Date: 7/15/2021
Virtual Meeting
(in lieu of meeting at the 2021 Summer National Meeting)

Valuation of Securities (E) Task Force
Thursday, July 15, 2021
11:00 – 12:00 p.m. ET / 10:00 – 11:00 a.m. CT / 9:00 – 10:00 a.m. MT / 8:00 – 9:00 a.m. PT

ROLL CALL

Dana Popish Severinghaus, Chair	Illinois	Gary Anderson	Massachusetts
Doug Ommen, Vice Chair	Iowa	Chlora Lindley-Myers	Missouri
Lori K. Wing-Heier	Alaska	Bruce R. Ramge	Nebraska
Ricardo Lara	California	Marlene Caride	New Jersey
Andrew N. Mais	Connecticut	Russell Toal	New Mexico
Trinidad Navarro	Delaware	Linda Lacewell	New York
David Altmaier	Florida	Doug Slape	Texas
Dean L. Cameron	Idaho	Jonathan T Pike	Utah
Vicki Schmidt	Kansas	Scott A. White	Virginia
James J. Donelon	Louisiana	Mike Kreidler	Washington
Kathleen A Birrane	Maryland	Mark Afable	Wisconsin

NAIC Support Staff: Charles A. Therriault, Marc Perlman

AGENDA

1. Consider Adoption of the meeting minutes for the Spring National meeting, and May 24, 2021, interim meeting. — Attachment One, Attachment Two
   (Doc. ID: 2021-036.01, 2021-037.01)
   —Kevin Fry (IL), Eric Kolchinsky (NAIC), Charles Therriault (NAIC), Marc Perlman (NAIC)

2. Discuss and Consider Adoption of 2022 Charges — Attachment Three
   (Doc. ID: 2021-038.01)
   —Kevin Fry (IL), Charles Therriault (NAIC)

3. Discuss Comments and Consider for Adoption an Updated Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Add Additional Instructions to the Review of Funds — Attachment Four, Four – A - E
   (Doc. ID: 2021-034.02, 2021-034.03, 2021-034.01)
   —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)

4.	Discuss Comments and Consider for Adoption a Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Permit Filing Exemption for Real Estate Lease-Backed Securities *(Doc. ID: 2021-035.03, 2021-035.02, 2021-035.04, 2021-035.05)* —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)	Attachment Five Five – A - C
5.	Discuss and Consider for Adoption Proposed Amendments to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) on:	
	i) Guidance for Working Capital Finance Investments Consistent with the Statutory Accounting Principles (E) Working Group Adoption of Changes to SSAP No. 105R – Working Capital Finance Investments. (Doc. ID: 2020-022.02, 2020-022.04, 2020-022.04b, 2020-026-02)	Attachment Six.i A - D
	ii) Permit the SVO to Rely Upon the Un-rated Subsidiaries of a CRP Rated Parent Entity for Only Working Capital Finance Investments (Doc. ID: 2020-026.02, 2020-026.01, 2020-026.03, 2020-026.04, 2020-026.05, 2020-026.06, 2020-026.07) —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)	Attachment Six.ii E - K
6.	Hear a Staff Report on Projects Before the Statutory Accounting Principles (E) Working Group —Julie Gann (NAIC)	
7.	Any other matters	

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Draft: 3/31/2021

Valuation of Securities (E) Task Force
Virtual Meeting (*in lieu of meeting at the 2021 Spring National Meeting)*
March 22, 2021

The Valuation of Securities (E) Task Force met March 23, 2021. The following Task Force members participated: Dana Popish Severinghaus, Chair, represented by Kevin Fry (IL); Doug Ommen, Vice Chair, represented by Carrie Mears (IA); Lori K. Wing-Heier represented by Wally Thomas (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan and Ray Spudeck (FL); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Bruce R. Ramge represented by Lindsay Crawford (NE); Marlene Caride represented by Nakia Reid and John Sirovetz (NJ); Linda A. Lacewell represented by Jim Everett (NY); Doug Slape represented by Amy Garcia (TX); Jonathan T. Pike represented by Jake Garn (UT); Mike Kreidler represented by John Jacobson (WA); and Mark Afable represented by Randy Milquet (WI). Also participating was: Dale Bruggeman (OH).

1. Adopted its Feb. 18, 2021; Dec. 18, 2020; and 2020 Fall National Meeting Minutes

The Task Force met Feb. 18, 2021; Dec. 18, 2020; and Nov. 18, 2020. During its Feb. 18, 2021, meeting, the Task Force took the following action: 1) received a proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to update the financial modeling instructions for residential mortgage-based securities (RMBS)/commercial mortgage-based securities (CMBS); 2) discussed comments received and adopted a proposed amendment to the P&P Manual to require the filing of private rating letter rationale reports; 3) received a referral from the Statutory Accounting Principles (E) Working Group on nonconforming credit tenant loans (CTLs); 4) received a proposed amendment to the P&P Manual to update the list of NAIC credit rating providers (CRPs) to reflect nationally recognized statistical rating organization (NRSRO) changes; and 5) discussed U.S. Securities and Exchange Commission (SEC) Rule 18f-4 under the federal Investment Company Act of 1940 related to the use of derivatives by registered investment companies. During its Dec. 18, 2020, meeting, the Task Force took the following action: 1) exposed an updated amendment to the P&P Manual to include instructions for financially modeled RMBS/CMBS to map NAIC designation categories for a three-day public comment period ending Dec. 22, 2020; and 2) discussed financially modeled RMBS/CMBS price breakpoints and other issues surrounding securities that have a zero-loss in 2020.

Mr. Thomas made a motion, seconded by Ms. Clements, to adopt the Task Force's Feb. 18, 2021 (Attachment); Dec. 18, 2020 (Attachment); and 2020 Fall National Meeting minutes *(see NAIC Proceedings – Fall 2020, Valuation of Securities (E) Task Force)*. The motion passed unanimously.

2. Adopted an Amendment to the *P&P Manual* to Update the Financial Modeling Instructions for RMBS/CMBS Securities

Mr. Fry said at the end of last year, there were some unusual results through the financial modeling process due to the economic scenarios. It produced more securities with losses that were previously zero loss securities that now needed to use the price breakpoint methodology. Coupled with lower interest rates, these securities also traded at a premium. The Task Force did some work last year to temporarily fix the issues with the price breakpoint methodology for year-end 2020, and it was agreed that a longer-term fix was necessary. In front of the Task Force now is that fix to the price breakpoint methodology for securities prior to 2013 and for securities after 2013—move away from price breakpoints and use more of a single-designation process.

Eric Kolchinsky (NAIC) said the proposed amendment P&P Manual is to move to two types of information. For legacy securities, those prior to 2013, the Task Force will continue to provide breakpoints for more post-crisis securities. The process of calculating the expected losses would be the same, except now, instead of converting the intrinsic price into breakpoints, it would be converted into a designation for non-legacy securities—those after 2013. The Structured Securities Group (SSG) believes it to be a good approach to minimize the convexity experienced in the zero loss securities and standardize reporting.

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The SSG would like to implement this for year-end but realizes that there may be some technical issues for the NAIC and application vendors. Therefore, it is open to a potential 2022 implementation.

Mr. Fry said the Task Force will be in a better position later this year to know whether it can implement by year-end 2021 or if a 2022 implementation is needed, which will give more than enough time.

Mike Monahan (American Council of Life Insurers—ACLI) said the ACLI would suggest setting a 2021 implementation date. The Task Force will know in a couple of months whether that is reachable by the vendors and by the SSG staff, and it can revisit the issue, if needed.

Francisco Paez (MetLife) said the ACLI is going to be focused on the implementation and making sure that this is done in an orderly way. The proposal is something that is supported. The proposal moving away from the breakpoints, viewed in conjunction with the anticipated change of through the cycle of modeling for CMBS, will avoid some of the distortions to risk-based capital (RBC) experienced for modeled securities at the end of last year. It accomplishes the stated purpose, and it is a positive step to having a longer-term solution for modeled securities. He said there are two points that the ACLI and the National American Securities Valuation Association (NASVA) want to raise. First, the price breakpoints concept, as a concept, is a sound one, and it aligns the incentives in a way that is prudent. Mr. Paez encouraged that this be an open dialogue in the future and evaluate if there are ways to incorporate that concept in a way that deals with some of the distortions experienced last year. There are a few options that could be studied. Realizing that this is a longer-term type of project, he said he wants to see if there are other more workable solutions with respect to price points, given the soundness of the concept and the history of how those breakpoints really played such a key role in helping an orderly navigation during the great financial crisis for insurance companies. The second point is in regard to transparency. Acknowledging all the extensive work that the SSG has undertaken on this front, which is appreciated, he asked to continue this dialogue and to try to identify additional disclosures that may be possible, both in terms of the assumptions and in terms of the results at a more granular level than today so that insurance companies can better understand the drivers of their RBC results at the end of the day. He said he would like insurers to get some discussion on the frequency of these disclosures to have a better sense of the direction of RBC ahead of year-end rather than waiting towards the end of the year.

Mr. Fry said the Task Force always looks for procedures and improvement. He said there will be more time in the future to look at the items mentioned, but for now, these are the right steps to address the problems and get rid of some of the results that are not logical. Mr. Fry asked Charles A. Therriault (NAIC) if the amendment were adopted, is there a part about when it is implemented or is that was something that the Task Force can set along with the motion to adopt. Mr. Therriault said the Task Force can adopt it with a year-end effective date. He said if later this year there is a technology implementation problem, that effective date can be changed to 2022. Mr. Kolchinsky said the SSG staff will work on transparency and, if the Task Force directs it to do so, work on another methodology.

