Supplementary Criteria for Credit Guarantee Companies

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1. ABOUT THIS CRITERIA

Scope

This criteria paper is issued as a supplement to CI Ratings' Non-Bank Financial Institutions (NBFIs) Rating Methodology and describes the criteria we use and the principal factors we consider when rating credit guarantee companies, including credit guarantee funds operating in Poland.

Our overall approach, including the analytical pillars we assess, is the same for all NBFIs. However, while the NBFI Methodology is broadly applicable to the credit guarantee sector, there are certain characteristics of credit guarantee companies that require a more nuanced approach when deriving a company's indicative standalone rating, or Entity Standalone Assessment (ESA).

Accordingly, this criteria paper explains how we interpret and apply our NBFI Methodology in the context of credit guarantee companies and identifies the additional or alternative metrics – as well as the associated considerations – we use to assess performance against key rating factors.

This supplementary criteria paper should be read in conjunction with the NBFI Rating Methodology, particularly as the principal considerations for assessing a number of key rating factors are the same for guarantee companies as for other NBFIs. In addition, if a guarantee company engages in financial activities beyond issuing guarantees or shares characteristics of other NBFIs that are not addressed in this criteria paper, we will apply our base methodology (fully or partly) instead.

Sector

Credit guarantee companies primarily issue guarantees to banks and other financial institutions to partially or, less commonly, fully cover the risk of non-payment on loans and other financial instruments extended to certain types of clients – typically, but not exclusively, micro, small, and medium-sized enterprises (MSMEs).

Some companies also provide warranties or surety products, such as bid bonds and performance bonds, to contractors (or other principals) that may be called by project owners (or other beneficiaries) in the event of non-performance, or breach of contract, by the contractor – possibly due to reasons unrelated to creditworthiness.

Guarantee companies are often established with the aim of improving access to finance for commercially-viable entities that lack the collateral or security needed to unlock external financing. By providing that collateral in the form of a guarantee, clients are able to secure needed financing from a bank or other lender.

For most of the guarantee companies we expect to rate using this supplementary criteria paper, the ability to write guarantees is primarily based on the cash provided by owners. A high proportion of these funds are typically invested in liquid financial assets and are available to meet guarantee calls and other liabilities.

Most guarantee companies receive government or supranational support and often use risk transfer instruments – in particular counter-guarantees – to augment their capital base and increase underwriting/guarantee capacity. Profit maximisation is not a performance objective for most guarantee companies and many operate as not-for-profit entities.

Guarantee companies may be exposed to losses in the event that borrowers default on the loans or other financial obligations they have guaranteed. Like banks and other lending institutions, the credit strength of guarantee companies depends primarily on asset/guarantee quality, capital adequacy and the capacity to absorb credit losses, as well as funding and liquidity.

2. SUMMARY OF OUR ANALYTICAL APPROACH

Overview and Framework

We apply the same analytical framework to guarantee companies as with other NBFIs. We consider a company's standalone credit profile, as well as the likelihood of it receiving extraordinary external support from owners or the government should such assistance be required in order to avoid default. (Ongoing or 'ordinary' support from owners – for example to facilitate business growth or meet changes in regulatory requirements – is factored into our assessment of the standalone credit profile.)

If the entity is a member of a corporate group (which will rarely be the case for the guarantee companies we expect to rate), we would apply the criteria contained in Parent-Subsidiary Considerations in the Determination of Corporate and NBFI Credit Ratings (issue date: April 2022) to determine the likelihood of extraordinary support. If the entity is owned by the public sector, we would apply the criteria and notching contained in our Bank Rating Methodology.

When we rate a guarantee company, we also take into account the potential ratings impact of sovereign risk factors, including the risk of transfer and convertibility restrictions and other state-imposed controls that could impede the entity's ability to meet its financial obligations in a timely manner. We apply the same considerations and notching criteria set out in our Bank Rating Methodology and, as with other financial institutions, generally expect most guarantee companies to be rated no higher than the sovereign of the country in which the entity is domiciled.

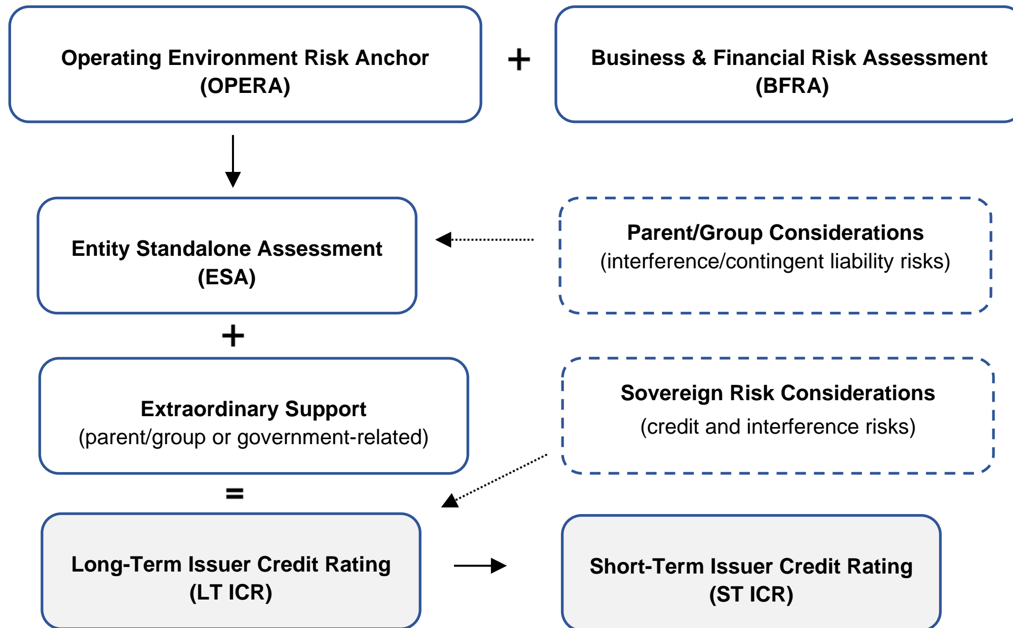
Determining a Guarantee Company's Credit Ratings

The framework for determining credit ratings on CI's international rating scale is summarised in Box 1, while the methodological process we follow is outlined in the following sections.

Our evaluation of a guarantee company's fundamental credit strength is based on an assessment of the seven analytical pillars identified in our NBFI Rating Methodology:

1. Operating Environment Risk
2. Business Risk
3. Governance and Management
4. Risk Profile and Risk Mitigation
5. Funding and Liquidity
6. Earnings and Profitability
7. Capitalisation and Leverage

BOX 1: GUARANTEE COMPANY CREDIT RATING FRAMEWORK (SIMPLIFIED)



OPERA for Guarantee Companies

Our starting point is to determine operating environment risk, utilising the Operating Environment Risk Anchor (OPERA) assigned to the banking system of the country in which the guarantee company operates. Where appropriate, we adjust the bank OPERA to better reflect the risks facing guarantee companies using the criteria outlined in our NBFI Methodology.

Business and Financial Risk Assessment

Once we have established the OPERA for the credit guarantee sector, we then evaluate the intrinsic financial, operational and business risk profile of the entity, which we summarise in the Business and Financial Risk Assessment (BFRA). In essence, the BFRA captures those financial and company-specific non-financial factors (i.e. excluding the operating environment and certain sovereign risk factors) that have a significant bearing on the likelihood of a guarantee company failing and requiring extraordinary support in order to remain a going concern, and is largely determined by Analytical Pillars 2 to 7.

Each of these six pillars consists of a number of key rating factors. A company's relative strength in terms of each key rating factor is assessed and the results of our analysis are combined to form an overall assessment of each pillar. The assessments of all six pillars are then combined to arrive at an opinion of the BFRA. The relative weights of the key rating factors and analytical pillars are decided by CI's rating committee and may vary according to entity-specific circumstances.

The six pillars and associated key rating factors are shown in Box 2. The pillars are the same as those in the NBFI Methodology, while the key rating factors are broadly the same but with some changes to better capture the specific risk profile of guarantee companies.

BOX 2: ANALYTICAL PILLARS OF BFRA

Pillar	Factors
Business Risk	• Business Model Stability • Market Position and Franchise Strength • Business Diversification
Governance & Management	• Quality of Corporate Oversight • Management Effectiveness • Risk Management and Control • Financial Reporting and Transparency
Risk Profile & Risk Mitigation	• Asset Mix and Concentration Risk • Credit Risk and Asset Quality • Market Risk • Operational Risk
Funding & Liquidity	• Funding Structure Risk Profile • Liquidity Risk
Earnings & Profitability	• Profitability and Efficiency • Earnings Quality
Capitalisation & Leverage	• Capital Adequacy and Leverage • Capital Flexibility

The principal characteristics of each key rating factor by assessment category ('very strong', 'strong' etc) are tabulated in each of the report sections below. These 'key characteristics' tables are offered for guidance. They do not constitute a checklist and are not exhaustive. Some, but not necessarily all of the characteristics of a particular assessment category may apply to the rated guarantee company and there may be cases where the company is best described by attributes from a combination of assessment categories. It is ultimately for the rating committee to determine which category fits best.

Entity Standalone Assessment

We combine OPERA and BFRA using internal guidelines and taking into account the guarantee company's business and financial profile relative to industry peers, as well as any other relevant rating considerations, to derive an indicative standalone rating for the company, which we call the Entity Standalone Assessment (ESA). To avoid any confusion with the ICR, the ESA is published in lowercase letters and does not have an outlook (it may, however, include the '+' or '-' modifiers).

Issuer Credit Ratings (ICRs)

We then establish a baseline for the LT ICR either by (i) mapping the company's ESA to the LT ICR scale and notching the rating up for extraordinary government-related support (if applicable) or, (ii) if group considerations are relevant, applying the criteria contained in Parent-Subsidiary Considerations in the Determination of Corporate and NBFI Credit Ratings. At the same time, we also take into account sovereign risk factors, including the risk of transfer and convertibility restrictions and other state-imposed controls that could impede the company's ability to meet its financial obligations in a timely manner.

The final LT ICR for the guarantee company will generally be set at the same level as the baseline for the issuer rating provided the latter is no higher than the sovereign rating. The guarantee company's long-term foreign and local currency ratings would also be equalised (if both are assigned) unless there are convincing reasons for judging default risk to be materially lower in one currency type compared to the other. However, where the baseline issuer rating is higher than the sovereign rating, we would apply our criteria for rating above the sovereign (explained in our Bank Rating Methodology) to determine whether the company's ratings could be higher than the sovereign or whether they should be constrained by the appropriate sovereign rating.

ST ICRs are mapped from LT ICRs using the guidelines shown in Annex 2.

Rating Scale and Definitions

The scale for guarantee company credit ratings and the associated rating definitions are provided in Annex 1. Outlooks are also assigned to long-term ratings to indicate the likely direction of a change in the ratings over the next 12 months. A Positive (Negative) outlook signals a better than even chance that the rating will be raised (lowered) within a year. A Stable outlook indicates that the rating is unlikely to change in the next 12 months.

