates into a specified number of negative notches that are applied to the anchor rating (see Figure 3). If the guarantee risk profile is considered excellent, the issuer credit profile is equal to the anchor rating. For less strong qualifications, between one and four notches can be deducted from the anchor rating. If the resulting evaluation is below the GRE's stand-alone profile, analysts consider whether the public support provider could possibly reduce GRE's financial standing. If this is unlikely, the GRE's SAP is assigned as the issuer credit profile.

Figure 3: Notching framework for explicit guarantees

	GUARANTEE RISK PROFILE				
	excellent	strong	fair	limited	weak
Notches subtracted from anchor	0	-1	-2	-3	-4

In the case of an explicit guarantee, the SAP of the rated entity need not be disclosed in all cases. If the financial interdependence between the guarantor and the issuer is very strong, it is often not possible to determine an SAP in a meaningful way.

2.2 Extraordinary Support

For a GRE or another issuer benefitting from extraordinary public support, the influence on its credit risk profile can be determined either by a top-down or a bottom-up approach. Which option will be applied depends on the primary nature of the goods and services provided by the issuer and on the strength of the operational and financial links between issuer and support providers.

When characterizing an issuer's activities, we distinguish between a mainly public or mainly private nature of its goods and services. For instance, if the issuer's activities are heavily regulated, constitute basic or infrastructure services, or cannot be readily substituted by other market participants, we consider them as mainly public in nature. However, if activities are provided in an open market, do not constitute basic goods or services or show adequate substitution possibilities, we judge them as mainly private. The operational links between the issuer and support providers are analyzed using two criteria: the share of ownership held by the support providers and the amount of oversight and control they can exert on the issuer. Both of these criteria can be assessed as either strong or limited. Finally, the financial links between issuer and support provider are assessed to be strong if either explicit guarantees exist or the issuer benefits from regular financial subsidies from the support provider.

If the majority of the above-mentioned criteria are considered as mainly public or strong, we use the top-down approach to analyze the influence of extraordinary public support on the issuer's credit risk profile. However, if the criteria are judged to be mainly private or limited, we follow the bottom-up approach to get to the issuer credit profile.

2.2.1 Top-down Approach

In the top-down approach, the assessment of the support profile depends on the strategic importance of the issuer to the support providers and on the strength of the links between them. Strategic importance can be judged by the analysts as critical, very high, high, moderate, or low, taking into account several factors: (i) the nature of the goods and services provided by the issuer and the direct negative consequences their discontinuation might have on the population; (ii) wider economic impacts such as negative effects on the labor market if the issuer is a large employer in the respective area and contagion effects on other sectors of the economy and on public budgets; and (iii) importance attributed in the political agenda of the support providers. For instance, due to their potentially far-reaching consequences for a support provider's own financial standing and reputation, the existence of statutory guarantees for an issuer is usually judged as an indicator of a critical or very high importance.

In addition to the operational and financial links already mentioned above, within the top-down approach we also assess institutional links between the issuer and support providers. As institutional links we describe a public entity's possibilities to mandate, prohibit or generally regulate an issuer's activities (e.g. via licenses, permits, concessions) and to impose sanctions in cases of non-compliance. Financial links are analyzed once again, putting higher emphasis on the history of ordinary and extraordinary direct payments the support providers have already made to the issuer and on any funding or liquidity facilities that are in place. We assess the combination of operational, institutional and financial links as strong, moderate, or limited.

The matrix in Figure 4 shows how the importance of the issuer and the links between issuer and support providers lead to an assessment of the public support profile as excellent, strong, fair, limited, or weak.

Figure 4: Top-down extraordinary support assessment

EXTRAORDINARY SUPPORT ASSESSMENT: TOP-DOWN					
	critical importance	very high importance	high importance	moderate importance	low importance
strong links	excellent	strong	fair	fair	limited
moderate links	strong	strong	fair	limited	weak
limited links	strong	fair	limited	weak	weak

If the public support profile is deemed excellent, the issuer credit profile of the GRE or other company or bank is aligned with the anchor. For support profiles that are judged to be less strong, we deduct up to four notches from the anchor to derive the issuer credit profile (see Figure 5). In case the issuer's SAP (or evaluation including group support) is higher than the resulting evaluation, normally the SAP would be assigned as issuer credit profile.