Mr. Everett asked how the cutoff date for the changeover was chosen. Mr. Kolchinsky said the cutoff date is already in the P&P Manual regarding legacy securities for the purposes of re-REMIC (real estate mortgage investment conduit) securities. He said it seemed as good as any date, and it avoids having several legacy dates.

Tracey Lindsey (NASVA) asked, from a vendor's perspective, when the cutoff date would be to make that decision should there be difficulties with technology. Mr. Kolchinsky said the SSG was committed to working with industry, their vendors and NAIC technology. There are some possible changes on the technology side. If together the opinion is that this is doable, it will move on, and if is not doable, it will come back as soon as possible to the Task Force for their advice and consent.

Mr. Thomas made a motion, seconded by Mr. Kozak, to adopt the amendment to the P&P Manual to update the financial modeling instructions for RMBS/CMBS securities. The motion passed unanimously.

3. <u>Discussed Comments Received for an Updated Proposed Amendment to the P&P Manual to Require the Filing of Private Rating Letter Rationale Reports</u>

Mr. Fry said the next item on the agenda is to discuss comments received on a proposed amendment to require the filing of private rating letter rationale reports. The Securities Valuation Office (SVO) worked with the ACLI, NASVA and the Private

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Placement Investors Association (PPiA) to update the amendment and resolve some of the operational issues that were raised during the Task Force's Feb. 18 meeting. Mr. Fry asked Mr. Therriault to review the updated amendment.

Mr. Therriault said this proposed amendment would require the rating rationale report to be filed with the SVO for privately rated securities. The rating rationale report should provide a more in-depth analysis of the transaction structure, the methodology used to arrive at the private rating, and, as appropriate, a discussion of the transaction's credit, legal and operational risks and mitigants. With both the private rating letter and the private rating letter rationale report, the SVO will be able to better understand the security.

During the Task Force's Feb. 18 meeting, interested parties raised several issues. The SVO staff held a follow-up meeting with the ACLI, NASVA and the PPiA on Feb. 22 to discuss the issues and revise the amendment based on that discussion. They also met March 4, March 18, and March 19 to review the changes and receive further feedback. The updated amendment reflects many, but not all, of the changes. Summarizing the changes that are in in the revised amendment, Attachment Five in the package, the first change was to the transition language in paragraph 11 to permit an option to companies that cannot provide the ratings rationale due to confidentiality or contractual reasons. The next issue, which was an extended discussion during the the Task Force's Feb. 18 meeting, related to the disclosure as to why something was ineligible. An update was made to paragraph 21 for a new brief disclosure visible to all filers in VISION for two specific situations: 1) the security type is ineligible for filing exemption (FE) according to the P&P Manual list of "Specific Populations of Securities Not Eligible for Filing Exemption"; or 2) the security is of a type outside the scope of *Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds*, *SSAP No. 32R—Preferred Stock* or *SSAP No. 43R—Loan Backed and Structured Securities*, which would also make it ineligible for FE. This requires a VISION technology change, and it has already been added to the development queue. The last update was to paragraph 22 to provide a reporting option if the private rating rationale report cannot be provided for reasons other than confidentiality or contractual limitations after Jan. 1, 2022.

Another issue raised during the Task Force's Feb. 18 meeting but is not in the updated amendment relates to the required content of the rating rationale report. Rating agencies are in the business of publishing credit analysis opinions and should be familiar with what they typically publish for a specific asset type. The SVO is expecting something comparable to their public reports. Rating agencies often mention that their private ratings are equivalent to their public ratings in terms of the analysis performed. The SVO is looking for something comparable to the publicly rated securities. It was mentioned possibly using the SVO's regulatory treatment analysis service (RTAS) letter as a benchmark. That is not a good comparison because it is just a summary of what the reporting treatment would be for the security, but it does not go into an in-depth analysis of the credit or methodology. There are few changes that still need to be made to the amendment and worked through with the ACLI, NASVA and the PPiA, specifically to the transition period and confidentiality provisions. With the Task Force's permission, the SVO would like to continue working with industry and expose a clean version of the amendment with those revisions and expose it for a short public comment period.

Sasha Kamper (PPiA) said there have been multiple meetings to discuss this amendment and agreed in concept during March 19's meeting to a workable solution. There are a few more changes needed to the amendment that will lay out some of those details.

Mr. Fry directed the SVO to continue working with industry on the amendment to require the filing of private rating letter rationale reports with the SVO and expose a clean version of the amendment, when it is ready, for a 30-day public comment period.

4. <u>Adopted an Amendment to the P&P Manual to Update the List of NAIC CRPs to Reflect NRSRO Changes</u>

Mr. Fry said this agenda item is to discuss comments received and consider for adoption a proposed amendment to update the list of CRPs to reflect NRSRO changes. The proposed amendment reflects the merger of Morningstar and DBRS, and the name update for the Kroll Bond Rating Agency LLC.

Ms. Kamper asked for clarification. She asked if this amendment is to recognize the merger of DBRS and Morningstar or the Kroll Bond Rating Agency name change. Mr. Therriault said on the original exposure, there was a different name for Kroll Bond Rating Agency, which was what was reflected on SEC's Office of Credit Rating (OCR) website. The amendment was revised to correct Kroll's name to reflect what is on their Form NRSRO. The rest of the amendment relates to the

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DBRS/Morningstar merger and a few other minor CRP name changes. Kroll was only highlighted because it was a change from the last time this amendment was discussed by the Task Force.

Mr. Thomas made a motion, seconded by Ms. Mears, to adopt the amendment to the P&P Manual to update the list of NAIC CRPs to reflect NRSRO changes. The motion passed unanimously.

5. Received a Request from the ACLI to Study the National Financial Presentation Standard for Spanish GAAP.

Mr. Fry said the next agenda item is to receive a request from the ACLI to study the national financial presentation standard for Spanish generally accepted accounting principles (GAAP). The ACLI submitted a letter dated March 1 (Attachment Seven) initiating this formal request for a review by the SVO as required in Part Two of the P&P Manual. In discussions with the SVO staff, the ACLI letter satisfies the pre-condition necessary to conduct the requested study, and the SVO is ready to begin.

Mr. Monahan said that two large multinational companies have asked to have the SVO study Spain as a national financial reporting standard. The SVO has a great process in place for such a review. The ACLI is close to signing the contract with an accounting firm to assist with the study, and it just needed the Task Force's approval to undertake the study. The accounting partners will not be flying to the U.S. to meet at the SVO office and instead will be meeting virtually via Zoom or RingCentral.

Mr. Fry said this is informational only; no action is required by the Task Force at this time. When the SVO concludes the study, the SVO will report back to the Task Force with their findings, recommendation and, if appropriate, a possible amendment.

6. Discussed and Received a Proposed Amendment to the P&P Manual to Clarify Guidance for Fund Leverage

Mr. Fry said the next agenda item is to discuss and receive a proposed amendment to the P&P Manual to clarify guidance for fund leverage. Mr. Fry asked Marc Perlman (NAIC) to provide a summary.

Mr. Perlman said the P&P Manual currently grants the SVO discretion when determining whether a fund's use of derivatives is consistent with a fixed income like security, meaning it will generate predictable and periodic cash flows and is, therefore, eligible for an NAIC designation. Recognizing that this discretion regarding the use of derivatives by funds can lead to a possible lack of predictability when a fund is submitted to the SVO for potential inclusion on its fund lists, some members of the Task Force requested the SVO propose a P&P Manual amendment that would create a more predictable bright line test.

As explained during the Task Force's Feb. 18 meeting, the SEC adopted a final version of Rule 18f-4 last year, which allows funds to enter into derivative transactions, notwithstanding the federal Investment Company Act's restrictions of them, so long as funds meet certain conditions. The SVO focuses most closely on the exception to these requirements for limited users of derivatives, meaning funds that limit their exposure to derivatives with potential risk of future payment or loss (call it downside risk) to 10% or less of net assets, exclusive of certain derivatives used to hedge certain currency and interest rate risks. The SEC recognized the risk that derivative transactions pose to funds because they involve leverage or the potential for leverage, which can magnify gains and losses compared to the fund's investment, while also obligating the fund to make a payment or deliver assets to a counterparty under specified future conditions. The SVO contends that such leverage is inconsistent with the predictable and periodic standard in the P&P Manual. As such, the SVOs recommend using Rule 18f-4's limited user standards as a kind of guidepost for creating the requested bright line test in the P&P Manual.

Specifically, the SVO is proposing two new tests. Test No. 1: For funds on the SVO-identified Bond ETF List, the SVO-identified Preferred Stock ETF List and the NAIC List of Schedule BA Non-Registered Private Funds with Underlying Assets Having Characteristics of Bonds or Preferred Stock (each of which is granted bond treatment on their respective reporting schedules), the SVO proposes a similar, but not identical, threshold to the limited user exception in Rule 18f-4, whereby the gross notional amount of derivatives that impose no future payment or margin posting obligation on the fund (meaning there is no future "downside" risk), cannot exceed 10% of the net asset value of the fund, except for (and these are the exclusions from the 10% calculation) derivatives that are either used by funds to create more bond-like cash flows or that are common for maintenance of fund portfolios. These acceptable exemptions would include: 1) certain currency and interest rate hedges on fixed-income or preferred stock in the fund portfolio; 2) certain futures or forwards on fixed-income or preferred stock to be held in the fund's portfolio and for which money for the future purchase have been set aside; 3) reserve-repurchase agreements associated with specific fixed income or preferred stock investments held by the fund; and 4) non-margin borrowing for

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purposes other than investment. While this first test, like the SEC's, caps derivatives at 10% of net asset value (NAV), the SEC only caps derivatives with future payment or downside risk. The SVO proposes not permitting any derivatives with future payment or downside risk, other than the exempt derivatives just listed, and capping derivatives with only upside potential at 10%. The reason for capping derivatives with only potential gain for the fund is that they are still speculative and, therefore, do not meet the periodic and predictable standard.