National Ratings

In some markets, CI may also assign long- and short-term credit ratings on a national scale. Unlike international credit ratings, national ratings are not comparable across countries and refer instead to the creditworthiness (usually in terms of local currency) of the rated entity relative to all other entities in the same country.

3. ENTITY STANDALONE ASSESSMENT: ANALYTICAL PILLARS

In this section we explain the rationale for each of the seven analytical pillars of the ESA and outline the criteria used to assess the underlying key rating factors. The analytical pillars are:

1. Operating Environment Risk
2. Business Risk
3. Governance and Management
4. Risk Profile and Risk Mitigation
5. Funding and Liquidity
6. Earnings and Sustainability
7. Capitalisation and Leverage

ANALYTICAL PILLAR 1

OPERATING ENVIRONMENT RISK

We apply our standard NBFI criteria for this analytical pillar (see NBFI Methodology). Accordingly, our starting point for assessing the operating environment risk for a guarantee company is to consider the Operating Environment Risk Anchor (OPERA) assigned to the banking system of the country in which the company operates.

Bank OPERAs capture those factors that are important for economic growth and broader macroeconomic and financial stability, including the strength of a country's legal and financial infrastructure. They also incorporate general business risks and growth opportunities arising from the structure, level of development, and regulation of a country's banking industry. OPERA also takes into account the ability of the central bank to provide sufficient support to the financial system to alleviate liquidity stresses and funding strains and preserve confidence.

OPERAs are based on an analysis of five (broad) key rating factors, which are further divided into a number of sub-factors. They are:

1. Macroeconomic Strength
2. Monetary Flexibility and Capital Market Development
3. Industry Structure and Performance
4. Regulatory Environment and Institutional Frameworks
5. Political and Policy Risk

(For more information on these key rating factors see the NBFI Methodology.)

As explained in our NBFI Methodology, our general view is that operating environment risk for NBFIs – including guarantee companies – within a particular country will generally be no lower than, and in most cases will probably be higher than, the level implied by the bank OPERA. Our criteria indicate the following possible adjustments to the bank OPERA to determine the appropriate baseline for an NBFI's operating environment risk anchor:

- We deduct one notch for a lack of, or more uncertain access to, central bank liquidity facilities.
- We deduct one notch for a less robust, or lighter, regulatory and supervisory framework and less rigorous oversight.
- We may deduct an additional notch where we consider the scope and strictness of prudential rules and standards and/or the quality and enforcement capabilities of the relevant regulatory and supervisory institutions to be particularly weak compared to the banking sector and inadequate given the risk profile of the NBFI sub-sector.
- We may also deduct a further notch for NBFI sub-sectors that experience much greater cyclicality and revenue variability compared to banks and where we believe the associated risks are not adequately captured in our company-specific criteria (i.e. Analytical Pillars 2 to 7).

We also state in our NBFI Methodology that downward notching may be reduced, or not applied, where:

(i) an NBFI sub-sector is subject to regulatory oversight and prudential standards that are commensurate with those applied to banks in the same country and/or firms within the sub-sector are able to access central bank liquidity facilities (even if subject to meeting collateral requirements); or

(ii) the above notch factors are less applicable due to the firm's business model (e.g. if it does not incur balance sheet risks as part of operating activities and has no reliance on short-term market-based or confidence-sensitive forms of funding).

The latter consideration may be applicable in cases where guarantee companies have no reliance on wholesale markets or other forms of short-term, confidence-sensitive funding and face minimal incremental operating environment risks relative to banks.

The application of our criteria results in an NBFI sectoral OPERA for the country in which the company is domiciled and primarily regulated. For guarantee companies with substantial operations in, or risk exposures to, more than one country, we may adjust this 'home' OPERA to reflect the operating environment risk in other countries. The extent of any notch adjustments (positive or negative) will depend on the relative size of foreign exposures and the difference in strength (or risk) between the home and foreign markets.

ANALYTICAL PILLAR 2

BUSINESS RISK

In assessing Business Risk, we assess the same key rating factors as with other NBFIs (see NBFI Methodology), but some of the underlying considerations differ. These are indicated below.

Our assessment of Business Risk is divided into three key rating factors:

- Business Model Stability
- Market Position and Franchise Strength
- Business Diversification

KEY RATING FACTOR 1

Business Model Stability

Business model analysis focuses on how a guarantee company generates and sustains revenues and profits, as well as the risks and vulnerabilities arising from what it does and how it does it.

Our approach is broadly the same as for other NBFIs. We consider how a company's business model has evolved over time (with the emphasis on stability and resilience), the seriousness of any threats to the way the company currently operates, and the appropriateness of any strategic intentions to modify or change the business model in order to ensure sustainability or cope with emerging challenges.

Many guarantee companies are established with some form of public sector backing and are expected to a play a role in the fulfilment of broader economic objectives, such as improving the access of MSMEs and start-ups to external finance.

Profit maximisation and volume growth may not be part of the business model. Where this is the case, we will attach a lower weight to earnings strength, company size and growth potential compared to our standard approach, provided the rated entity is able to operate on a sustainable basis by maintaining a degree of profitability through the economic cycle and ensuring that its capital and liquidity are commensurate with the risks it faces.

Key considerations for guarantee companies include:

- Whether the company operates on a fully commercial, for-profit basis and, if not, whether it aims for financial self-sustainability or is reliant on ongoing shareholder or other external support.
- The strategic aims of the business model, including in terms of targeted sectors and/or geographies, beneficiary eligibility criteria, the targeted total volume of guarantees, and the degree of leverage.
- Whether exposure to risky or more volatile entities or activities is an intrinsic (or mandated) part of the business model and, if so, whether solvency risk is higher than peers as a consequence or is successfully managed or mitigated (e.g. through high levels of credit protection or risk transfer arrangements).
- The stability of the business model over time and through economic cycles or, conversely, whether the company has a track record of significantly altering the business mix or shifting strategic focus.
- Whether the company utilises re-guarantee (or similar) programmes and how these programmes affect both its revenue streams and overall financial performance.
- The extent to which the company engages in other business activities that complement its core activities (e.g. risk management advisory services), and whether there are any restrictions on the types of activities it is permitted to undertake.
- Potential challenges to the current business model arising from expected changes in laws, regulations or technology, including changes driven by environmental, social and governance (ESG) considerations, such as climate change and the associated transition risks.

- The likely efficacy of, and execution risks associated with, strategies to develop, modify or change the business model (or business mix) in order to enhance the company's value proposition, competitiveness, and long-term profitability.
- Whether planned changes to the size, scale or scope of the business are prudent, or whether expansion plans and growth expectations are unrealistic and a potential source of vulnerability.
- The extent to which credit appraisal and debt recovery are carried out by the guarantee company or whether such activities are left largely to the originating financial institution.

Business Model Stability, Key Characteristics

Very Strong

Business model is well-established, very stable and highly resilient to operating environment adversities in absolute terms and relative to peers.

Exposure to high-risk activities is not material and the sensitivity of the principal business lines and revenues to changes in investor sentiment or consumer confidence is low.

Operating performance is not significantly affected by fluctuations in economic cycles and financial markets.

Company has a very strong track record of adapting the business model in a timely manner in order to meet emerging challenges, threats, or secular changes in client preferences and technology and is not expected to be significantly affected by any foreseeable medium-to long-term challenges.

Strong

Business model is well-established, stable and fairly resilient to operating environment adversities.

Exposure to high-risk activities is low and the sensitivity of the principal business lines and revenues to changes in investor sentiment or consumer confidence is modest.

Operating performance is modestly affected by fluctuations in economic cycles and financial markets.

Company has a strong track record of modifying the business model when necessary but may face significant but likely manageable medium- to long-term challenges.

Adequate

Reasonably stable business model but may be more affected by operating environment adversities compared to higher categories and peers.

Exposure to high-risk activities may be moderate. The principal business lines and revenues may be moderately sensitive to changes in investor sentiment or consumer confidence.

Operating performance may be somewhat affected by fluctuations in economic cycles and financial markets.

Company has a moderate track record of modifying the business model when necessary and may face significant and likely constraining medium- to long-term challenges.

Moderate

Business model stability is moderate, possibly due to the company's stage of development and still evolving business mix or periodic significant changes in the earnings mix driven by non-core business lines.

Exposure to high-risk activities may be significant. Reliance on more volatile and confidence-sensitive business lines and revenues may be significant.

Operating performance is significantly affected by fluctuations in economic cycles and financial markets.

Company may have a mixed (or untested) track record of modifying the business model when necessary and/or may face significant short- to medium-term challenges, which it may not be sufficiently well-positioned to meet.

Organisational complexity may be significant and some of the main legal/group entities may be somewhat opaque. Related operational risks may be significant.

Business Model Stability, Key Characteristics (continued)

Weak

Limited business model stability, possibly reflected in frequent shifts in strategic focus and risk appetite.

Business mix may be unstable/evolving rapidly or exposure to high-risk activities may be high. Reliance on more volatile and confidence-sensitive business lines and revenues may be high.

Company may have a relatively weak (or untested) track record of modifying the business model when necessary and/or may face major short- to medium-term challenges, which it may be unable to meet.

Organisational complexity and opacity may be high and the business raison d'être for some legal/group entities unclear.

KEY RATING FACTOR 2

Market Position and Franchise Strength

We apply our standard NBFI criteria for this key rating factor in cases where a credit guarantee company is active nationally or internationally on a commercial, for-profit basis. Our standard NBFI criteria is also broadly applicable to guarantee companies that are active locally or regionally, except that we would generally put less weight – but not no weight – on their typically small-scale of operations and limited economies of scale (if adequately insulated from competition in their principal market segment) and more emphasis on the ability to defend and maintain their niche market positions and adapt to changes in client needs and expectations.

In assessing the market position and franchise strength of guarantee companies, we consider:

- The strength of the company's market position, as well as the company's actual and expected performance through the business cycle, and how it coped in the past with any adverse economic shocks.
- Whether the company's market position benefits from formal barriers to entry or from obstacles to market entry associated with economic advantages such as economies of scale and network effects.
- The strength of the company's brand and reputation, and the loyalty or 'stickiness' of its clients/partners, including the strength of relations with originating banks and other financial institutions.
- The vulnerability of the company's market position to competition from other guarantors (e.g. from regional or national guarantors in the case of companies with a local focus), as well as from other financial institutions.
- Whether recent changes in market position/business volumes have been driven by aggressive business practices or excessive risk-taking.
- Whether the company specializes in particular types of guarantees, such as performance bonds, advance payment guarantees, or loan guarantees, and how well these offerings align with market demand.
- Prospects for increasing business volumes over the medium term without significantly weakening the risk profile of the entity.
- Whether the company's market position or franchise strength benefits from it being a member of a larger, well-established group.
- Whether product offerings and business volumes are largely dependent on the continued participation in government or supra-national business development support programmes, and the degree of vulnerability to shifts in the strategic priorities of funding providers or changes in programme type or eligibility criteria. Conversely, whether the company's market position and business prospects are constrained by the inability to access such funding programmes.