Figure 5: Notching framework for extraordinary support (top-down approach)

	SUPPORT RISK PROFILE				
	excellent	strong	fair	limited	weak
Notches subtracted from anchor	0	-1	-2	-3	-4

2.2.2 Bottom-up Approach

If the bottom-up approach is the appropriate methodology to evaluate the impact of extraordinary public support on an issuer, operational links between the issuer and the support providers are usually less strong. The public support profile then only depends on the strategic importance the support providers attribute to the issuer, where the same criteria are applied as in the top-down approach. Figure 6 shows how the qualification as critical, very high, high, moderate, or low translates into an assessment of the public support profile as excellent, strong, fair, limited, or weak.

Figure 6: Bottom-up extraordinary support assessment

EXTRAORDINARY SUPPORT ASSESSMENT: BOTTOM-UP				
critical importance	very high importance	high importance	moderate importance	low importance
excellent	strong	fair	limited	weak

Given the assessment of the support profile, a corresponding uplift is added to the stand-alone profile of the issuer to determine the issuer credit profile. The uplift is proportional to the gap between the issuer's SAP and the anchor, where the multiplication factor is determined by the qualification of the support profile as shown in Figure 7.

Figure 7: Notching framework for extraordinary support (bottom-up approach)

	SUPPORT RISK PROFILE				
	excellent	strong	fair	limited	weak
Percentage of difference btw SAP and anchor added to SAP	75%	50%	35%	20%	10%

3 Group Support

Corporate groups can often be characterized as a conglomerate of member companies ranging from the holding company to the parent company, the financing company, and operating companies. The degree of complexity of such group structures is often considerable. Assessing the creditworthiness of a specific group entity requires a case-by-case analysis of cash flows between the different member companies, taking into account structural subordination issues, guarantees and other interdependencies.

Financing instruments are often issued by specific financing companies, holding companies or even operating subsidiaries. The funds are then distributed to other entities within the group structure. In order that instruments can be repaid when they are due, sufficient cash must flow back to the issuing companies. The creditworthiness of these companies thus relies on the financial ability of the group as a whole (the anchor rating) and the willingness to honour the issuing company's obligations.

In most cases, the anchor rating corresponds to the group stand-alone profile. This is based on the consolidated financial data and includes qualitative rating factors that affect the whole group. However, if the analysts perceive a migration of the group SAP as very likely in the near term, adjustments can be made accordingly.

The specific support methodology then differs depending on whether explicit guarantees or extraordinary support will be relevant for the group company's assessment. The following subsections describe the two approaches, respectively.

3.1 Explicit Guarantees

The evaluation of guarantees is based on two criteria: (1) the extent of the risk transfer between the issuing company and the guarantor (normally the group or a parent company) and (2) their timeliness and enforceability.

The extent of the risk transfer can be assessed as integral, strong, or moderate. For instance, guarantees often exist for financing companies that have no operating business and thus no potential to generate operating cash flows of their own. These guarantees are typically listed explicitly in the issue prospects of the respective financing instruments. Analysts would usually judge them as integral. For other entities, such as operating subsidiaries, explicit support statements can take the form of Letters of Intent or Letters of Comfort. Depending on the specific circumstances, their implied risk transfer might be judged as less strong. Also, limited guarantees with a binding cap would likely lead to a weaker assessment.

The timeliness and enforceability of a guarantee is categorized as integral, strong, or limited, depending on how well the following criteria are met: whether the guarantee is direct or subsidiary; if legal enforceability is unproblematic or limited; if payments are expected to be timely or delayed; how easily the guarantee can be terminated or substantially altered; and if it has a fixed duration.

Figure 2 shows how the two criteria are combined to determine the guarantee risk profile. It can take one of five assessments: excellent, strong, fair, limited, or weak. This qualification then translates into a specified number of negative notches that are applied to the anchor rating (see Figure 3). If the guarantee risk profile is considered excellent, the issuer credit profile is equal to the anchor rating. For less strong qualifications, between one and four notches can be deducted from the anchor rating. If the resulting evaluation is lower than the issuer's stand-alone profile, analysts also consider any negative financial effects the group companies might exert on the issuer, thus reducing its SAP. However, with strongly integrated groups it is often impossible to derive meaningful SAPs of single group companies, anyway.