Test No. 2: Funds on the NAIC Fixed Income-Like SEC Registered Funds List are in scope of *SSAP No. 30R—Unaffiliated Common Stock* and reported on Schedule D, Part 2, Section 2. Based on such reporting, if the Task Force deems it appropriate, NAIC designations assigned to those funds could be permitted to include assessments of risk other than credit risk, including market and liquidity risk—both risks introduced by derivatives. This also addresses requests by several Task Force members that a wider range of funds be eligible to receive an NAIC designation. Therefore, if the Task Force thinks it appropriate, these funds could be permitted a larger derivative threshold of up to 20% of the NAV of the fund, but, unlike the first test, with no exempt derivatives. This threshold would also prevent violation of the P&P Manual fund methodology's predominantly hold requirement that a fund will hold at least 80% of its assets in bonds or preferred stock, depending on the type of fund. For both tests, the SVO recommends incorporating an assessment of counterparty risk into its credit risk assessment. It should also be noted that these increased thresholds for derivatives might not be acceptable under certain state laws. For example, a bill under consideration in New York would cap funds' non-reserve investments at 10%, meaning derivatives would likely be capped at that amount.

The SVO thinks the two tests would achieve the goal of providing greater clarity and predictability to fund sponsors and investors regarding the SVO's fund reviews while still maintaining the P&P Manual's predictable and periodic standard. Though, it should be noted, the two tests would be more generous than the current approach in that some speculative derivatives would be permitted. While the second test may permit additional funds on the NAIC Fixed Income-Like SEC Registered Funds List, the inconsistent, and possibly punitive, RBC treatment of funds on this list versus other funds with NAIC designations is not something that the Task Force can address directly. For example, exchange-traded funds (ETFs) on the NAIC Fixed Income-Like SEC Registered Funds List would have a different RBC treatment from ETFs on the SVO Identified Bond or Preferred Stock ETF Lists. For this reason, the Task Force might consider a referral to the Capital Adequacy (E) Task Force and the Financial Condition (E) Committee requesting the assignment of bond RBC factors for all funds whose credit risk has been assessed by the SVO and assigned an NAIC designation pursuant to the Task Force's policies, including the NAIC Fixed Income-Like SEC Registered Funds List. This would be similar to the referral the Task Force made to the Capital Adequacy (E) Task Force in 2018. Equalizing the RBC treatment for assets with similar credit risk, represented by the SVO assigned NAIC designation, would provide a consistent and uniform NAIC process consistent with regulatory needs for funds. With these amendments the Task Force would be redefining what goes on the NAIC fund lists and, therefore, redefining the fund asset. Therefore, it would be appropriate to refer the proposed amendment to the Statutory Accounting Principles (E) Working Group.

Additionally, the SVO is proposing to add an assessment of a fund's management to the fund methodology. Under this assessment, the SVO would have the ability to consider a fund's management and organization, including: 1) key-man risk; 2) its risk management and compliance infrastructure; 3) its credit management standards and credit research capabilities; and 4) its derivatives risk management program for funds required to have one under Rule 18f-4. Based on the management assessment, the SVO would be able to notch down from its credit risk assessment or choose not to assign an NAIC designation.

Mr. Everett said states have defined their bond treatment by NAIC treatment. "Speculative" was mentioned regarding certain funds. Does the SVO know what funds those are? And if states permit these to be used for surplus, that would seem to be a departure. What is being defined as "speculative"? Mr. Perlman said "speculative" is anything with leverage where a fund can have outsized gains or losses. What the SVO is proposing—except for the exempt derivatives discussed, which are derivatives hedging certain risks on assets within the fund portfolio, but other than those preventing risks—where there is potential loss or future payment obligations, capping those with the potentially unlimited upside gain because the P&P Manual has the predictable and periodic standard to be bond-like.

Mr. Everett asked how many states that permit bond ETFs for primary capital surplus may be affected. Mr. Therriault said given the definition change, putting a 10% speculative threshold for those that are on the bond or preferred stock ETF lists, the change is not expected to have any impact for those lists. The threshold is generally consistent with the ETF list today. The other test is a little more generous for the SEC registered fund list, which is reported on the common stock schedule.

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Mr. Everett asked if it would it be the Statutory Accounting Principles (E) Working Group or this Task Force that would be looking at standards for the management assessment. Mr. Perlman said the SVO would do that. Mr. Fry said this would be just another thing the SVO assesses in the whole package of things assessed with funds.

Mr. Fry directed the SVO to expose this amendment to the *P&P Manual* to clarify Guidance for Fund Leverage for a 45-day public comment period ending May 6, 2021, and make a referral to the Statutory Accounting Principles (E) Working Group requesting their approval of the proposed changes to these definitions.

7. Received a Staff Report on Projects Before the Statutory Accounting Principles (E) Working Group

Mr. Fry said the next agenda item is to hear a report on projects before the Statutory Accounting Principles (E) Working Group. Mr. Fry asked Julie Gann (NAIC) to provide that report.

Ms. Gann said a there were a few things to highlight from the Statutory Accounting Principles (E) Working Group's March 15 meeting. She said that while the Working Group adopted several items and exposed several items, this update will only highlight four adoptions and two exposures. For the adoptions, the Working Group:

- Incorporated revisions to clarify that publicly traded preferred stock warrants should be treated as preferred stock. This is something similar to what was already in place for publicly traded common stock warrants to be treated as common stock. The reason it is required to be specified is all other warrants are captured as derivatives in the scope of *SSAP No.86—Derivatives*. The Working Group had not seen those preferred stock publicly traded warrants before, but they are out there, so the guidance was clarified accordingly.
- Adopted revisions to indicate that the changes to the Freddie Mac Structured Agency Credit Risk (STACR) and Fannie Mae Connecticut Avenue Securities (CAS) programs, which will be issued through REMIC, which is a REMIC trust, will still be in scope of SSAP No. 43R, and those revisions align the financial model guidance to match the P&P Manual.
- Clarified that perpetual bonds with an effective call option shall be amortized, using the yield to worst method with all other perpetual bonds that do not have an effective call option to be reported at fair value.
- Incorporated guidance and new disclosures to ensure that all related parties, including those with over a 10% ownership that may have disclaimed affiliation, are still reported as related parties in the financial statements. There is also a new schedule Y Part 3 to detail age-related parties.

Regarding exposures, Ms. Gann said comments are due April 30. She reiterated that while the Working Group exposed a long list of items, she will highlight only two of them. The Working Group exposed:

- Exposed revisions to data capture and expanded disclosures in *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* to make it easier to identify when an insurer has transferred an asset and maintains continuing involvement, such as with a self-securitization. There are existing disclosures in SSAP No. 103R, but they are currently in the narrative. It is not possible to aggregate and assess those transactions or to see problems. That is one of the main goals of this new disclosure.
- Exposed a proposed interpretation to clarify that cryptocurrency such as Bitcoin does not meet the definition of cash and is a non-admitted asset under statutory accounting. With that exposure, the Working Group requested for industry to provide information regarding the extent that insurers hold cryptocurrency.

Ms. Gann said the Working Group plans to meet May 20 to hear comments on those exposed items and take action, particularly with regards to those that have blanks-related revisions.

Ms. Gann said the Working Group also discussed the SSAP No. 43R project. She said there has been a small group of industry that has been meeting with Iowa and NAIC staff weekly since Fall 2020. The initiative is to draft a definition of what should be captured as a bond on Schedule D-1. The project was undertaken as an initial first step in the 43R substantive project as it was identified that some investments that caused regulator concern are not necessarily limited to SSAP No. 43R, and they could have been either captured or reclassified to SSAP No. 26R. By identifying what should be captured as a bond first, the project removes the concern of potential reclassification for those investments. The small group has made significant progress in

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drafting this definition, and it is anticipated that this preliminary definition will be publicly exposed by the end of May, possibly in accordance with the Working Group's May 20 meeting.

Ms. Gann added that the draft definition currently focuses on investments that reflect issuer credit obligations and asset backed securities. It establishes definitions and criteria of what should be captured within both classifications. Once the definition has been publicly discussed, it is anticipated that SSAP revisions will occur to incorporate the definitional concepts. Those are currently anticipated to occur within SSAP No. 26R and SSAP No. 43R; future discussions will determine the best approach. She said it is also anticipated the investments that no longer qualify for D-1 will move to Schedule BA. It is anticipated that the discussions will include accounting and reporting concepts for those investments and that referrals will be sent to the Capital Adequacy (E) Task Force to determine RBC.

Ms. Gann said the Working Group has received questions regarding CTLs and how the current project for D-1 assessment will affect that specific investment. These questions also asked about the purpose of the prior referral that the Working Group sent to the Task Force. To provide some clarity on this situation, there are two workstreams: 1) the Statutory Accounting Principles (E) Working Group project on the D-1 bond definition; and 2) the Valuation of Securities (E) Task Force project to revisit the structural requirements that are in the P&P Manual. It is anticipated that these will ultimately converge. However, with the specific discussion on CTLs last fall, specific focus is being given to these investments concurrently with the bond project. The determination of whether an investment qualifies within an SSAP and a particular reporting schedule is a decision of the Statutory Accounting Principles (E) Working Group. However, in certain cases, such as with CTLs, a structural analysis by the SVO under the requirements of the P&P Manual is necessary to satisfy this requirement. The original determination of residual risk allowing the reporting on Schedule D was made by the Invested Asset (E) Working Group, which has since been disbanded. Since that residual risk threshold is currently housed in the P&P Manual and information on the CTLs filed with the NAIC is reviewed by the Task Force, the prior referral intends to solicit the expertise of the Task Force and the NAIC SVO staff from their knowledge of those filed CTLs, which includes an assessment of whether that residual risk threshold should be revised. Both the structural parameters and the ultimate role of the structural analysis in relation to the principles developed through the Statutory Accounting Principles (E) Working Group bond project will require coordination between both groups as these projects progress. Statutory Accounting Principles (E) Working Group staff will continue to work closely with the Valuation of Securities (E) Task Force staff regarding those investments.