Market Position and Franchise Strength, Key Characteristics

Very Strong

Leading and sustainable market position in all or most key business lines and/or geographies, with no discernible weaknesses.

Strong competitive advantages internationally (e.g. in terms of economies of scale, distribution channels, product innovation, product differentiation, pricing power and client relationships). Likely benefits from very high formal or informal barriers to entry.

Very good growth potential and prospects across all key markets and segments.

Strong

Sound and sustainable market positions in most key business lines and/or key geographies. May be reliant on a leading position in a single large economy.

Sound competitive advantages with limited weaknesses. Likely benefits from high formal or informal barriers to entry.

Good growth potential and prospects in most key markets and segments.

Adequate

Adequate (mid-tier) franchise/brand with moderately good or average market positions in key business lines and/or key geographies. Alternatively, franchise strength may be associated with a strong position in a single small- or medium-sized economy or a leading and defendable position in a niche sector or activity.

Adequate competitiveness with some weaknesses. Barriers to entry likely provide moderate protection against new entrants.

Average growth potential and growth prospects in some key markets and segments.

Moderate

Moderate (below average) market positions in key business lines and/or key geographies. Operating history may be limited.

Moderate competitiveness with possibly significant constraints (e.g. weak pricing power/price-sensitive market position, limited brand presence, limited economies of scale, scope etc, customer base that exhibits significant turnover).

Moderate growth potential and prospects in key markets and segments, albeit subject to substantial competition and/or regulatory pressures. Alternatively, the focus of business growth/franchise development may have shifted to high risk and potentially more volatile (non-core) business lines or geographies.

Weak

Weak market positions and very limited franchise strength across business lines and geographies. Operating history may be very limited.

No significant competitive advantages, very limited brand presence, and possibly serious weaknesses in a number of key areas.

Very limited growth potential and prospects due to inherent shortcomings/constraints and substantial competitive and/or regulatory pressures.

KEY RATING FACTOR 3

Business Diversification

Our standard NBFI criteria are broadly applicable to this key rating factor.

The breadth and diversification of a guarantee company's products and services, as well as its customer base, contributes to the growth, reliability and diversity of earnings. Moreover, well diversified guarantors with low concentrations and limited correlations in terms of business segment, product, geography, and customer are generally better positioned to withstand cyclical swings and extended periods of economic stress.

Key considerations include:

- The degree of revenue concentration risk posed by, for example, high reliance on a single business line, client type, or geography. This risk may be particularly pronounced when a considerable proportion of guarantees have been issued under a re-guarantee (or similar) programme that is approaching its expiration, with no clearly defined successor programme in place.
- Whether the company is highly exposed to business disruption risk due to a high reliance on a small number of origination partners or reinsurance providers.
- The expected riskiness of new or recent diversification efforts (e.g. launching new products with no obvious synergies, or aggressively entering new markets where the company has limited expertise).
- Whether the product range is narrow or highly correlated and, if so, whether the attendant risks are mitigated to a significant extent by an associated revenue stream that has proven to be reasonably stable during economic downturns.

Business Diversification, Key Characteristics

Very High

Very high level of diversification and very low levels of concentrations and correlations across business segments, customers, and geographies, including by industry standards and relative to peers.

High

High business diversification and generally low levels of concentrations and correlations relative to most peers.

Geographical diversification may be moderate but the markets the company operates in are relatively large and a source of stable business volumes and revenue streams.

Adequate

Adequate diversification with material, but manageable, levels of concentrations and correlations that are in line with the average for peers.

Alternatively, business or geographical concentrations may be significant but associated risks are considered to be moderate and revenues from core business lines have proven to be fairly robust through economic cycles.

Moderate

Significant business concentrations and less diversified than average for peers.

May be reliant on a few key business lines and a higher risk product mix, and have little or no geographical diversification.

Business volumes and revenue streams may be reliant on a few key clients.

Low

High business concentrations and substantially less diversified than most peers.

May be very reliant on a very small number of possibly volatile business lines.

Business and revenue streams may be highly dependent on a few large customers.

ANALYTICAL PILLAR 3

GOVERNANCE AND MANAGEMENT

The focus of this analytical pillar is on how the governance and management of a company may support or potentially hinder its overall risk profile and operational and business performance.

We apply our standard NBFI criteria for this analytical pillar and the four associated key rating factors (see NBFI Methodology) as the considerations are relevant to all types of NBFIs, including guarantee companies, and take into account the nature, scale and complexity of the business model.

The key rating factors we assess are:

Quality of Corporate Oversight – which focuses on the effectiveness of the board of directors, specifically whether the board has sufficient independence, authority, expertise, diversity, and resources to discharge its core responsibilities effectively, hold management to account, and provide appropriate checks and balances against conflicts of interest.

Management Effectiveness – which considers the experience and recent track record of the current management, the capacity to develop business plans and meet strategic objectives, and whether management (other than risk managers) has a clear understanding of the amount of risk that is acceptable in order to implement the company's business plan.

Risk Management and Control – which involves an assessment of the effectiveness of a company's policies, procedures and resources for identifying, assessing, monitoring and mitigating all relevant risks, as well as its ability to maintain risk levels within acceptable limits. This analysis includes an assessment of the company's risk appetite, as well as a review of how it has managed risks over the time, including through economic cycles, market fluctuations and periods of market stress, and as evidenced by its loss history.

Financial Reporting and Transparency – which focuses on the quality of transparency and financial disclosures. We regard this to be a largely asymmetrical rating factor. The impact of good disclosure on ratings is usually neutral, in part because it cannot on its own outweigh weaknesses in a company's business or financial risk profile. However, significant shortcomings in the quality of financial reporting and disclosure would normally have a negative impact on ratings, while severe deficiencies would pose an insurmountable obstacle to ratings been assigned or maintained.

See our NBFI Methodology for more detailed information on each of these key rating factors.

ANALYTICAL PILLAR 4

RISK PROFILE AND RISK MITIGATION

We use the same key rating factors as for other NBFIs when assessing this analytical pillar, although the criteria is tailored to the specificities of guarantee companies.

The focus of this analytical pillar is on the risk profile of a guarantee company's on- and off-balance sheet exposures. We consider the nature and scale of risk exposures both in absolute terms and after considering mitigants aimed at reducing the degree of risk and the size of potential losses. We also consider a company's capacity to accommodate losses through accumulated provisions without impairing its capital.

We define 'assets' in broad terms to include financial guarantees, as the gross amount of guarantees is recorded off-balance sheet, but those guarantees are both a key source of income and potential loss.

Our evaluation of a guarantee company's risk profile and risk mitigation is based on four broad-based key rating factors:

- Asset Mix and Concentration Risk;
- Credit Risk and Asset Quality;
- Market Risk; and
- Operational Risk

The weight we place on each of these factors depends to some extent on the business model of the NBFI. For guarantee companies, the first two key rating factors are usually the most important rating drivers.

KEY RATING FACTOR 1

Asset Mix and Concentration Risk

In this key rating factor, we assess a guarantee company's on- and off-balance sheet asset mix in terms of its fundamental soundness and consistency with the company's stated business and investment strategies. We focus in particular on the degree of risk and vulnerability in the asset structure, especially in terms of:

(a) the relative importance of asset class and credit/guarantee exposure categories that are considered to be higher risk; and

(b) risk characteristics that may increase a guarantee company's relative susceptibility to asset risk/asset quality problems independently of the asset class or credit category, in particular exposure concentrations and rapid (excessive) growth of the asset base and off-balance sheet (e.g. guarantee issuance) activities.

We consider a number of factors including:

- The size of the asset base in absolute terms, as small guarantee companies may be less capable of coping with event risk compared to large companies (all other things being equal).
- The degree of direct or indirect exposure to relatively high-risk or complex assets or sectors.
- Recent changes in the risk profile of the asset base or guarantee portfolio, in particular indications of a permanent increase in risk appetite. Evidence that the company is tolerating much higher levels of risk in order to increase earnings is generally regarded negatively.
- The pace of asset growth, as an expansion of the company's guarantee portfolio at a rate exceeding the growth of its equity could translate into higher credit risk, as well as leverage.

Vulnerabilities in the asset/guarantee portfolio structure often arise from high exposure to individual borrowers, issuers or counterparties, or excessive sectoral concentrations of guarantees and investments. Such concentrations may leave a guarantee company vulnerable to financial loss if the

underlying obligor or counterparty defaults or fails to perform, or if the asset loses significant value.

CI generally regards credit concentration risk to be high and a potential rating constraint when a guarantee company's asset/guarantee portfolio structure features any of the following:

- High exposure to a single industry or economic sector, particularly highly cyclical or troubled sectors or, more broadly, to a highly correlated set of sectors or activities, especially sectors with more volatile income streams (e.g. commercial real estate and construction).
- Large exposure to a small number of obligors.
- Outsized exposure to a single obligor.
- High exposure to related or connected parties, such as entities within the same group.
- High exposure to borrowers, issuers or counterparties in more volatile emerging markets or in countries currently under, or at elevated risk of, economic and financial stress.
- High exposure to illiquid investment assets (relative to long-term stable funding).

A high share of guarantees in foreign currency may be viewed similarly, particularly if the underlying borrowers lack a natural hedge against adverse movements in exchange rates.

The pace of asset/guarantee growth is another important risk factor as excessive growth may presage an increase in a guarantee company's risk profile. This could be intentional, for example if the company is pursuing an aggressive growth strategy focused on higher-risk/higher-reward activities or markets. However, it may also be unintentional since rapid asset/guarantee growth may stretch the company's risk management capabilities and internal controls, resulting in poorer underwriting and investment decisions.

An important supplementary factor in assessing forward-looking risks associated with the growth rate and composition of assets and guarantees is the quality of the guarantee company's risk management, including the soundness of underwriting standards. Prudent risk management is a rating strength and any concerns we may have about the current pace or composition of asset/guarantee growth may be at least partly allayed where there is evidence the company is taking appropriate risk-reducing or mitigating actions.

Asset Mix and Concentration Risk, Key Characteristics

Very Low

The nature and composition of risk exposures imply very low risk.

Exposure to higher risk assets and illiquid investment assets is very low.

Risk exposures are very well diversified.

Asset growth is sustainable and driven by core activities.

The overall risk profile of the company's assets is not expected to change to any significant degree in the medium term.

Low

The nature and composition of risk exposures imply low risk.

Exposure to higher risk assets and illiquid investment assets is low.

Risk exposures are well diversified.

Asset growth is generally sustainable and driven mainly by core activities but may also reflect new or higher risk business lines or products that are expanding at a faster rate than the total.

The overall risk profile of the company's assets is not expected to increase significantly in the medium term.

Moderate

The nature and composition of risk exposures imply moderate risk.

Exposure to higher risk assets and illiquid investment assets may be moderate.