3.2 Extraordinary Support

If the influence of group support on a specific entity's issuer credit profile is determined by the extraordinary support methodology, we follow either a top-down or a bottom-up approach. Which option will be applied depends on the strategic importance of the issuer's activities to the group and on the strength of the operational and financial links between issuer and support providers.

The assessment of strategic importance focuses on whether an issuer's activities constitute mainly core business or mainly side business of the group. If the issuer's activities generate a large share of a groups sales and profits or constitute central corporate functions, we consider them as core business. However, if the issuer generates low sales and profits or is held as a mere financial investment, it will likely be assessed as side business.

Operational links look at the ownership structure between the different group entities and the active influence, oversight and control that can be exerted on the issuer. Financial links take into account the integration of the member company in the group risk management and the direct financial links between the issuer and other group companies. All of these criteria can be assessed as either strong or limited.

If the majority of the above-mentioned criteria are considered as mainly core business or strong, we use the top-down approach to analyze the influence of group support on the issuer's credit risk profile. In contrast, if the criteria are judged to be mainly side business or limited, we follow the bottom-up approach to get to the issuer credit profile.

3.2.1 Top-down Approach

In the top-down approach, the group support profile depends on a closer assessment of the strategic importance of the issuer to other group companies and on the strength of the links between them. Strategic importance can be judged by the analysts as critical, very high, high, moderate, or low, based on the following criteria: (i) the material importance of the member company's production or services for the group and the direct negative consequences their discontinuation will have on the group; (ii) its contribution to sales, profits, up-stream dividends and the value chain; (iii) financial guarantees or cross-default and cross-acceleration covenants between the issuer and group companies; and (iv) the objectives of the group's corporate agenda (integration vs. investment).

In addition to the operational links already mentioned, also institutional links are analyzed in more detail. These include the organizational group structure and the prevalence of a corporate identity and joint brands. The combination of operational and institutional links is then assessed as strong, moderate, or limited.

The matrix in Figure 4 above shows how the strategic importance of the issuer and the links between issuer and other group companies lead to an assessment of the group support profile as excellent, strong, fair, limited, or weak.

If the support profile is deemed excellent, the issuer credit profile of the analyzed group entity is aligned with the anchor. For support profiles that are judged to be less strong, we deduct up to four notches from the anchor to derive the issuer credit profile (see Figure 5). In case the issuer's SAP is higher than the resulting evaluation, the SAP could be assigned as issuer credit profile. However, in such a case we would analyze if the issuer's financial standing could be influenced negatively by the group, for instance by demanding higher dividend payouts. If this is likely, analysts can reduce the issuer's SAP accordingly.

3.2.2 Bottom-up Approach

If the bottom-up approach has been determined as the appropriate methodology to evaluate the impact of extraordinary group support on an issuer, the combination of operational and financial links between the issuer and other member companies is usually less strong. The group support profile then only depends on the strategic importance the group attributes to the issuer, where the same criteria are applied as in the top-down approach. Figure 6 above shows how the qualification as critical, very high, high, moderate, or low then translates into an assessment of the support profile as excellent, strong, fair, limited, or weak. As specified in Figure 7, the analysts then add a corresponding uplift (proportional to the difference between the SAP of the issuer and the anchor rating of the group) to the stand-alone profile of the issuer to determine the issuer credit profile of the specific company.

4 Limitations and Extensions

The methodology for guarantee and extraordinary support assessment describes a range of potential risk drivers that could affect rating assignments. However, guarantee and extraordinary support risk profiles can vary significantly and the rating team may judge certain criteria non-relevant or include other criteria not listed in this document. Analysts may also deviate from standard weighting of rating relevant soft risk drivers if they consider this to be appropriate.

These guidelines may also be applied to risk profiles other than third-party guarantees and extraordinary support, accordingly, if the analysis shows similar credit enhancement properties as described in this documentation. Guarantee-like features are exhibited, for example, by credit insurance. Support-like features could be present for entities affiliated to corporates such as foundations, funds, or trusts.

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