8. Heard an Update on CTLs

Mr. Fry said he would cover the CTL update next. The Statutory Accounting Principles (E) Working Group recently did an interpretation on CTLs that are called nonconforming CTLs and have a rating agency rating. These could be reported on Schedule D for year-end 2020 as long as they were filed with the SVO before Feb. 15, 2021. These securities were also required to be listed in the notes of the financial statement for year-end 2020. It was agreed that if the SVO assigns a designation to these securities, they would be allowed to be reported on Schedule D through the third quarter of 2021. The reason why the Working Group selected that date was that it was anticipated by then that the SSAP No. 43R project would provide a framework that would address these securities. If that framework has not been provided by that time, it might be possible for an extension of that policy until the SSAP No. 43R project matures. The SVO is committed to applying its methodology for CTLs or any other securities that have a residual risk up to 50%. If that residual risk is over 50%, on a case-by-case basis, the SVO would assess whether there are enough mitigating factors to designate these securities. The SVO is looking at the securities that were filed for last year-end. If there are any new securities in the market, the SVO will look at those it can designate. A designation does not mean that it goes on a specific schedule; that is the Statutory Accounting Principles (E) Working Group's responsibility. If the SVO designates one of these and Statutory Accounting Principles (E) Working Group decides that it is not eligible for bond treatment on Schedule D, there may still be a Schedule BA home for these with fixed income like RBC, provided the Capital Adequacy (E) Task Force and everyone else signs off on this treatment. Mr. Fry asked Ms. Gann if she had anything to add or if he had mis-characterized anything. She responded that Mr. Fry had summarized the issues correctly and that she had nothing to add. Ms. Mears and Mr. Theriault both also responded that Mr. Fry's summary was accurate.

Ms. Belfi said there was a lot of confusion on direction from some of the interested parties and Task Force members. Hopefully, there will be a resolution. Mr. Everett said that if this unfreezes the market, then the Task Force is moving in the right direction.

Tom Sargent (Waterway Capital), representing the Lease-Backed Securities Industry Group, asked how My. Fry sees this moving forward. He asked, "If there is a CTL with a residual in the neighborhood of 20% to 50%, do we proceed in placing

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that in front of the SVO to get a designation?" Mr. Fry said it should be filed with the SVO as it has been looking at the ones that came in last at the end of last year, and the SVO will use that same methodology. This is a new area, looking at ones where there is a greater than 5% residual. The SVO is in a position where it is looking at them through 50%, verifying the structure and then looking through to the lessee. The SVO is going to look at those that will need mitigating factors. There is the project before the Statutory Accounting Principles (E) Working Group, and as that framework becomes more mature, everything will come together by the end of the year.

Mr. Sargent asked if they should be submitted as an RTAS. Mr. Therriault said insurers can be submit them to the SVO as a regular filing. The SVO did receive 21 filings that were identified as nonconforming by the Feb. 15 deadline. There were an additional 27 filings that have not been reviewed but were submitted by the deadline. Any direction the SVO receives from the Task Force, including accepting additional residual risk, will be taken into consideration during the SVO's assessment, but the rest of the CTL criteria would still apply, just that the residual component would widen up to 50%.

Mr. Sargent asked if the definition of "residual risk" was using the original loan balance or the appraised loan to value. Mr. Therriault referred the question to Mr. Perlman who said it would be the loan balance. Mr. Therriault suggested they take this up "off-line".

Mr. Bruggeman asked that since the Statutory Accounting Principles (E) Working Group sent over the letter to evaluate the old 5% threshold, is 50% the new standard or is that still ongoing, and is the SVO still evaluating it. Mr. Fry said the SVO can safely go to 50% in this interim period and can look at ones higher, but they will need other mitigating factors. The Task Force will formally change it in the P&P Manual up to the 50% mark once the interim solution becomes permanent. Mr. Bruggeman asked if the 50% is temporary just as the SVO is going through the process for the year-end files and then the Task Force will evaluate whether to make it permanent. Mr. Fry said that is right and probably any new securities so that the market is not frozen. They will still be at the mercy of the Statutory Accounting Principles (E) Working Group ruling and if they do not belong on the bond schedule, they will likely end up with a Schedule BA and will still need to go through the Capital Adequacy (E) Task Force to get RBC certainty.

Mr. Kozak asked if there was a potential that some of this would go on Schedule B as opposed to Schedule BA. Mr. Fry said that is not completely off the table. As the SSAP No. 43R project plays out, there will be some things that are in or out. If they are not in scope of SSAP No. 43R, it is possible one could consider those going on Schedule B. Some people may also see them on Schedule BA with a designation for fixed income, but that is only available to life insurers and fraternal insurers. That would not be available to the property/casualty (P/C) insurers. Ms. Gann said it really depends on the structure of the investment. If it is not a security, then technically it would go on the mortgage loan schedule, which is Schedule B. The ones that are securities are where there may be a gray area, whether they should be SSAP No. 43R or Schedule BA. All of this is expected to be discussed further as part of the bond project.

Mr. Therriault said as the SVO receives filings with increasing amounts of residual exposure, the SVO will need additional documentation on the property because that additional component will now need to be assessed. This will be additional documentation beyond what is currently identified in the P&P Manual now.

9. <u>Received a Report from SVO on Year-End Carry-Over Filings</u>

Mr. Fry said once a year, the SVO gives the Task Force an update on its backlog and how that is looking. Mr. Fry asked Mr. Therriault for a quick update on that.

Mr. Therriault said for 2020, the SVO reviewed 12,696 filings comprised of: 3,092 initial filings; 7,866 annual updates; 1,209 additional issuances; and 529 other filing types. The total filing numbers included 2,027 manually processed private rating letters. For year-end 2020, there were 795 carry-over filings, 351 that received an "IF" for an accepted initial filing and 444 that received a "YE" for an accepted annual update. This was a carry-over rate of 6.3% for 2020, well below the rate of 10% or higher that the SVO considers concerning or reflective of a resource constraint.

As of March 16, there were only 70 remaining carry-over filings, 45 accepted initial filings and 25 accepted annual update filings. The remaining carry-over rate was 0.6% as of that date and has only gotten lower since then. This was an impressive performance by the SVO staff and managers given the significant disruptions introduced by working 100% remotely starting

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March 10, 2020, along with the team absorbing the new analytical work related to ground lease financing (GLF) transactions. At this time, Mr. Therriault said he is not seeing any SVO analyst resource constraint issues, but there are significant resource limitations with technology support for the office that have affected the SVO's ability to improve the core systems, VISION, Automated Valuation Service+ (AVS+) and Structured Securities (STS), or fully use the SVO's investment data. Also, if additional analytical tasks are assigned to the SVO, which the SVO is happy to take on for the Task Force, additional resources may be needed.

Mr. Monahan said a suggestion for the future is to add the report as an attachment, and he thanked and congratulated the SVO for their hard work.

Having no further business, the Valuation of Securities (E) Task Force adjourned.

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Draft: 6/4/21

Valuation of Securities (E) Task Force
Virtual Meeting
May 24, 2021

The Valuation of Securities (E) Task Force met May 24, 2021. The following Task Force members participated: Dana Popish Severinghaus, Chair, represented by Kevin Fry (IL); Doug Ommen, Vice Chair, represented by Carrie Mears (IA); Lori K. Wing-Heier represented by Wally Thomas (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan and Ray Spudeck (FL); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Eric Dunning represented by Lindsay Crawford (NE); Marlene Caride represented by Nakia Reid and John Sirovetz (NJ); Linda A. Lacewell represented by Jim Everett (NY); Doug Slape represented by Amy Garcia (TX); Jonathan T. Pike represented by Jake Garn (UT); Scott A. White represented by David Smith (VA); Mike Kreidler represented by John Jacobson (WA); and Mark Afable represented by Randy Milquet (WI). Also participating was: Dale Bruggeman (OH).

1. Adopted an Amendment to the P&P Manual to Require the Filing of a Private Rating Letter Rationale Report

Mr. Fry said the first item on the agenda is to discuss comments and updates to a proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to require the filing of a private rating analysis report. The Task Force has discussed this amendment several times, most recently at the Spring National Meeting. The Securities Valuation Office (SVO) staff has been working closely with the American Council of Life Insurers (ACLI), the North American Securities Valuation Association (NASVA), and the Private Placement Investors Association (PPiA) to address concerns regarding confidentiality restrictions and potential operational issues since this amendment was first exposed at the 2020 Fall National Meeting on Nov. 18, 2020. As reflected in their supportive joint comment letter, this collaboration has resulted in the amendment before the Task Force today that addresses those outstanding issues. The amendment requires the filing of private rating letter rationale reports beginning Jan. 1, 2022. There is a provision for deferring the submission for private letter rating securities in certain situations. The Task Force was informed of a typo in the last section of paragraph 22; the word “Filing Exception” should be changed to “Filing Exemption.” Mr. Fry thanked industry and staff on their close collaboration on developing this amendment.