Risk exposures are adequately diversified, and concentrations are generally within acceptable limits. There may

Asset Mix and Concentration Risk, Key Characteristics (continued)

be some significant geographical or sectoral concentrations, possibly reflecting the size or business model of the company or the narrowness of the local economy. There may be significant, but not high, exposure to issuers, borrowers or counterparties in economies that are particularly volatile or weak.

Asset growth may be slightly above sustainable levels and/or reflect non-core and higher-risk activities.

The overall risk profile of the company's assets may be expected to increase moderately in the medium term.

Moderately High

The nature and composition of risk exposures imply moderately high risk.

Exposure to higher risk assets and illiquid investment assets may be substantial.

Risk exposures may not be sufficiently diversified and there may be some sizeable concentrations that are at or slightly in excess of prudent levels. There may be some sizeable exposures to issuers, borrowers or counterparties in economies that are particularly volatile or weak.

Asset growth may be significantly above sustainable levels and/or reflect a significant shift into non-core and higher-risk activities.

The overall risk profile of the company's assets may be expected to increase significantly in the intermediate term.

High

The nature and composition of risk exposures imply high risk.

Exposure to higher risk assets and illiquid investment assets may be relatively high.

Concentration risk may be comparatively high and there may be some large concentrations that are well above prudent levels. There may be high exposure to issuers, borrowers or counterparties in economies that are particularly volatile or weak.

Asset growth may be highly excessive and/or reflect a significant expansion of higher-risk activities.

The overall risk profile of the company's assets may be expected to increase significantly in the short to intermediate term.

KEY RATING FACTOR 2

Credit Risk and Asset Quality

Guarantee companies are exposed to credit risk from the guarantees extended to banks and other financial institutions with respect to underlying credit facilities to third parties, such as MSMEs. For most business models it is the principal risk faced, with borrower defaults and guarantee calls having potentially serious adverse consequences for a guarantee company's earnings, liquidity, and capital position.

Although typically less important, guarantee companies may also be exposed to credit risk arising from their investment/securities portfolios and holdings of other interest-earning assets (mainly bank deposits, in the case of small guarantors).

Our assessment of a guarantee company's credit risk exposure takes into account, inter alia:

- The quality of the guarantee book and the investment/securities portfolio, as well as historic credit losses;
- The capacity to absorb future losses from aggregate provisions/ loss reserves; and
- Potential credit loss mitigation from counter-guarantees and other credit enhancements.

Asset Quality

To assess the quality and performance of the guarantee portfolio, we draw on a variety of asset quality indicators, including the following:

- **Non-performing assets ratio** (NPAs to total guarantees) – where NPAs are the value of guarantees classified as Stage 3 under IFRS 9. If IFRS data is not available, we will use the closest equivalent measure in a given jurisdiction based on local accounting definitions or regulatory reporting requirements (e.g. classification by substandard, doubtful, and loss).

- **Guarantees at risk** – calculated by dividing the value of guarantees classified as Stage 2 and Stage 3 under IFRS 9 by total guarantees. If IFRS 9 is not used, we will use a similar measure (e.g. guarantees classified as special mention/watch, substandard, doubtful, and loss).

- **Provisioning expenses for guarantees to total guarantees** – a complementary indicator that provides an indication of newly expected credit losses on guarantees and hence the change in asset quality during the year.

- **Gross pay-out ratio** – a broad indicator of annual losses on outstanding guarantees, calculated by dividing the total claims paid on guarantees over a 12-month period by total guarantees outstanding at the start of the period.

We also consider key qualitative factors, such as the company's guarantee classification criteria and approach to loss recognition.

More specifically we will generally lower our assessment of asset quality from the level implied by headline ratios if any of the following conditions apply:

- Asset quality is materially worse than indicated by the above ratios owing to weaknesses in the approach to classifying guarantees or recognising impairments. This may include deficiencies in the measurement of NPAs; the accuracy of classification standards; and adherence to those standards.

- Asset performance risk is higher than indicated by the above ratios owing to weaknesses in the guarantee company's ability to assess the creditworthiness of borrowers and/or monitor changes in creditworthiness, including due to weaknesses in the quality and timeliness of information provided by the originating financial institution.
- We expect guarantee calls to increase significantly over time (all other things being equal) given the credit quality of the underlying borrowers (e.g. that they are sub-investment grade/high risk on average).
- The guarantee portfolio is unseasoned and/or asset quality has not been tested in a more unfavourable economic environment.
- Observed declines in NPA ratios are misleading due to the rate of growth of total guarantees (denominator effects) or the amount of write-offs.

We also consider the average guarantee rate of the underlying loans. The higher the percentage covered by guarantee, the lower the incentive of the originating bank to adequately evaluate loan applicants or pursue recoveries in the event of default – potentially increasing the likelihood of a guarantee claim and the size of the associated credit loss (all other things equal).

To assess the credit quality of a guarantee company's securities and investment portfolios we consider:

- Recent or expected impairments on securities, investments and other non-loan exposures.
- The creditworthiness of the issuers of securities and of depositary institutions (and whether protection from deposit insurance would be available in the event of a default).
- The liquidity profile of the securities and investment portfolio, with assets that are available for sale or held for trading usually regarded as less vulnerable to credit risk, except when current market liquidity conditions pose a material risk to the company's ability to exit or hedge a position in the near term. Significant holdings of unquoted securities issued by sub-investment grade entities would generally be regarded as a potentially material source of credit risk for a guarantee company.
- The degree of investment exposure to illiquid or inherently risky asset classes (private equity, real estate, and complex securitised instruments).

Credit Loss Absorption Capacity

This sub-factor focuses on the ability of a guarantee company to withstand credit losses in its guarantee book and investment portfolio without impairing its own equity position and earnings base.

Our assessment takes into account loss reserve coverage as well as other forms of credit risk mitigation, such as counter-guarantees.

Loss reserve coverage

We use the **NPA coverage ratio** (loss reserves to gross NPAs) to provide a prima facie indication of a guarantee company's capacity to accommodate losses on guarantees through accumulated provisions.

While high reserve coverage is generally preferable to low reserve coverage, we also consider the driving factors behind the determinants of the ratio to ensure that it provides a meaningful measure of loss absorption capacity. Consequently, we examine the trend in the coverage ratio over time, as well as the underlying provisioning policies of the guarantee company.

We view provisioning practices with material weaknesses negatively. Such shortcomings might include an excessive focus on incurred losses – with little or no forward-looking component – or the use of optimistic or inappropriate assumptions and estimations in provisioning calculations.

We also take into account the use of counter-guarantees and similar types of credit protection, as such risk mitigants might enable a guarantee company to operate with comparatively lower (and less than full) reserve coverage ratios.

Where a guarantee company benefits from counter-guarantees or loss-absorbing funding provided under a government programme, we will also consider the adequacy of provisions held against guarantees at own risk relative to the value of NPAs at own risk (subject to data availability).

Where material, we also gauge the adequacy of provisions for credit losses on other impaired assets (such as securities), as well as for any other off-balance-sheet positions and contingent liabilities (i.e. other than guarantees)

Credit risk mitigation

Counter guarantees are a key source of credit protection for many guarantee companies and result in the net amount payable by the company in the event of guarantee calls being lower than the guaranteed amount. Counter-guarantees are often provided at low-cost by governmental or supra-national institutions, but may also be extended on more commercial terms by other financial institutions.

We view high counter-guarantee coverage by sufficiently creditworthy counterparties as a key rating strength, and a factor which – depending on the proportion of the guarantee covered – may greatly mitigate any concerns we have about the credit quality of the underlying loan exposure.

Similar considerations apply where a guarantee company benefits from long-term, risk-covering funding under a government or supra-national investment/development programme. Although there are many types of arrangements, the key rating consideration is whether the guarantee company would be able to use the provided funds to meet guarantee calls on an eligible facility, without any obligation to repay the funds used for such a purpose.

We also assess the ability of a guarantee company to reduce the size of losses from guarantee calls through the recovery of impaired assets pledged or secured against loans and other credit facilities. Prospects for recoveries on non-performing loan receivables depend on a number of factors including the amount, quality, and enforceability of collateral, as well as the strength and effectiveness of the bad-debt management and recovery practices of the guarantee company and – often more importantly – the originating financial institution (assuming an appropriate recovery sharing arrangement is in place).

Key indicators of credit risk mitigation include the following:

Net Retention Ratio (net guarantees divided by total guarantees) – an indicator of risk mitigation which measures the proportion of guarantees that are retained at the guarantee company's own risk (the lower the ratio, the better). Net guarantees are defined as total guarantees *minus* the value ceded to counter-guarantors (or similar risk sharers).

Net incurred loss ratio (total claims paid over 12 months minus claims paid by counter-guarantors minus recoveries on impaired assets divided by net guarantees at the start of the period) – which indicates the magnitude of net losses on guarantees extended at own risk.

Credit Risk and Asset Quality, Key Characteristics

Very Low

Current level of NPAs is very low; expected trend is stable or positive. Credit risk of performing exposures is very low.

Quality of investments and other on-balance sheet assets is very high overall. Securities held are overwhelmingly of very high credit quality and are readily marketable and liquid. There is little exposure to equities or other financial assets that are not actively traded or to other illiquid assets.

Credit losses and impairments relating to securities and investments are very low and not expected to increase significantly in the intermediate term.

Credit loss mitigation and absorption capacity is very high.

Low

Current level of NPAs is low; expected trend is stable or positive. Credit risk of performing exposures is low.

The quality of investments and other on-balance sheet assets is high. Securities held are overwhelmingly of high credit quality and are readily marketable and liquid. There may be modest exposure to equities or to financial assets that are not actively traded or to other illiquid assets.

Credit losses and impairments relating to securities and investments are low, but recent or ongoing changes in the size and composition of the portfolio may suggest a modest increase in risk in the intermediate term.

Credit loss mitigation and absorption capacity is high.

Moderate

Current level of NPAs is moderate; expected trend may be broadly stable or slightly negative. Credit risk of performing exposures is moderate or lower.

The quality of investments and other on-balance sheet assets is moderate. Securities held are generally of moderate credit risk and readily marketable and liquid. There may be a moderate degree of exposure to equities or to financial assets that are not actively traded or to other illiquid assets.

Credit loss mitigation and absorption capacity may be moderate.

Moderately High

Current level of NPAs may be moderately high; expected trend may be negative. Credit risk of performing exposures may be moderate or moderately high.

The quality of investments and other on-balance sheet assets may be less than satisfactory. A substantial proportion of the securities and investments portfolio may consist of financial assets issued by sub-investment grade issuers or assets that lack liquidity.

The company may have recently taken significant impairment charges on balance sheet assets or unrealised losses on securities.

Credit loss mitigation and absorption capacity may be less than satisfactory.

Credit Risk and Asset Quality, Key Characteristics (continued)

High

Current level of NPAs may be high; expected trends may be negative. Credit risk of performing exposures may be moderately high or high.

The quality of investments and other on-balance sheet assets may be low. A high proportion of the securities and investment portfolio may consist of financial assets issued by sub-investment grade issuers or assets that lack liquidity.

