GCR RATINGS

Criteria Research

Frequently Asked Questions: How GCR analyse legal entities operating within groups

Scope

The Frequently Asked Questions ('FAQ') publication on GCR's group rating approach applies to all issuer credit ratings assigned by GCR. The FAQ publication is not separate criteria and should be read in conjunction with Criteria for the GCR Ratings Framework and GCR's Rating Scales, Symbols and Definitions.

Frequently Asked Questions

When and why does GCR adopt a group approach for ratings?

While GCR assigns ratings exclusively to legal entities/obligations, the creditworthiness of the rated entity or obligation is often influenced by the financial and corporate strength of its immediate group or parent. This is because there is tangible likelihood of support or risk transfer, either up from subsidiaries, across from sister companies under the same holding company/parent or down from that holding company/parent.

As a result, GCR's ratings on a legal entity can be based on its own standalone strengths and weaknesses, solely on group/parent factors, or on a mixture of standalone and support characteristics. GCR also notes that due to a myriad of legal, regulatory, or geographic elements, several different legal entity ratings could be relevant within one consolidated group at any one time.

We decide our analytical approach using section 6 of the *Criteria for the GCR Ratings Framework*, available of the GCR website. An example can be found on page 24 of the Criteria.

How can group risks affect an operating entity?

One example of the risk of group linkages can be demonstrated by groups which take a significant amount of leverage out at a non-operating holding company (NOHC) level in order to invest in or recapitalise operating subsidiaries. In our opinion, ultimately that NOHC debt (whilst potentially structurally subordinated to operating company debt) affects the other legal entities in the group because it will require cash to be up streamed from operating subsidiaries through dividends or loans to service debt. This is because NOHCs, by their nature, rarely have their 'own' cash flows.

Group risks also affect rated entities through related companies or subsidiaries. For example, a corporate group can invest (through the NOHC) in foreign subsidiaries or other business lines which introduce risk/reward to the group as a whole. Positively, related entities can improve the diversification of business lines and revenues for the group or contribute to synergies, improving the creditworthiness of the 'whole'. Conversely, such subsidiaries can expose the group (and therefore the rated entity by proxy) to additional product/country/financial risk. The mechanism for such risk spreading from the 'weaker' entity to the group and the rated entity (even though they are separate legal entities) could be as simple as the supply of capital or liquidity from group members to support the 'riskier' entity. GCR's Group Support Criteria also captures the possibility that a group (presuming it has control) can transfer assets from one group entity to another during periods of financial stress and/or that the stressed related companies/affiliates' legal/reputational/gearing or regulatory problems could compromise the credit risk profile of the rated entity.

For regulated entities, the risk of such transfers may be limited by regulatory surveillance and restrictions and therefore we can allow some insulation if we view the regulations to be effective in protecting the entity from joint default risk and believe that there is operational and financial severability of the rated entity from the group. The same can be said for legally ring-fenced corporates and some other creditor protections (see question on insulation below). However, broadly group risk generally applies for regulated entities because financial groups can set up sister companies under the NOHC, and around the bank/ insurer, so the group can conduct business which is disallowed under the terms of their license or have punitively high capital charges. Analysing these operating entities alone, could risk ignoring such risk, unless insulation can be achieved (see below).

In the worst cases, we have seen groups use offshore or smaller sister companies to 'hide' poorly performing assets or additional debt or other risks. Therefore, adopting a consolidated approach and analysing intracompany flows is a key part of our analysis. Lastly, in the case where we have good reason to believe a rated entity belongs to a group, but where there are no consolidated financials provided to us or available, we will typically use the management and governance factor to bring down the ratings on the entity. We may also incorporate an assessment of the potential impact of dividend stripping or additional capital needs at other group entities in our analysis of the rated entity's financial profile.

How does GCR choose what part of a group to analyse?

Typically, GCR analyse the nearest consolidated group around a legal entity. However, given the complexity of groups, this is not always the case. GCR has three major categories for its group approach. *See the group support analytical decision tree on page 20 of the GCR Ratings Framework.*

A standalone credit analysis is performed on entities that are an insignificant part of a group, are a small part of a group, or are insulated from the rest of the group. The analysis focuses on the entity's solo operations and financial information. However, the final ratings of the rated entity would typically still be capped by its group's creditworthiness or could be provided uplift from the group's creditworthiness.

A group credit analysis is performed for rated entities that are the significant part of their group (typically accounting for over 50% of the operations' assets, revenues, loans or premiums) or conduct a critical role or is the ultimate parent of the group. The analysis focuses on the wider group operations and financials, although insulation may alter this approach. This is because the creditworthiness of the subsidiary and the parent drive each other's credit profile.

A sub-group credit analysis is performed when rated entities are a significant size within a sub-group but not of significant size to a larger consolidated group. For example, if a Kenyan bank contributes 80% of East African (sub-group) loans but only 5% of wider group loans. In this case, we would typically analyse the East Africa sub-group (assuming there is a holding company for such operations). However, the ratings on the legal entity could be capped or supported by the first consolidated group above the sub-group or indeed the ultimate consolidated group.

Can an operating entity's ratings be insulated from group risk?

To some extent where regulatory/statutory/contractual creditor protections exist we can somewhat insulate the ratings for a rated entity from its group/parent(s). However, we would severely limit the uplift and in order to do so, the entity would have to demonstrate such regulatory/legal or operational insulation, which is often hard to achieve. To view how this may be achieved please look at section 6.5 of the *Criteria for the GCR Ratings Framework*, available on the GCR website. Broadly, GCR would examine (among other local jurisdictional elements) the following characteristics:

1. whether there are limited reputational linkages, i.e. no co-mingled distribution, shared products, branding or franchise;
2. if the rated entity has a high degree of operational independence, specifically there is no joint management, funding or other credit linkages;
3. if there is a strong economic basis for the group or a regulator/creditor to preserve the entity's credit strength and the entity is operationally severable;
4. whether the assets and liabilities of the rated entity would (not) be consolidated upon the parent's or group member's liquidation.

We may also override the group ratings analytical approach in one or more of the following circumstances;

a) The parent is an investment holding company or private equity company.
b) There are guarantees from external parties that have been used to bolster the creditworthiness of a subsidiary
c) It is a Bank or Insurance Branch and not a subsidiary
d) If the parent has defaulted or is vulnerable to default and we think that regulatory or contractual protections mean that the rated entity is not similarly vulnerable.

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Related criteria and research

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