Sasha Kamper, representing the ACLI, the PPiA and the NASVA, said industry's concerns with the Bespoke Securities proposal was always twofold. Industry wanted to provide the transparency that state insurance regulators are asking for so they can understand what insurers are investing in and minimize the amount of disruption that any sort of change could potentially cause in capital markets. The private placement market not only is an opportunity to provide incremental yield to insurers at a time when interest rates are quite low, but it also provides incremental downside protection through financial covenants and collateral packages in many of these deals. The U.S. private placement market is a very important market for several insurers and something to preserve. Industry believes that this exposure really strikes that right balance. There was extensive work over the last several months to get through some of the operational details and get the timing right in this proposal. The proposal is somewhat retroactive, and the first stage takes place for securities issued beginning Jan. 1, 2018. It was important not to expect rating agencies to go back and reopen commercial contracts with borrowers and need to amend the terms of those contracts. The SVO staff were very understanding of that and worked to accommodate these concerns; if there was a ratings rationale and it was allowed to be shared, if required to do so, they would not expect insurers and borrowers to renegotiate deals that were done a few years ago. Industry also worked with the SVO staff to explain that certain rating agencies, even some of the larger more established rating agencies, do less surveillance work on certain types of structured securities. There will be an initial study and publication put forth that describes the transactions and the ratings rationale in great detail. If nothing changes with the structure and things are performing about as expected, the annual surveillance reports are light. This is true, both on the public and private side. The SVO staff understood that and were only looking for similar work product to what is produced in the public sector. Industry believes this is something that all the rating agencies should be able to comply with, and they are being given enough time to put things in place. There are still some operational details to work out with the SVO, and the rating agencies specifically, about the delivery mechanism, but these ratings rationales will be provided to the SVO.

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Ms. Doggett made a motion, seconded by Mr. Thomas, to adopt the amendment to the P&P Manual to require the filing of private rating letter rationale reports. The motion passed unanimously.

2. Discuss and Receive an Amendment to the P&P Manual to Permit FE for CTLs and GLF Transactions

Mr. Fry said the next item on the agenda is to discuss and receive an amendment to the P&P Manual to permit filing exemption (FE) for credit tenant loans (CTLs) and ground lease financing (GLF) transactions that exceed a 5% residual exposure. This amendment would give insurers the option to submit either CTLs or GLF transactions to the SVO for their review, or they could use the NAIC FE process. After exposing this amendment, the Task Force received a referral from the Statutory Accounting Principles (E) Working Group chairs with an alternative P&P Manual amendment recommendation to achieve the same outcome, but without what the chairs saw as a possible overstep of the Task Force and possible conflict in guidance.

Mr. Bruggeman said that part of this challenge has always been the term "CTL." It has been used in a lot of different ways than what was originally introduced back in the '90s. A CTL, by statutory accounting definition, is a direct mortgage to someone that is backed by whoever is leasing the property and backed by those lease payments. It is a mortgage that is following *Statement of Statutory Accounting Principles (SSAP) No. 37—Mortgage Loans*, and if those credit tenant financings are being provided at least 95% (one minus the 5% the Task Force has been talking about), that can move from Schedule B (the mortgage schedule) to Schedule D-1 (the bond schedule). All of those had to be reviewed by the SVO. Over the years, these CTLs have been put inside securities. Those securities are also called CTLs. Therein lies part of this confusion; i.e., when that CTL ends up inside of a security and that security issues debt, now that debt is a security, and it is now covered under *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities*. If there are multiples of these inside a structure, that goes to SSAP No. 43R; otherwise, it will stay in SSAP No. 26R. Those are the statutory accounting definitions. The challenge is that when statutory accounting staff see CTLs, they immediately assume the mortgage SSAP No. 37 definition, but it has been utilized more than that. The memo that was sent out to the Task Force from the Working Group chairs tries to go through that process. The memo tried to highlight the terms "security" and "mortgage." The memo proposes changes in the P&P Manual in Part Three, paragraph 4, in the "FE Securities" section, changing the sentence from, "[a] CTL is a mortgage loan …" to, "[a] CTL is a mortgage loan, in scope of SSAP No. 37…," because by definition, SSAP No. 37 excludes securities that would be covered under SSAP No. 26R or SSAP No. 43R. There is a similar change in Part One, paragraph 100; any change to the residual percentage on the securities side does not affect the SSAP No. 37 CTLs. CTLs really fit into three different buckets—a mortgage bucket under SSAP No. 37, a bond bucket under SSAP No. 26R, and a structured bucket SSAP No. 43R.

Julie Gann (NAIC) said the Working Group chairs are recommending exposing the very limited proposed changes to the P&P Manual to clarify that the references of the CTL are mortgage loans in scope of SSAP No. 37. That separates the conversation between what is a direct mortgage loan and what is a security. This guidance would then refer to the *Accounting Practices and Procedures Manual* (AP&P Manual) to SSAP No. 26R and SSAP No. 43R on defining what should be in scope and reported on Schedule D. It was anticipated that this would eliminate the inconsistency and the confusion that currently exists regarding the different named structures that could perhaps have underlying real estate risk. From information that the SVO has provided, some companies have called those CTLs, some have called them lease-backed securities, and some companies call them other names. Anything that meets the current definition of a bond would continue to be in scope of SSAP No. 26R or SSAP No. 43R, as applicable. As the bond proposal continues, if there is concern about some of these investments and the ultimate residual risk, they would also be captured within that bond proposal and perhaps need be relocated to a different schedule once that project is done; but it would eliminate the inconsistency that currently exists and clarify that the current reference to mortgage loans is specific to those non-security structures that are in scope of SSAP No. 37. This came about Thursday evening after the Working Group call. The Working Group took action to expose modifications to *Interpretation (INT) 20-10: Reporting Nonconforming Credit Tenant Loans*. Contingently, in response to the original proposal that was suggested to the Task Force, if the Task Force moves forward with the limited edits that are reflected in the chair memo that was submitted, that exposure would be pulled back, and the Working Group would be informed of this change and work on the next way forward with regards to INT 20-10. If these proposed revisions to clarify the scope of the CTLs go through, INT 20-10 may no longer be applicable.

Mr. Fry said operationally, if there is a security that has a lot of CTL characteristics and under 5%, as defined in the P&P Manual, the SVO can still designate those; even though they are a security, they would not lose their standing in that regard. Mr. Everett questioned how the proposal interacts with the proposal that was sent out for the P&P Manual on Friday. Mr. Fry said the exposure in the materials has an amendment that would have created a similar effect. The Task Force will expose a new version, the simplified version that Mr. Bruggeman and Ms. Gann explained, and take comments on it. If the Task Force adopts that exposure, it would be the smoother, or at least disruptive path, and complement the SSAP No. 43R project It would

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put a natural guard rail around those investments as everyone begins understanding those principles. If there are a lot of residual risks and securities start looking and acting like something else, there is a risk of possibly not falling into the new principles-based SSAP No. 43R. The Task Force has got some work to do regarding looking at how it is using ratings and private letter rating. The Task Force can always look at ways to accomplish accounting for these risks through its processes.

John Garrison (Leased-Backed Securities Working Group) said this is an elegant and simple solution to the confusion that has been existing in the market. CTLs would stay in the P&P Manual, as they always have with all their guidelines and so forth. They would be preserved as an asset class with just a clarification that they would be deals that would normally be in the scope of SSAP No. 37. The clarification would be that any deal that is done in the form of a security would be FE, just like any bond. Investors would have the option, depending on the characteristics of the deal, to either do them under FE or submit them to the SVO for an NAIC Designation. This also applies to GLF transactions that are a security, and they would be FE. Mr. Fry confirmed that interpretation.

Ms. Mears said insurers should be thoughtful about those types of security characteristics that currently have large residual values in relation to the bond project and the bond proposal. As the residual values get higher and higher, more of an analysis needs to occur to show that those still produce bond like cash flows under the proposal. Should that proposal move forward the detail, securities with CTL like characteristics, along with any other investments that have those high residual values, would fall under that definition and its requirements.

Ms. Mears made a motion, seconded by Mr. Everett, directing the SVO staff to expose a new amendment to the P&P Manual following the suggestions proposed by the Working Group chairs permitting CTLs and GLF transactions that are securities to be FE for a 30-day public comment period. The motion passed unanimously.

3. <u>Discussed the SVO Referral Response to the Statutory Accounting Principles (E) Working Group on CTLs</u>

Mr. Fry said the next item on the agenda is to hear a summary from the SVO on the referral it received from the Statutory Accounting Principles (E) Working Group on CTLs. The referral asked the SVO some basic questions about CTLs.

Mr. Therriault said a lot has changed, given the new direction just discussed, but the Working Group asked the SVO a number of questions related to CTLs centered around the appropriateness of the 5% residual exposure and whether it is appropriate to revisit the 5% risk threshold restrictions for conforming CTLs. The SVO agreed that it makes sense to revisit that threshold. It sounds like the bond definition project will be covering that issue, so it is not necessary to do that here. Also, with the change in definition just discussed, it seems like it will no longer be necessary for the P&P Manual instructions.

Another question was for a recommendation of an appropriate residual risk threshold. That is where the SVO response went into some detail on the various risks that it has observed. The SVO staff did not think it was appropriate for the SVO to weigh in on the residual risk threshold, as that was more of a regulatory policy decision. The SVO staff assumed that the Task Force would come back and make a recommendation to the Working Group in that regard as to what it believes is the appropriate residual risk for the bond project.

Mr. Therriault said there was a question regarding other mechanisms for compensating controls beyond a residual risk insurance policy that could be incorporated to mitigate those factors for CTLs. The residual risk insurance is the most common mitigant that the SVO is seeing, but other mitigants that would be acceptable include non-cancelable guarantees, cash escrows and reserves, excess rent set asides, and recourse to the lessee. The SVO did not have an all-encompassing list, because it was anticipated that there could be other mitigants, and it did not want to exclude them.