The company may have recently taken large impairment charges on balance sheet assets or unrealised losses on securities.

Credit loss mitigation and absorption capacity may be weak.

KEY RATING FACTOR 3

Market Risk

We apply our standard NBFI criteria for this key rating factor.

We would expect market risk to be a low risk factor for most guarantee companies rather than a principal ratings constraint. Guarantors tend to follow conservative investment policies focused on liquidity and capital preservation, but earnings may be sensitive to interest rate changes given the generally high share of cash and deposits in total balance sheet assets. Larger, for-profit companies may also have sizeable securities portfolios.

Our overall assessment of this key rating factor takes into account not only a guarantee company's exposure to market risk, but also – if such exposure is material – its ability to manage and mitigate relevant risks within its risk tolerances.

See our NBFI Methodology for more information on this key rating factor.

KEY RATING FACTOR 4

Operational Risk

We apply our standard NBFI criteria for this key rating factor.

Our assessment of operational risk considers the risk of loss resulting from system failures, inadequate internal processes, breaches of procedures, and other operational deficiencies, as well as from the materialisation of reputational, legal and compliance-related risks.

Operational risk is difficult to assess and quantify accurately, but the risks may be mitigated to some extent by a combination of comprehensive internal controls and adequate capital buffers. However, when operational risks crystallise, the losses can be substantial.

Operational risk is captured, to some extent, in our assessment of risk management and control. Consequently, for the purpose of this analytical pillar we treat operational risk as a neutral factor provided:

- The guarantee company has adequate internal systems and controls;
- No material operational failures have occurred in recent years; and
- The company's principal business activities are not particularly susceptible to operational risk.

If any of these conditions do not apply, we will make a negative adjustment to our overall assessment of the guarantee company's risk profile.

ANALYTICAL PILLAR 5

FUNDING AND LIQUIDITY

We use the same key rating factors as for other NBFIs when assessing this analytical pillar, although the criteria is tailored to the specificities of guarantee companies.

This analytical pillar focuses on: (a) the ability of a guarantee company to support its business activities with funding sources that are appropriate for its business model and do not expose it to undue risk; and (b) its capacity to ensure sufficient liquidity to meet guarantee calls and other liabilities as they fall due, including in a stress situation.

Accordingly, our assessment of this analytical pillar is based on two key rating factors:

- Funding Structure Risk Profile; and
- Liquidity Risk

KEY RATING FACTOR 1

Funding Structure Risk Profile

As explained in our NBFI Methodology, we evaluate funding profiles in terms of the following:

- Stability and diversity of funding sources
- Maturity profile of the funding base
- Access to funding markets
- Contractual funding constraints
- Funding risk management

We would apply the standard criteria set out in the NBFI Methodology to guarantee companies that have any significant reliance on wholesale funding.

However, for most of the guarantee companies we expect to rate using this supplementary criteria, market-based borrowing is likely to be a very small part of the overall funding mix and may be non-existent for not-for-profit guarantors.

We expect most of these companies to be funded by shareholder equity and retained earnings, with participation in loan-guarantee schemes established by government-related and supranational organisations a key source of complementary (non-debt) external funding. In this context, guarantee issuance capacity may be greatly enhanced by the use of unfunded credit protection (i.e. counter guarantees), which lower on-balance sheet funding needs and reduce the exposure of equity to the default risk of the underlying loans (provided the counter-guarantor is sufficiently creditworthy).

We would generally treat funding risk as a neutral ratings factor in such cases provided that guarantee leverage is not deemed excessive and the need for wholesale funding is expected to remain very low or negligible over the medium term. This neutral assessment balances the benefits of adequate non-debt creating funding against the funding concentration risk and limited funding flexibility exhibited by small- to medium-sized guarantee companies.

The ability to access sufficient funding in order to meet unexpected financial demands could be more challenging if guarantee leverage is very high – particularly if economic conditions become stressed – and we are less likely to consider funding risk to be neutral in such cases.

High reliance on funding from external government-related programmes may pose challenges for the sustainability and long-term viability of guarantee companies, rendering them potentially vulnerable to programme cycles and terminations, as well as to changes in participant eligibility criteria.

Visibility about the long-term funding prospects for guarantee companies that are dependent on own

funds and/or public resources is therefore an important rating consideration. However, it is underweighted here to avoid double counting as related factors are captured in the 'Business Risk' analytical pillar, while the strength of internal capital generation and ongoing shareholder equity support is considered separately in the analytical pillar 'Capitalisation and Leverage' (see key rating factor 'Capital Flexibility').

Funding Structure Risk Profile for Debt-Funded Companies, Key Characteristics

Very Strong

Funding profile exhibits very high stability and good diversity, and is highly aligned with the nature, scale, maturities, and currencies of the asset base. There are no significant funding concentrations.

Excess funding relative to funding needs is available from various highly stable sources. Reliance on wholesale/confidence-sensitive funding is very low.

Longer-term assets are predominantly funded by liabilities with similar residual maturities.

Refinancing risk is very low and there are no significant maturity concentrations.

Strong

Funding profile exhibits high stability and generally good diversity, and is adequately aligned with the nature, scale, maturities, and currencies of the asset base.

There are limited funding concentrations.

Ample funding is available from several stable funding sources.

Reliance on wholesale/confidence-sensitive funding is low.

Longer-term assets are largely funded by liabilities with similar residual maturities.

Refinancing risk is low and there are no significant maturity concentrations.

Adequate

Funding profile exhibits adequate stability and is generally aligned with the nature, scale, maturities, and currencies of the asset base. There may be some material, but highly manageable, concentrations in the funding structure.

Adequate funding is available from predominantly stable but possibly not diverse sources.

Reliance on wholesale/confidence-sensitive funding may be moderate. A moderate portion of longer-term assets may be funded by liabilities with shorter residual maturities.

Refinancing risk may be moderate. Maturity concentrations may be material but manageable; funding availability may be somewhat sensitive to adverse changes in economic and financial market conditions.

Moderate

Funding profile exhibits moderate stability. There may be some significant mismatches and concentrations.

Adequate funding is generally available, albeit from a limited number of funding sources. Funding availability may be vulnerable to adverse changes in economic and financial market conditions and uncertain in times of market stress.

Reliance on wholesale/confidence-sensitive funding and/or short-term funding may be significant. Reliance on secured forms of borrowing may be significant. Covenants and negative pledges in existing debt arrangements may mean there is limited flexibility in arranging new borrowing.

Refinancing risk may be moderate-to-high due to sizeable maturity concentrations.

Weak

Funding profile is characterised by significant mismatches and concentrations. There may be moderate-to-high reliance on potentially volatile funding sources.

The availability of sufficient funding relative to funding needs may be fairly dependent on favourable market conditions and creditor sentiment, and may be highly uncertain at times of market stress.

Reliance on secured forms of borrowing may be fairly high. Covenants and negative pledges in existing debt arrangements may mean there is limited flexibility in arranging new borrowing.

Refinancing risk may be high. Maturity concentrations are expected to be manageable in the short term but challenging in the intermediate to medium term, where there may be some uncertainty with regards to the refinancing of debt falling due.

KEY RATING FACTOR 2

Liquidity Risk

We apply our standard NBFI criteria for this key rating factor, particularly to guarantee companies that utilise wholesale markets or have material amounts of debt outstanding (see Cashflow and Liquidity in the NBFI Methodology).

For guarantee companies with material short-term debt, the liquidity metrics we consider include:

- **Liquid resources to short-term debt** – where liquid resources consist of liquid assets (i.e. cash and banks plus liquid marketable securities) and available committed unsecured lines, while short-term debt is measured on a remaining maturity basis.
- **Broad liquid assets to short-term debt** – where the numerator is the sum of liquid resources (defined as above) plus short-term gross financing receivables, and the denominator is short-term debt on a remaining maturity basis.

Sources of liquidity considered by CI to be generally reliable in this context include unrestricted cash, deposits, and unencumbered investments in securities issued by the rated company's own sovereign and higher-rated foreign governments, as well as other unencumbered marketable securities and available committed, unsecured credit lines.

The factors we consider when assessing these metrics are described in the NBFI Methodology.

For all guarantee companies (i.e. including those that do not borrow), we evaluate liquidity using an additional metric:

- **Net liquid assets ratio** – where the numerator consists of liquid resources (i.e. cash and banks plus liquid marketable securities) and the denominator is total guarantees minus restricted liquid assets held against guarantees or third-party guarantee funding.

The net liquid asset ratio is an indicator of the ability of a guarantee company to meet financial commitments in a hypothetical severe stress scenario in which all guarantees are called and accelerated simultaneously.

Guarantee companies may hold possibly significant amounts of financial assets that are not truly liquid in the sense of being readily available to meet any financial obligation but would be available to satisfy claims relating to specific guarantees on an individual or portfolio basis. These include collateral deposits held against active guarantees in the originating bank, as well as restricted financial assets that are held as the counterpart to external funding received under government or supranational programmes but which may be liquidated to meet eligible payment claims. Given the extreme stress scenario inherent in the above ratio, we net these current assets against total guarantees to avoid liquidity being overly diluted.

We would generally expect guarantee companies to write guarantees that require debt-service payments be made over the original maturity of the underlying loan if called following a borrower default, as this facilitates liquidity management and helps mitigate liquidity risk. Consequently, we will make a negative adjustment to our liquidity risk assessment if a significant proportion of issued guarantees contain acceleration clauses that could trigger large payment obligations in a short period of time.

We view favourably guarantee companies that have effective systems in place to monitor liquidity requirements, undertake an appropriate level of stress testing, and maintain contingency plans for a range of possible funding liquidity risk scenarios.

For those guarantees companies that are subsidiaries, our overall assessment of this key rating factor (and analytical pillar) may also be bolstered by the availability – on an ongoing basis – of funding and liquidity from a stronger parent or group, provided there are no regulatory or legal obstacles to the continuation of such support.

Liquidity Risk, Key Characteristics

Very Strong

The liquidity position is very robust and the ability to withstand stressed market conditions is very high.

Sources of reliable and unencumbered liquidity greatly exceed liquidity needs.

Relations with banks and other creditors are very strong; financial market reputation is very high (if debt funded).

Contingent liquidity risks (beyond guarantee calls) are low.

Contingent liquidity plans are well-established, comprehensive, and credible and indicate no significant impact on the liquidity position in a stressed environment.

Strong

The liquidity position is robust and the ability to withstand stressed market conditions is high.

Sources of reliable and unencumbered liquidity comfortably exceed liquidity needs.

Relations with banks and other creditors are strong; financial market reputation is high (if debt funded).

Contingent liquidity risks are modest.

Contingent liquidity plans are well-established, comprehensive, and credible and indicate a modest impact on the liquidity position in a stressed environment.

Adequate

The liquidity position is adequate, as is the ability to withstand stressed market conditions.

Sources of reliable and unencumbered liquidity moderately exceed liquidity needs.

Relations with banks and other creditors are sound; financial market reputation is good (if debt funded).

Contingent liquidity risks are modest.

Contingent liquidity plans are well-developed, reasonably comprehensive, and generally credible and indicate a moderate but generally manageable impact on the liquidity position in a stressed environment.

Moderate

The liquidity position is moderate, as is the ability to withstand stressed market conditions.

Sources of reliable and unencumbered liquidity modestly exceed liquidity needs.

Relations with banks and other creditors are reasonable but access to credit and markets, if required, may be somewhat restricted during periods of stress.

Contingent liquidity risks may be significant.

Contingent liquidity plans may not be sufficiently developed and/or may indicate a significant impact on the liquidity position in a stressed environment.

Low

The liquidity position is weak and the ability to withstand stressed market conditions is low.

Sources of reliable and unencumbered liquidity are generally below liquidity needs.

Relations with banks and other creditors may be mixed and access to credit and markets significantly restricted during period of stress.

Contingent liquidity risks may be fairly high.

Contingent liquidity plans may be non-existent or greatly underdeveloped.

ANALYTICAL PILLAR 6

EARNINGS AND PROFITABILITY

Earnings and profitability provide an indication of the relative success of a guarantee company's business strategy. Earnings provide guarantee companies with the ability to absorb losses, asset write-downs and other adverse shocks without eroding the equity base. Good profitability also enables a guarantee company to replenish or increase its capital internally through retained income. For profit-oriented companies, earnings strength underpins the payment of a regular stream of dividends to shareholders, making it more likely that they will support calls for additional capital when needed.

Profitability is generally considered to be high when revenue is more than sufficient to cover operating costs (including interest payments on any debt) and provisioning expenses on a consistent basis, while contributing to a company's capital needs and long-term growth objectives. Conversely, persistent net losses erode capital and, in the absence of appropriate corrective action, threaten the viability of an institution.

CI's assessment of earnings strength and sustainability for guarantee companies is analogous to our approach to other financial institutions and encompasses various quantitative measures of returns, margins, and costs, as well as a more qualitative, forward-looking evaluation of the capacity to generate revenues and sustain profitability over time.

We use the same key rating factors as for other NBFIs when assessing this analytical pillar, although the assessment criteria is tailored to the specificities of guarantee companies.

The key rating factors are:

1. Profitability and Efficiency
2. Earnings Quality and Stability

KEY RATING FACTOR 1

Profitability and Efficiency

Our analysis of profitability and efficiency includes an assessment of guarantee companies' revenue sources and cost structure, which together determine underlying earnings capacity. We examine the principal drivers of revenue, cost and earnings over time, as well as future prospects.

The key metrics we use for guarantee companies are different from those we use for NBFIs that utilise their balance sheets, such as finance companies, as guarantors generate a substantial part of their income from off-balance sheet activities, namely the writing of guarantees.

To assess the profitability and efficiency of guarantee companies, we generally focus on the relative strength of, and trends in, the following ratios:

- **Return on Average Equity** (ROAE) – which compares net income to average total equity and provides an overall indication of a guarantee company's efficiency in using its own capital funds, as well as an indication of the ability to generate capital internally through retained earnings. The numerator, net profit, takes into account income from all sources, as well as all operating costs and other expenses. The ratio provides a useful basis of comparison when guarantee capacity is largely a function of shareholder equity and retained earnings. Since this metric tends to favour companies with higher leverage (including debt-funded and unfunded), we consider performance in combination with the ratio of total guarantees to own funds as well as the associated degree of risk.

- **Risk Provisioning Expenses to Operating Profit** – This ratio, in effect, measures a company's ability to provide for guarantee calls out of net operating earnings. The meaningfulness of the ratio hinges on the adequacy of the company's classification of guarantee credit quality (or impairment recognition) and provisioning rules. The adequacy of provisioning levels and practices is taken into account separately as part of the assessment of earnings sustainability. Insufficient provisioning will result in net profit being overstated. Higher provisioning will likely be required in subsequent periods, potentially at the cost of future earnings.

- **Operating Expenses to Gross Income** (cost-to-income ratio) – which essentially compares the administrative other overhead costs incurred in generating a guarantee company's gross income with the level of that income. As such it provides an indication of the efficiency of a company's use of resources and the extent to which earnings are absorbed by operating expenses. The lower the cost-to-income ratio, the greater a company's ability to cope with a decline in earnings without having to resort to drastic cost-cutting measures. Conversely, a high ratio implies less operating flexibility and could reflect excessive salaries and bonuses or large management fees, as well as relative weaknesses in income generation.

In addition to the above, we may also draw upon other indicators of earnings and profitability, where appropriate, to further investigate company- or sector-specific factors. We do not overemphasise the latest available financial results because earnings and profitability metrics may be heavily distorted by tax strategies, asset valuation methods, accrual and reserving practices, as well as by extraordinary or non-recurring items. We may also apply quantitative or qualitative adjustments to reported financial statements if we deem such changes necessary to better reflect the underlying economics or to enhance comparability.

We recognise that some guarantee companies operate on a not-for-profit basis or are focused on achieving development or policy objectives (e.g. improving MSME access to financing) rather than growing profits. For such companies, we will generally attach a lower weight to earnings performance in the determination of credit ratings compared to for-profit companies that are expected to increase business volumes and revenues over time. However, even if profit maximisation is not a core goal, we would still expect a guarantee company to operate on a sustainable basis and generate reasonably stable earnings over the business cycle.

Generally, we view positively guarantee companies which demonstrate:

- Sound revenue and profitability indicators through economic and market cycles;
- Strong cost efficiency indicators, a flexible cost base, and a consistent track record in managing costs; and
- The ability to consistently generate pre-provision earnings that would be sufficient to absorb elevated credit costs in a more stressful environment.

Conversely, we view more negatively guarantee companies which exhibit:

- Weak revenue and profitability indicators through economic and market cycles; or
- Weak cost efficiency indicators, an inflexible cost base, and a poor track record of managing costs.

Profitability and Efficiency, Key Characteristics

Very Strong

Earnings and profitability are highly robust through economic and/or market cycles.

Key profitability metrics are consistently very strong relative to peers and are commensurate with a low-to-moderate risk appetite.

Company exhibits superior cost control and cost management.

Strong

Earnings and profitability are generally robust through economic and/or market cycles.

Key profitability metrics are consistently strong relative to peers and are commensurate with a low-to-moderate risk appetite.

Company exhibits generally better cost control and cost management than peers.

Adequate

Earnings and profitability are generally good but may be somewhat variable through economic and/or market cycles.

Key profitability metrics are adequate and generally on par with peers, but may reflect a moderate risk appetite.

Company's cost control and cost management is broadly in line with peers.

Profitability and Efficiency, Key Characteristics (continued)

Moderate

Earnings and profitability are generally moderate and variable through economic and/or market cycles (and more vulnerable to adverse changes in business conditions, financial markets or asset quality).

Key profitability metrics may be variable and often below the peer average and/or may reflect a moderate-to-high risk appetite.

Company's cost control and cost management is somewhat weaker than peers.

Company may be facing significant competitiveness challenges; cost efficiency may be relatively weak or declining and funding costs reasonably high.

Weak

Earnings and profitability are generally weak. At best, they may be highly correlated with economic and/or market cycles. At worst, the structural earnings weakness is unlikely to be remedied by an improvement in the broader economic environment or financial market conditions.

Key profitability metrics may be highly volatile (but fundamentally weak) and/or may reflect a high-risk appetite.

Company's cost control and cost management is weak by industry standards.

Company may be engaging in higher risk activities and/or cost cutting to improve its bottom line.

Company may be making insufficient provisions for probable losses and may have failed to recognise losses that have already occurred.

KEY RATING FACTOR 2

Earnings Quality and Stability

Earnings quality and stability refers to the ability of a guarantee company to consistently generate favourable earnings and to maintain this performance going forward.

A guarantee company that has strong headline indicators of current profitability and cost efficiency could be assessed more cautiously if there are concerns about its ability to sustain this performance. Moreover, as profits can be boosted by short-term (transient) factors – such as the release of credit loss provisions or strong loss recoveries – we examine carefully sudden improvements in reported income by companies that do not have a track record of consistent and resilient earnings.

Earnings quality and stability are influenced by a number of factors including: the inherent riskiness and volatility of the underlying product offering/activity and client type; the diversity of revenue sources; and the degree of structural rigidity of operating expenses (i.e. whether spending could be easily reduced should revenues decline).

For most guarantee companies, fee income from guarantees and income from investments are the principal sources of revenue. The fee type varies with the business model and transaction structure but typically includes an upfront origination fee, as well as a utilisation fee paid periodically during the lifetime of the guarantee.

We therefore assess:

- The stability, diversification, and repeatability of fee and commission income;
- The strength and stability of underwriting profitability;
- The reliance (if any) on investment income to offset underwriting losses; and
- The volatility of investment income.

Key considerations in this context include:

Pricing policies – including how guarantee fees are set and whether the fee is commensurate with the risk assumed or whether there is no link between the fee charged and the risk of the product/obligor. While we do not necessarily expect guarantee companies to price at the level that maximises profits,

setting very low fees by market standards would leave risk unremunerated, thereby undermining the ability of the company to sustain its operations.

Underwriting performance – namely whether guarantee fee income is sufficient to cover associated operating expenses and claim payouts.

Revenue diversification – including whether the company offers different types of guarantee products and related services, and the diversity of the guarantee portfolio in terms of borrower credit quality, industry/sector, and geography.

Revenue sustainability – namely the ability to generate stable and recurring revenues from core activities, which is important for a company's long-term survival. We consider a company's track record in this regard, and prospects for maintaining an adequate degree of revenue generation. Related considerations include the extent to which the guarantee company's origination business is reliant on access to external programmes and, if so, the sensitivity of revenues to third-party funding cycles. Reliance on programme funding and counter-guarantee arrangements is not necessarily a negative ratings factor; indeed, it may be a supporting factor if regular access helps to increase underwriting capacity and profitability over time. Separately, where a company's revenue prospects are dependent on the success of growth in higher-yielding, non-credit commercial segments, such as bid bonds and performance guarantees (possibly to offset low returns on development or policy-linked activities, such as loan guarantees to MSMEs), we consider the repeatability and stability of these products, which in some cases have short contract durations.

Strength and stability of investment income – particularly where investment income is critical for the generation of positive net profit. Investment income is an important contributor to earnings for most guarantee companies given the nature of the business model, and may be the dominant source of revenues if guarantee leverage is low. Consequently, the strength and stability of investment income, as well as the underlying investment policy and risk appetite, are key determinants of earnings quality. The smaller the scale of operations or the greater the reliance on investment income, the more we would expect the company to follow a conservative approach focused on generating recurring returns from relatively low-risk investments. While larger companies may be in a position to take on more exposure to higher-yielding financial assets – and therefore greater market risk – we would still expect the primary investment objectives to be capital preservation and liquidity rather than financial performance.