The other question from the Working Group was for a listing of the nonconforming CTLs that had been filed with the SVO and some characteristics about them. The SVO received 61 CTLs since the time INT 20-10 was issued through April 21. There were 16 conforming CTLs, 27 nonconforming CTLs, and 18 transactions where documentation was still pending. Typical outstanding documentation include the primary legal agreement, the CTL evaluation form, the mortgage, residual value insurance, lease agreement, condemnation insurance, appraisal, and assignment of lease and rents. For the nonconforming CTLs, 20 had balloon payments in excess of 5%, six involved a lack of casualty or condemnation gap insurance, and one involved a keep-well agreement that would not be adequate for credit substitution purposes. The Working Group was sent a regulator-only list of those nonconforming CTLs, as it had requested.

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Mr. Fry said the Task Force would likely preserve the 5% residual risk for the things that otherwise would be on the mortgage loan schedule that want to go over to Schedule D. It may no longer be relevant how much over the 5% limitation the Task Force would suggest to the Working Group because there is no limit now for any other asset class. The new SSAP No. 43R principles will probably end up setting that benchmark.

Mr. Bruggeman asked Mr. Therriault if all the CTLs listed were structured as securities. Mr. Therriault said that is correct; CTLs structured as securities is what the SVO has traditionally received. The SVO has not received a mortgage type CTL in a long time. Mr. Therriault said the comments in the SVO's response to the Working Group highlighted risks that were generic to any lease-backed securities. The SVO wanted to make the Working Group and Task Force aware of those risks without making any policy recommendations. Mr. Bruggeman said he appreciated the SVO memo sent to the Working Group, as it broke out CTLs from the old definition and how they are being used now in securities.

Ms. Belfi asked for clarification regarding whether the Task Force should take up the policy questions from the Working Group, such as whether the residual exposure percentage should increase from 5% to something else now that it would not apply anymore, because the Working Group is going to be looking at the risk factors within SSAP No. 43R. Mr. Fry said a lot of these CTLs were not mortgage loans. They were a security, and like any other security, such as collateralized fund obligations (CFOs), they have different characteristics; and the Task Force does not really highlight those and create a special process for them, but they are just part of the FE universe. Everything is being put into that basket, then someday the new SSAP No. 43R principles will serve a useful purpose to keep that in check.

Mr. Bruggeman said for the bond definition project, most of these are already there, but there might be a few that fall outside of that principle in the bond definition. Those that are outside of the principles would have to move off Schedule D as securities, not as mortgages that are on Schedule D, but the second two buckets described earlier.

Having no further business, the Valuation of Securities (E) Task Force adjourned.

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VALUATION OF SECURITIES (E) TASK FORCE
PROPOSED 2022 CHARGES

The mission of the Valuation of Securities (E) Task Force is to provide regulatory leadership and expertise to establish and maintain all aspects of the NAIC's credit assessment process for insurer-owned securities, as well as produce insightful and actionable research and analysis regarding insurer investments.

Ongoing Support of NAIC Programs, Products or Services

1. The **Valuation of Securities (E) Task Force** will:

   A. Review and monitor the operations of the NAIC Securities Valuation Office (SVO) and the NAIC Structured Securities Group (SSG) to ensure they continue to reflect regulatory objectives.

   B. Maintain and revise the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to provide solutions to investment-related regulatory issues for existing or anticipated investments.

   C. Monitor changes in accounting and reporting requirements resulting from the continuing maintenance of the *Accounting Practices and Procedures Manual*, as well as financial statement blanks and instructions, to ensure that the P&P Manual continues to reflect regulatory needs and objectives.

   D. Consider whether improvements should be suggested to the measurement, reporting and evaluation of invested assets by the NAIC as the result of: 1) newly identified types of invested assets; 2) newly identified investment risks within existing invested asset types; or 3) elevated concerns regarding previously identified investment risks.

   E. Identify potential improvements to the credit filing process, including formats and electronic system enhancements.

   F. Provide effective direction to the NAIC's mortgage-backed securities modeling firms and consultants.

   G. Coordinate with other NAIC working groups and task forces—including, but not limited to, the Capital Adequacy (E) Task Force, the Investment Risk-Based Capital (E) Working Group, the Statutory Accounting Principles (E) Working Group and the Blanks (E) Working Group—to formulate recommendations and to make referrals to such other NAIC regulator groups to ensure expertise relative to investments, or the purpose and objective of guidance in the P&P Manual, is reflective in the guidance of such other groups and that the expertise of such other NAIC regulatory groups and the objectives of their guidance is reflected in the P&P Manual.

   H. Identify potential improvements to the filing exempt process (the use of credit rating provider ratings to determine an NAIC designation) to ensure greater consistency, uniformity and appropriateness to achieve the NAIC's financial solvency objectives.

NAIC Support Staff: Charles Therriault, Marc Perlman

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NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

150 1871 2021

MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Add Additional Instructions to the Review of Funds

DATE: May 27, 2021

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1. Overview –At the request of the Task Force to provide greater clarity and predictability to fund sponsors and investors regarding the acceptable use of derivatives in funds and permit some funds to have greater flexibility in their use of derivatives, the SVO proposed several amendments to the P&P Manual fund guidelines at the Spring National Meeting of the Task Force on March 22, 2021. The Task Force voted to receive the proposal and expose it for 45 days. The Task Force received comments from interested parties during the exposure period, aspects of which the SVO has incorporated into a new proposed amendment to the P&P Manual fund guidelines.

2. Recommendation Summary – The new proposal would adhere much more closely to Rule 18f-4 (the Rule) under the Investment Company Act of 1940 related to the use of derivatives by registered investment companies, including funds, which the Securities Exchange Commission (SEC) adopted in October 2020. Unlike the previous amendment which had two separate tests for derivatives depending on the NAIC Fund List on which a fund is listed, this amendment would create a single test. Pursuant to the new proposal a fund's exposure to: (i) derivatives under which a fund *is or may* be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payments or otherwise, (ii) short sale borrowings and (iii) reverse repurchase agreements or similar financing, would be limited to 10% of the fund's net assets in normal market conditions. Exposure would be calculated based on the gross notional amounts of derivatives, the value of assets sold short for short sale borrowings, and the proceeds received by the fund but not repaid for reverse repurchase agreements. Consistent with the Rule, interest rate derivatives and option contracts exposure could be calculated with other defined methods consistent with market practice. Also consistent with the Rule, certain currency and interest rate derivatives that hedge currency or interest rate risk associated with one or more specific equity or fixed-income investments of the fund would be exempt from the 10% exposure calculation.

One difference between our proposal and the SEC Rule is that the P&P Manual's methodology requires a look-through assessment of all funds which, in turn, includes a requirement that a fund "predominantly hold" bonds or preferred stock, as applicable. As defined in the P&P Manual, "Predominantly Hold" means, in part, "The fund will hold *at least* 80% of its assets in bonds if the fund is a bond fund or at least 80% of its assets in preferred stock if the fund is a preferred stock fund, in normal market conditions." This existing requirement, therefore, limits total derivatives, short sale borrowing and reverse repurchase agreement exposure in any fund to 20%, exclusive of the currency and interest rate derivatives mentioned above. We propose calculating that exposure as explained above. However, for derivatives under which a fund *shall not* be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payments or otherwise, exposure would be calculated based on the derivative's market value. These derivatives would include, for example, certain options pursuant to which the fund would have no possible future payment obligation following the initial premium payment. Due to diminished risk of loss to the fund it is more appropriate to calculate the exposure based on the less conservative market value measure rather than the gross notional amount. The Credit Risk Assessment portion of our existing methodology would also be updated to include a calculation of derivative exposure and, if analytically appropriate, the inclusion of derivatives in the WARF analysis.

Derivative documentation can be complex and its review time consuming. To expedite reviews of funds with derivatives while ensuring that the fund does not breach the proposed exposure thresholds, we propose a new filing requirement to include certain derivatives information in the schedule of portfolio securities and assets which is provided to the SVO for its review. Such additional information would include (i) derivative type, (ii) might the derivative require the fund to make a future payment or delivery of cash or other assets, (iii) is the derivative an "excluded derivative transaction," (iv) the counterparty credit rating, and (v) the derivative exposure and how it is calculated. Our expectation is that a complete and accurate summary of derivatives in the schedule will obviate the need for the SVO to review derivative legal documentation, but we would reserve the right to request it if we deem it necessary.

Based on comments we received from interested parties, we have decided to remove the initially proposed management assessment from this amendment. Interested parties expressed concern that the management assessment could further weaken market clarity and predictability.

2. Proposed Amendment – The text referencing the Investments in Funds is shown below, edits in red, as it would appear in the 2020 P&P Manual format.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

…

NAIC FIXED INCOME-LIKE SEC REGISTERED FUNDS LIST

Description

269. This section encompasses SEC registered funds issued by any type of investment-company registered with the SEC under the Investment Company Act of 1940 that sponsors a fund that will predominantly hold bonds or preferred stock. This listing excludes money market mutual funds as those securities are subject to different accounting treatment.) Different type of investment companies can be considered to have business models that operate differently as to redemption of shares, the life of the fund, whether the portfolio is held to maturity or traded over the life of the fund. The four types of investment companies are summarized below:

- **Open End Management Company (OEMC)** – An OEMC sell redeemable shares, directly or through a broker, on a continuous basis at the fund's approximate net asset value (NAV) per share and invests the proceeds in highly liquid bonds. Investors redeem shares of an OEMC fund by selling them back to the fund or to a broker. OEMC's may include exchange-traded funds.
- **Closed End Fund (CEFC)** – A CEFC lists its shares on a stock exchange or trades in the over-the-counter market. The assets of a CEFC are professionally managed in accordance with the fund's investment objectives and policies. The market price of a CEFC share is determined by supply and demand in the marketplace. Because a CEFC does not maintain cash reserves or sell securities to meet redemptions, it can invest in less-liquid portfolio securities. A CEFC has a stated termination date.
- **Unit Investment Trust (UIT)** – A UIT issues a fixed number of securities called "units" in a public offering and uses the proceeds to buy a diversified professionally selected portfolio of securities. UITs have a preset termination date tied to its portfolio investments and investment goals. The portfolio is held for the life of the UIT; but is not actively managed or traded. Although UITs are required by law to redeem outstanding units, the UIT sponsor usually maintains a secondary market so investors can sell units back and other investors can buy units. UIT's may include exchange-traded funds.