Earnings Quality and Stability, Key Characteristics

Very High

Revenue stability is very high and underpinned by very high levels of recurring income.

Underwriting performance is very strong, with guarantee fee income comfortably exceeding associated expenses and claim payouts.

Revenue diversification is high.

Cost flexibility is high.

High

Revenue stability is high and underpinned by high levels of recurring income.

Underwriting performance is strong, with guarantee fee income exceeding associated expenses and claim payouts.

Revenue diversification is moderate to high.

Cost flexibility is moderate to high.

Adequate

Recurring revenue generation is adequate, but there may be some structural weaknesses.

Underwriting performance is adequate, with guarantee fee income generally in line with associated expenses and claim payouts.

Income may exhibit moderate volatility and/or moderate diversification.

Cost flexibility is adequate.

Earnings Quality and Stability, Key Characteristics (continued)

Moderate

Recurring revenue generation is moderate, with some significant structural weaknesses.

Underwriting performance may be moderate, with associated expenses and claim payouts frequently well somewhat below the level of guarantee income.

Revenue diversification may be relatively limited.

Cost flexibility may be moderate.

Low

Core earnings may be erratic or declining, and reliance on volatile income or income from unsustainable sources may be increasing.

Underwriting performance may be weak, with associated expenses and claim payouts consistently well below the level of guarantee income.

Revenue diversification may be low and from relatively low-quality sources.

Cost flexibility may be low.

ANALYTICAL PILLAR 7

CAPITALISATION AND LEVERAGE

Capital provides guarantee companies with the ability to absorb losses and maintain a cushion to meet financial obligations while remaining a going concern. Capital is therefore important for maintaining the confidence of investors and counterparties as it reduces the potential cost to liability holders of the company failing.

Capital also enables a guarantee company to leverage (or gear) its balance sheet and is a key determinant of a company's ability to expand the size of its on- and off-balance sheet asset base and, in turn, increase earnings.

However, excessive leverage reduces financial flexibility and may be particularly problematic during times of economic and financial market stress as it typically increases the risk that the cash flow generated from a guarantee company's on- and off-balance sheet assets will be insufficient to cover guarantee calls as and the fixed servicing obligations associated with any debt liabilities.

In assessing a guarantee company's capital strength and leverage, CI focuses on the following key rating factors:

1. Capital Adequacy and Leverage

2. Capital Flexibility

KEY RATING FACTOR 1

Capital Adequacy and Leverage

From CI's perspective, it is critical that risk exposures are backed by a high-quality capital base that is permanently and freely available, with no repayment requirements and against which losses can be written off whilst the guarantee company continues to conduct its normal business activities.

Capital instruments with the greatest capacity to absorb losses on a going-concern basis include common shares, retained earnings and disclosed reserves (i.e. common equity). We view as medium quality those types of hybrid capital instruments and preferred stock with strong equity-like features that may also absorb losses and help prevent insolvency. We view as lower quality those types of capital that are less reliable – due, for example, to uncertainty about their future realisable value – or are generally only available to absorb losses after a firm has failed and is being wound up. These include asset revaluation reserves and traditional types of subordinated debt. We generally do not give any credit for weaker forms of capital in our assessment of this key rating factor.

In addition to assessing the quality of capital, it is equally important to evaluate whether a guarantee company holds sufficient levels of high-quality capital relative to both the size and riskiness of its on- and off-balance sheet assets. Risk exposures may be many times higher than a guarantee company's equity, and excessive leverage tends to be a major rating constraint as it amplifies the impact of adverse (loss-generating) changes in asset quality on the solvency of a company.

The principal ratios we use are described below.

Guarantee Leverage ratio (total guarantees divided by total equity) – which indicates the gross exposure of the company's equity base to guarantee calls and therefore provides a measure of its absolute vulnerability in an extreme large-scale default scenario. To facilitate comparability, loss reserves are excluded from equity. The higher a guarantee company's leverage on this metric, the lower the amount of capital it has to absorb losses per unit of guarantee issued, all other things being equal.

The guarantee leverage ratio makes no allowance for the quality of the guarantee portfolio or the availability of credit risk protection, so two companies could have the same leverage ratio but be exposed to very different degrees of credit risk. Consequently, we also take into account factors such as the credit quality of the guarantee portfolio and use of counter-guarantee facilities and similar risk-sharing arrangements (which can greatly increase risk-taking capacity) when evaluating leverage using

this metric, and always consider the metric alongside the net guarantee leverage ratio (see below).

Net Guarantee Leverage ratio (net guarantees divided by own funds) – which indicates the extent to which own capital funds would cover the net amount of guarantees payable by a guarantee company in an extreme default scenario.

For the purpose of this metric, own funds consist of total equity plus loss reserves. Net guarantees are derived by subtracting the value of counter-guarantees (or similar) from total guarantees and therefore represent the value of guarantees at own risk.

We interpret the capital coverage ratio in combination with our assessment of guarantee portfolio risk, with a very high coverage ratio potentially fully mitigating any concerns we might have if the guarantee portfolio is deemed to be high risk.

If a guarantee company has any reliance on debt funding, we will also consider the leverage ratios described for this key rating factor in the NBFI Methodology, in particular the ratio of gross debt to equity.

If available, we will also take into account risk-weighted measures of capital adequacy. However, guarantee companies are typically not subject to capital regulations and prudential capital requirements, and do not tend to produce such metrics on a voluntary basis.

Capital adequacy cannot be evaluated using static ratios only. Indeed, capital ratios, judged in isolation, may provide a spurious or misleading indication of the relative strength (or weakness) of a guarantee company's capitalisation. We therefore consider the extent to which a guarantee company's capital position is commensurate with its risk on a forward-looking basis, including, but not limited to, its business model, business strategy, asset-liability structure and operating environment.

For example, a guarantee company that appears to be sufficiently capitalised based on current quantitative metrics may be deemed less adequately capitalised overall after considering:

- The credit strength of counter-guarantors and their ability to meet their obligations in a timely manner.
- The rate of guarantee growth – particularly if rapid – and the pace relative to equity (i.e. leverage growth).
- Expected changes in the risk profile of the guarantee portfolio, particularly whether any shift towards higher risk exposures would be commensurate with the current level of equity and, if not, whether there are credible plans to increase equity (counter-guarantee protection might be a partial risk mitigant in this context).
- The appropriateness of provisioning rules and, if insufficient reserves are held against non-performing guarantees, the risk that credit losses will erode the amount of equity actually available to the company.
- The credit quality of balance sheet assets (including loan receivables and investments) and the potential impact on capital in the event of impairment.
- The ability to generate capital internally through earnings and sustained profitability.
- The quality of financial disclosure and regulatory supervision (if any).

Conversely, capitalisation could be deemed stronger than indicated by the net guarantee leverage ratio if a significant part of the guarantee portfolio at own risk is assessed as low risk after taking into account the credit quality of the borrower, the degree of credit protection (other than counter-guarantees), and historical loss rates on the type of guarantee (for example, we would generally consider a lower capital charge to be appropriate for short-term bid bonds, all other things equal).

Capital Adequacy and Leverage, Key Characteristics

Very Strong

Capital and leverage are fully commensurate with the company's risk profile (broadly defined to include exposure to credit, market and operational risk, risk from the funding structure, and earnings volatility) and indicate a strong capacity to absorb severe shocks.

Strong

Capital and leverage are commensurate with the company's risk profile and indicate adequate capacity to absorb severe shocks.

Adequate

Capital and leverage are reasonably consistent with the company's risk profile and indicate adequate capacity to absorb moderate shocks.

Moderate

Capital and leverage may not be fully consistent with the company's risk profile. Leverage may be high compared to peers. Capital buffers may be moderate, and capital may be impaired to a small degree by unprovided NPAs or by other assets where book value exceeds market value.

The company has moderate-to-adequate capacity to absorb small-to-moderate shocks.

Weak

Capital and leverage are inconsistent with the company's risk profile and indicate inadequate capacity to absorb small-to-moderate shocks. Leverage may be very high compared to peers and capital buffers too low given the company's exposure to risk (credit, market, operational).

Capital may be significantly impaired by unprovided NPAs or by other assets where book value exceeds market value.

KEY RATING FACTOR 2

Capital Flexibility

Capital flexibility considers a guarantee company's ability to manage its capital position over time and in response to changing circumstances and, in particular, to increase capital – internally or externally – when needed. Future needs often arise in connection with a company's strategic objectives and growth targets, but may also be necessary in the aftermath of large losses linked, for example, to significant stress in the guarantee or investment portfolios.

We consider a guarantee company's track record of building (or rebuilding) its capital base through retained earnings, its ability to continue doing so, as well as the appropriateness and flexibility of any dividend policies. We view internal capital generation as a structural feature and generally look through cyclical improvements in earnings and capital.

We also consider a guarantee company's ability to raise new capital from shareholders, taking into account the latter's track record of supporting the company during both good and bad times. This is a key rating consideration for not-for-profit guarantors with little or no market access since – unless retained earnings generation is sufficient – they are likely to be reliant on equity injections from shareholders to support sustainable growth.

While counter-guarantee facilities can be used to boost underwriting capacity and help with the management of portfolio-related risks, they do not have the same permanency or loss-absorbing capacity as equity and therefore do not contribute to capital flexibility.

Capital Flexibility, Key Characteristics

Very High

Capital flexibility is very high, underpinned by very strong and robust internal capital generation and appropriate (flexibly applied) dividend and share buy-back policies.

Shareholders are highly supportive of maintaining a very strong capital position.

Other sources of capital flexibility may also be strong.

There are no material impediments to the free flow of loss-absorbing capital between group members. Sufficient capital is highly likely to be available from other parts of the group if needed.

High

Capital flexibility is high, underpinned by strong and resilient internal capital generation and appropriate dividend and share buy-back policies.

Shareholders are supportive of maintaining a strong capital position.

Other sources of capital flexibility may also be fairly strong.

There are no significant impediments to the free flow of loss-absorbing capital between group members.

Adequate

Capital flexibility is adequate. Internal capital generation is good but may be somewhat variable.

Shareholders are generally responsive to capital needs, and dividend/share buy-back policies are generally appropriate.

Other sources of capital flexibility may be adequate.

There may be some moderate impediments to the free flow of loss-absorbing capital between group members.

Moderate

Capital flexibility is moderate. Internal capital generation is generally satisfactory, but variable.

Shareholders are mildly supportive, but may not always be sufficiently responsive to capital needs. Dividend and share buy-back policies may be somewhat aggressive.

Other sources of capital flexibility may be limited.

Capital fungibility and transferability between group entities may be subject to significant constraints. There may be some uncertainty regarding the availability of sufficient capital from other parts of the group if needed.

Low

Capital flexibility is low. Internal capital generation is weak and highly inconsistent.

Dividend and share buy-back policies may be inappropriate. Shareholders are unlikely to be a reliable source of new capital should additional resources be needed to strengthen the capital base or grow the business.

Other sources of capital flexibility may be very limited.