- **Exchange-Traded Fund (ETF)** – An ETF is an investment company that is registered under the Investment Company Act of 1940 either as an OEMC or as a UIT. An ETF combines the valuation feature of an OEMC or UIT, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value.

Regulatory Treatment of Eligible Funds

270. An SEC registered fund on the NAIC Fixed Income-Like SEC Registered Funds List is in the scope of *SSAP No. 30R—Unaffiliated Common Stock* and reported on Schedule D, Part 2, Section 2 with an NAIC Designation. ~~These investments are reported at fair value although reporting at net asset value is permitted if there is no readily determinable fair value.~~

. . .

REQUIRED DOCUMENTATION, ANALYTICAL PROCEDURES AND ELIGIBILITY CRITERIA

Objective

277. The objective of the SVO's review is to assess whether for NAIC regulatory purposes discussed above, the fund's portfolio will generate predictable and periodic cash flows so similar to a bond (or a preferred stock) that it should be assigned an NAIC Designation and obtain applicable risk-based capital charges.

Definitions

278. **Bond** – For fund investment purposes, Bond means debt securities defined or encompassed within *SSAP No. 26R–Bonds* and *SSAP No. 43R–Loan-Backed and Structured Securities*.

279. **Credit Risk Assessment** – A calculation of the credit risk of a fund's underlying investment portfolio using a weighted average rating factor methodology (WARF). The WARF factor for each portfolio security (issue/security specific) is determined by first translating its NAIC CRP rating into an NAIC Designation. For securities that are unrated but have an NAIC Designation, the Designation is used. The WARF factor for that NAIC Designation is then market value-weighted. The weighted factor for each investment is summed to determine the fund's credit rating which is then translated into the equivalent NAIC Designation. For funds which use any *derivatives instrument* or *derivatives transaction*, the WARF analysis may incorporate each derivative counterparty and the credit risk assessment may include a determination of *derivatives exposure.*

280. **Derivatives Exposure** – means the sum of the gross notional amounts of the fund's *derivatives transactions*, described in clause (1) of the definition, below, of the term "*derivatives transaction*"; in the case of short sale borrowings, the value of the assets sold short; and, in the case of reverse repurchase agreements or similar financing transactions, the fund's derivatives exposure also includes, for each transaction, the proceeds received but not yet repaid or returned, or for which the associated liability has not been extinguished, in connection with the transaction. Consistent with Securities Exchange Commission Rule 18f-4 under the Investment Company Act of 1940, in determining derivatives exposure a fund may convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts and exclude any closed-out positions, if those positions were closed out with the same counterparty and result in no credit or market exposure to the fund.

281. **Derivatives Transaction** – means: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("*derivatives instrument*"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; (2) any short sale borrowing; and (3) any reverse repurchase agreement or similar financing transaction.

~~282. **Financial Commitment Transactions** – Refers to reverse repurchase agreements, short sale borrowing, any firm or standby commitment or similar agreement as these terms are defined and as they may be subsequently amended by the SEC as part of proposed Rule 18-f-4.~~

283. **Fixed Income Like** – An SVO determination that a fund will generate predictable and periodic cash flows in a manner broadly similar to a situation where the holdings of bonds or of preferred stock of a known credit quality were held individually. A fund's use of derivatives shall be deemed fixed income like if it meets the guidelines in this section.

284. **Fundamental Policy** – A policy adopted by a fund that requires shareholder approval to change or a policy to provide at least 60 days' notice to fund shareholders of an intended change of a stated policy. The subject of the policy is that under normal circumstances the fund will invest at least 80% of its net assets plus any leverage for investment purposes in the type of bonds indicated by its name in compliance with Section 13 (a) of the Investment Company Act of 1940 and/or Rule 35d-1 of the 1940 Act. If the fund's prospectus does not state that this investment objective is a fundamental policy for the fund, the SVO will assume it is not.

285. **Look-through Assessment** – A qualitative and quantitative evaluation of the fund, encompassing the following criteria:

- Verify that the fund's portfolio, in the case of a bond fund or, preferred stock, in the case of a preferred stock fund *predominantly hold*s bonds or preferred stock.
- Confirm that the fund has adopted its investment objective as part of its *fundamental policy* and that other policies are consistent with fixed income investment.
- Review the fund's stated investment objective to ensure it is consistent with a fixed income investment, and evaluate the fund's investment policies and investment strategies for consistency with the investment objective and the fund's portfolio.
- Evaluate the extent to which the composition of the fund's portfolio can vary under normal market conditions given the fund's policies and investment strategies and the extent to which the composition of the fund's portfolio may vary under abnormal market conditions and the extent to which changes in composition of the fund's portfolio in abnormal market. conditions may persist given the fund's leverage profile or other relevant factors.

Note: A fund that invests in another fund will need to have that other underlying fund approved by the SVO and maintained on the appropriate fund list, if not already done.

286. **Predominantly Hold** – The fund will hold *at least* 80% of its assets in bonds if the fund is a bond fund or at least 80% of its assets in preferred stock if the fund is a preferred stock fund, *in normal market conditions* and will deviate from this policy only temporarily to respond to abnormal market conditions. In the case of an ETF, predominantly hold also means that the fund will track a specified bond or preferred stock index, if passively managed, or refers to the bond or preferred stock portfolio the fund will actually hold, if actively managed—under normal market conditions. The *derivatives exposure* of *derivatives transactions* (exclusive of *excluded derivatives transactions*, as defined in "Speculative Characteristics Analysis"), and the market value of all other assets will be used when determining whether a fund predominantly holds bonds or preferred stock, as applicable, according to this clause.

287. **Speculative Characteristics Analysis** – Means: ~~(a)~~ an assessment of the fund's use of ~~leverage, including, but not limited to, its use of derivatives, financial commitment~~ *derivatives transactions* ~~and borrowings~~, to examine the impact ~~the fund's use of leverage~~ they may have on the fund's portfolio cash flow as assessed under the *credit risk assessment* under normal and abnormal market conditions~~; and (b) a review and evaluation of the fund's policy and approaches to covering leverage obligations in relation to current and potential future guidance on the issue provided by the SEC. As used herein potential future guidance refers to proposed SEC Rule 18-f-4, "Use of Derivatives by Registered Investment Companies and Business Development Companies, ICA Release No. 31933 (December 11, 2015) [17 CFR Parts 270 and 274] Proposed Rule 18-f-4."~~, the resulting *derivatives exposure* not to exceed 10% of the fund's net assets in normal market conditions, excluding, for this purpose, currency or interest rate derivatives that hedge currency or interest rate risks associated with one or more specific (i) equity or fixed-income investments held by the fund (which must be foreign-currency-denominated in the case of currency derivatives), or (ii) the fund's borrowings, provided that the currency or interest rate derivatives are entered into and maintained by the fund for hedging purposes and that the notional amounts of such derivatives do not exceed the value of the hedged investments (or the par value thereof, in the case of fixed-income investments, or the principal amount, in the case of borrowing) by more than 10 percent (each, an "*excluded derivatives transaction*").

NOTE: For the avoidance of doubt, Funds on the NAIC U.S. Government Money Market Fund List are not permitted to use any *derivatives transaction* or other *derivatives instrument*. ~~Examples of speculative characteristics may include the need to sell assets to meet leverage obligations at a loss; instability in the cash flow introduced by the use of leverage; the need to employ alternative portfolio management strategies as a result of the need to meet payment obligations; the extent to which changes in the composition of the fund's portfolio in response to abnormal market conditions may persist given the fund's leverage profile or other relevant factors. The purpose of an analysis of speculative characteristics is to determine whether the fund's cash flow is inconsistent with a fixed income like determination.~~

Methodology*

288. The SVO shall:

- Conduct a *look-through assessment*
- Conduct a *credit-risk assessment* to determine the credit risk of the fund's cash flows.
- Conduct a *speculative characteristics analysis*.
- Determine whether the fund's cash flow can or cannot be appropriately characterized as *fixed income like* for regulatory purposes.

- If the SVO determines that the fund's cash flow can be appropriately characterized as fixed income for regulatory purposes, it assigns an NAIC Designation to reflect the credit risk associated with the fund's cash flow and includes the name of the fund on the appropriate NAIC List.**
- If the SVO determines that the fund's cash flow cannot be appropriately characterized as fixed income for regulatory purposes it shall communicate the determination to the insurance company or fund sponsor in writing.

*** NOTE**: *Italicized text* indicates that the term used is a defined term. Please refer to the definition of the term for a description of SVO criteria associated with the methodology component being described.
**** NOTE**: The NAIC Designation does not address the fund's ability to meet payment obligations because the insurer/shareholder does not own the bonds in the portfolio; the NAIC Designation instead conveys the credit risk/quality of the fixed income like cash flow generated by the ETF.