Capital fungibility and transferability between group entities may be highly constrained. Sufficient capital is unlikely to be available from other parts of the group if needed.

5. EXTRAORDINARY SUPPORT AND GROUP CONSIDERATIONS

Once we have established the ESA, we evaluate the likelihood that, in the event of difficulties, the guarantee company would receive sufficient and timely financial assistance from its parent, shareholders, the government, or other support providers to enable it to remain current on its liabilities and avoid a payments default or insolvency.

Such support, which we label 'extraordinary support', can potentially mitigate weaknesses in the company's standalone financial profile and therefore improve its creditworthiness, resulting in its ICR being notched up above the ESA.

This type of temporary assistance is different to the 'ordinary support' that a company might receive, for example from its parent, during the normal course of business, such as an increase in equity to facilitate business growth or to meet changes in regulatory requirements. Ordinary financial support, as well as the operational and business benefits (and risks) that may accrue to an entity from being part of a larger group, is reflected in the ESA.

Where the guarantee company is a member of a corporate group, we apply the criteria contained in Parent-Subsidiary Considerations in the Determination of Corporate and NBFI Credit Ratings to determine the likelihood of extraordinary support and to assess the rating impact of other potential group influences.

For subsidiaries, the application of our parent-subsidiary criteria may result, inter alia, in:

- The ICR being notched above its standalone level due to the likelihood of such extraordinary support from a stronger parent (or group).
- The ICR being constrained by the rating of a weaker parent due to group interference risk even though it may be the stronger of the two entities on a standalone basis (interference risk aside).
- The ICR being set higher than the rating of the parent due to greater standalone strength and limited linkages, which may include effective constraints on potentially harmful parental interference. If linkages are limited and autonomy high, a company's default risk may be largely (or wholly) unaffected by stress at the parent level or elsewhere within the group. Consequently, its ICR will largely depend on its standalone strength and may potentially be notched above (or decoupled from) the actual or notional rating of the parent/group.

Where an entity's ICR incorporates extraordinary support, we indicate the degree of uplift and the reasons for it in the published credit rating rationale.

6. SOVEREIGN CONSIDERATIONS

As with other NBFIs, the final LT ICR assigned to a guarantee company will generally be set at the same level as the baseline for the issuer rating provided the latter is no higher than the sovereign rating of the country in which the company is based.

If the baseline ICR is higher than the sovereign rating, we apply our criteria for rating above the sovereign (explained in our Bank Rating Methodology) to determine whether the company's ratings could be higher than the sovereign and, if so, by how many notches. This entails considering whether the company's financial strength and debt-servicing capacity would be sufficiently robust to withstand the direct and indirect impact of a government default (including potential losses on sovereign debt and other financial instruments) and highly stressed economic and financial operating conditions.

Even if a guarantee company is able to withstand severe sovereign and related economic stresses, it could still default should the government decide to interfere with the ability of entities to service financial obligations in a timely manner by imposing highly restrictive measures, such as exchange controls, payments moratoria, deposit freezes, and other restrictions that prevent bank account holders from accessing their funds in a timely manner. We refer to this direct impact as sovereign interference risk.

Sovereign credit risk and sovereign interference risk are often highly positively correlated; but they can differ (or decouple), and interference risk is usually much harder for firms to mitigate or circumnavigate. In general, where sovereign interference risk in the event of a government debt crisis is high, a guarantee company will be rated no higher than the sovereign rating.

Where sovereign interference risk is moderate or low, a sufficiently strong guarantee company could be rated above the sovereign. However, the maximum rating differential would normally be restricted to three notches above the sovereign long-term local currency rating for a guarantee company's long-term local currency ICR and two notches above the sovereign long-term foreign currency rating for its foreign currency ICR.

Our policy of generally restricting ICRs in the ratings space above the sovereign rating reflects the degree of uncertainty in the assessment of a company's capacity to withstand sovereign-induced stress. This in turn reflects several key unknowns, including the scope and severity of a future crisis and the policy reaction of the authorities in the event of financial stress (including the severity of any restrictive measures).

We may deviate from this practice when the likelihood of a government default in the short term is very high and we are better able to evaluate with greater certainty the company's ability to survive the associated stress. In addition, we may increase the notching differential in cases where we are convinced that the government would not impose transfer and convertibility or other debt-service impeding restrictions were it to default on its own obligations, or that the company would be exempt from, or somehow able to circumvent, any such restrictions. However, such cases are likely to be uncommon.

ANNEX 1: ISSUER CREDIT RATINGS: RATING SCALE AND DEFINITIONS

CI's international issuer credit ratings (ICRs) indicate the general creditworthiness of an entity (such as an NBFI, bank, corporate or sovereign) and the likelihood that it will meet its financial obligations in a timely manner. Foreign currency ratings refer to an entity's ability and willingness to meet its foreign currency denominated financial obligations as they come due. Foreign currency ratings take into account the likelihood of a government imposing restrictions on the conversion of local currency to foreign currency or on the transfer of foreign currency to residents and non-residents.

Local currency ratings are an opinion of an entity's ability and willingness to meet all of its financial obligations on a timely basis, regardless of the currency in which those obligations are denominated and absent the risk of transfer and convertibility restrictions that may constrain the servicing of foreign currency obligations. Both foreign currency and local currency ratings are internationally comparable assessments.

Foreign and local currency ratings take into account the economic, financial and country risks that may affect creditworthiness, as well as the likelihood that an entity would receive external support in the event of financial difficulties.

The following rating scale applies to both foreign currency and local currency issuer ratings. Short-term ratings assess the time period up to one year.

Long-Term Issuer Credit Ratings

Investment Grade	
AAA	The highest credit quality. Exceptional capacity for timely fulfilment of financial obligations and most unlikely to be affected by any foreseeable adversity. Extremely strong financial condition and very positive non-financial factors.
AA	Very high credit quality. Very strong capacity for timely fulfilment of financial obligations. Unlikely to have repayment problems over the long term and unquestioned over the short and medium terms. Adverse changes in business, economic and financial conditions are unlikely to affect the institution significantly.
A	High credit quality. Strong capacity for timely fulfilment of financial obligations. Possesses many favourable credit characteristics but may be slightly vulnerable to adverse changes in business, economic and financial conditions.
BBB	Good credit quality. Satisfactory capacity for timely fulfilment of financial obligations. Acceptable credit characteristics but some vulnerability to adverse changes in business, economic and financial conditions. Medium grade credit characteristics and the lowest investment grade category.
Speculative Grade	
BB	Speculative credit quality. Capacity for timely fulfilment of financial obligations is vulnerable to adverse changes in internal or external circumstances. Financial and/or non-financial factors do not provide significant safeguard and the possibility of investment risk may develop.
B	Significant credit risk. Capacity for timely fulfilment of financial obligations is very vulnerable to adverse changes in internal or external circumstances. Financial and/or non-financial factors provide weak protection; high probability for investment risk exists.
C	Substantial credit risk is apparent and the likelihood of default is high. Considerable uncertainty as to the timely repayment of financial obligations. Credit is of poor standing with financial and/or non-financial factors providing little protection.
RS	Regulatory supervision (this rating is assigned to financial institutions only). The obligor is under the regulatory supervision of the authorities due to its weak financial condition. The likelihood of default is extremely high without continued external support.
SD	Selective default. The obligor has failed to service one or more financial obligations but CI believes that the default will be restricted in scope and that the obligor will continue honouring other financial commitments in a timely manner.
D	The obligor has defaulted on all, or nearly all, of its financial obligations.

Short-Term Issuer Credit Ratings

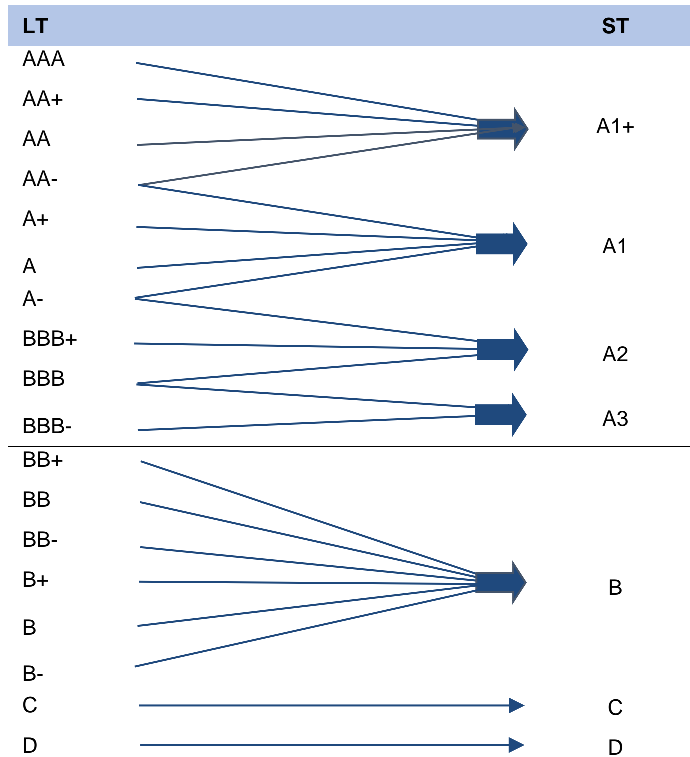
Investment Grade	
A1	Superior credit quality. Highest capacity for timely repayment of short-term financial obligations that is extremely unlikely to be affected by unexpected adversities. Institutions with a particularly strong credit profile have a '+' affixed to the rating.
A2	Very strong capacity for timely repayment but may be affected slightly by unexpected adversities.
A3	Strong capacity for timely repayment that may be affected by unexpected adversities.
Speculative Grade	
B	Adequate capacity for timely repayment that could be seriously affected by unexpected adversities.
C	Inadequate capacity for timely repayment if unexpected adversities are encountered in the short term.
RS	Regulatory supervision (this rating is assigned to financial institutions only). The obligor is under the regulatory supervision of the authorities due to its weak financial condition. The likelihood of default is extremely high without continued external support.
SD	Selective default. The obligor has failed to service one or more financial obligations but CI believes that the default will be restricted in scope and that the obligor will continue honouring other financial commitments in a timely manner.
D	The obligor has defaulted on all, or nearly all, of its financial obligations.

CI Ratings appends '+' and '-' signs to foreign and local currency long-term ratings in the categories from 'AA' to 'C' to indicate that the strength of a particular rated entity is, respectively, slightly greater or less than that of similarly rated peers.

Outlook: expectations of improvement, no change or deterioration in an entity's long-term issuer ratings over the 12 months following its publication are denoted 'Positive', 'Stable' or 'Negative'.

ANNEX 2: CORRESPONDENCE BETWEEN LONG-TERM AND SHORT-TERM ISSUER RATINGS

Short-term ratings are mapped from long-term ratings using the guidelines below. Deviations may be permitted where entity-specific circumstances render the guidelines inappropriate.



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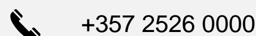
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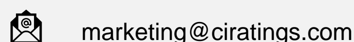
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