Documentation

289. An insurance company or the sponsor of a bond or preferred stock fund that request that the SVO conduct the look through and credit assessment submits the following required documentation to the SVO:

- A completed RTAS Application (Information about the RTAS process is contained here: *www.naic.org/documents/svo_rtas_app.pdf*. A fund with *derivatives transactions* or other *derivative instruments* may be considered a Highly Customized Transaction if the SVO determines it necessary to review a derivative's operative legal documentation.
- For all funds subject to look-through and credit risk assessment and to speculative characteristics analysis: the Prospectus and Statement of Additional Information (SAI) for the fund.
- For funds which use *derivative transactions* or other *derivative instruments*, the applicable operative legal documentation, if requested by the SVO.
- In the case of an ETF, copies of the Application, Notice and Order associated with the fund sponsor's request for Exemptive Relief from the SEC or a link to the SEC's EDGAR where the SVO can obtain the documents.
- In the case of a private equity fund, the Private Placement Memorandum, Limited Partnership Agreement or Limited Liability Company Agreement, the Subscription Agreement and the Form D, if one has been filed.

- Schedules of the fund's portfolio securities and assets with a description of the security, the CUSIP or other security identifier and NRSRO credit ratings for the last four quarters of the fund's existence. For funds which use *derivative transactions* or other *derivative instruments*, the schedule shall include for each derivative:
  - The derivate type (e.g. ISDA swap, purchase call option, written put option, short sale borrowing, reverse repurchase agreement);
  - Is or may the fund be required, pursuant to the derivative, to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise;
  - Is the derivative a *derivatives transaction* (as defined above), an *excluded derivatives transaction* (as defined in "Speculative Characteristics Analysis") or neither;
  - The counterparty credit rating;
  - (i) The *derivative exposure* or market value, as applicable, both as a dollar amount and converted to a percentage of the fund's net assets in normal market conditions, and (ii) a summary of how the amount is calculated (e.g. gross notional amount, convert the notional amount of interest rate derivative to 10-year bond equivalent, delta adjust the notional amount of option contract, market value, value of assets sold short, proceeds received but not yet paid or returned).

NOTE: The documentation provided must enable the SVO to conduct the analysis described below. Applicants are free to provide any supplemental material they believe will assist the SVO to:

- Verify that the fund has adopted a *fundamental (stated) policy* to *predominantly hold bonds* (or preferred stock).
- Evaluate the fund's use of leverage in relation to the management of portfolio risk and in relation to other purposes relevant to the *speculative characteristics analysis*.
- Understand the fund's policy and approaches to coverage of obligations arising from the use of leverage, in relation to SEC guidance on the subject.
- ~~Schedules of the fund's portfolio securities and assets with a description of the security, the CUSIP or other security identifier and NRSRO credit ratings for the last four quarters of the fund's existence.~~

- A description of likely changes in the fund's composition under normal market conditions given the fund's investment objective and the strategies to be employed to attain it.

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John Petchler, on behalf of the PP*i*A Board of Directors

June 28, 2021

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Ms. Carrie Mears, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Add Additional Instructions to the Review of Funds

Dear Mr. Fry and Ms. Mears,

The American Council of Life Insurers ("ACLI")[1], Private Placement Investors Association ("PPiA")[2], and North American Securities Valuation Association ("NASVA")[3] (collectively, the "undersigned") appreciate the opportunity to comment on the above-referenced proposed amendment to the P&P Manual.

The undersigned are supportive of the Valuation of Securities Task Force's ("VOSTF") goal to provide greater clarity and predictability to fund sponsors and investors regarding the acceptable use of derivatives in funds and permit some funds to have greater flexibility in their use of derivatives. We are also supportive of the Securities Valuation Office's ("SVO") well thought out and appropriately targeted changes to the P&P Manual that achieve that end.

[1] The *American Council of Life Insurers* ("ACLI") is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

[2] The *Private Placement Investors Association* ("PP*i*A") is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PP*i*A serves 63 member companies and works with regulators, NASVA, the American College of Investors Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace. Learn more at www.usppia.com.

[3] The *North American Securities Valuation Association* ("NASVA") is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes. Find more information here

We greatly appreciate both the VOSTF's and SVO's continued efforts to expand the universe of funds where the SVO can appropriately assess a fund's portfolio to determine if it will generate predictable and periodic cash flows so similar to a bond (or a preferred stock) that it can be assigned an NAIC Designation and obtain an applicable risk-based capital charge.

We, therefore, continue to support any further efforts to obtain bond-like risk-based capital charges for an SEC registered fund on the NAIC Fixed Income-Like SEC Registered Funds List in the scope of SSAP No. 30R—Unaffiliated Common Stock and reported on Schedule D, Part 2, Section 2 with an NAIC Designation. Similar treatment may also be warranted for certain funds that issue debt securities, that may not meet the definition of a bond because the debt security is "stapled" together with the equity tranche, per Example 1 of Appendix 1, of SAPWG's recently exposed bond definition for purposes of Schedule D reporting.

We again sincerely thank the VOSTF, SVO, and regulators for their efforts on this important matter and we continue to stand ready to offer our assistance and input as needed.

Sincerely,

MMonahan | Tracey Lindsey | John Petchler

Mike Monahan
American Council of Life Insurer

Tracey Lindsey
NASVA

John Petchler
on behalf of PPiA Board of Directors

cc: Charles Therriault, Director, Securities Valuation Office

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National Association of Insurance Commissioners

The Center for Insurance Policy and Research

MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Add Additional Instructions to the Review of Funds

DATE: March 1, 2021

1. Summary –At the request of the Task Force to provide greater clarity and predictability to fund sponsors and investors regarding the acceptable use of derivatives in funds and permit some funds to have greater flexibility in their use of derivatives, the SVO proposes creating two new tests. One test would be for all funds other than those on the NAIC Fixed Income-Like SEC Registered Funds List and the other test would apply only to funds on that list. Pursuant to the P&P Manual, the SVO's stated objective regarding funds is to "*…assess whether for NAIC regulatory purposes …, the fund's portfolio will generate predictable and periodic cash flows so similar to a bond (or a preferred stock) that it should be assigned an NAIC Designation and obtain applicable risk-based capital charges.*" The P&P Manual further requires the SVO, in its opinion, to determine if the fund is Fixed Income Like, meaning the SVO must determine whether, *"a fund will generate predictable and periodic cash flows in a manner broadly similar to a situation where the holdings of bonds or of preferred stock of a known credit quality were held individually.*" Currently, the P&P Manual grants the SVO discretion in determining whether a fund's use of derivatives is consistent with a fixed income like security.

On October 28, 2020, the Securities Exchange Commission (SEC) adopted Rule 18f-4 (the Rule) under the Investment Company Act of 1940 related to the use of derivatives by registered investment companies, including funds. The SEC designed the Rule to create a more comprehensive approach to the regulation of the use of derivatives by funds. While the Rule imposes rigorous management, reporting and leverage requirements on funds which use derivatives, limited users of derivatives are exempt from those requirements. Under the Rule, a fund is considered a limited user of derivatives if its gross notional derivatives exposure, exclusive of certain currency and interest rate hedges associated with specific fixed-income or equity investments held by the fund, does not to exceed 10 percent of the fund's net assets. The SEC recognized the risk derivative transactions pose to funds and wrote, "Many derivatives transactions, such as futures, swaps, and written options, involve leverage or the potential for leverage because they enable the fund to magnify its gains and losses compared to the fund's investment, while also obligating the fund to make a payment or deliver assets to a counterparty under specified future conditions."[1] The SEC specifically noted the differences in risk to a fund between the hedging, for example, the currency risk of a fund investment denominated in a different currency and the fund taking a speculative position on price movements of two currencies. The SVO contends that such leverage is inconsistent with the "predictable and periodic" standard in the P&P Manual definition of Fixed Income Like and therefore proposes using the Rule's limited user standards as a guidepost for updated P&P Manual guidance on what is an acceptable use of derivatives use by a fund so that the fund payments can be considered fixed income like.

2. Recommendation – Based on requests from Task Force members that a more definitive limitation on the use of derivatives in funds be established we propose the following two tests. For funds on the SVO-Identified Bond ETF List[2], the SVO-Identified Preferred Stock ETF List[3] and the NAIC List of Schedule BA Non-Registered Private Funds with Underlying Assets Having Characteristics of Bonds or Preferred Stock[4], we propose, similar to the limited user exception in the Rule, a threshold whereby the gross notional amount of derivatives which impose no future payment or margin posting obligation on the fund, cannot exceed 10% of the net asset value of the fund, under normal market conditions, except for certain currency and interest rate hedges, certain futures or forwards on fixed-income or preferred stock to be held in the fund's portfolio, reverse-repurchase agreements associated with specific fixed-income or preferred stock investment held by the fund, and non-margin borrowing for purposes other than investment, each of which could impose a future payment or margin posting obligation on the fund.

Funds on the NAIC Fixed Income-Like SEC Registered Funds List are in scope of SSAP No. 30R-Unaffiliated Common Stock and reported on Schedule D, Part 2, Section 2. Based on such reporting, if the Task Force deems it appropriate, NAIC Designations assigned to those funds could be permitted to include assessments of risk other than credit risk, including market and liquidity risk, both risks introduced by derivatives. This also addresses requests by several Task Force members that a wider range of funds be eligible to receive an NAIC Designations. Therefore, if the Task Force thinks it appropriate, these funds could be permitted a larger derivative threshold of up to 20% of the net asset value of the fund, under normal market conditions. This threshold would also prevent violation of the P&P Manual fund methodology's "predominantly hold" requirement that a fund, "will hold *at least* 80% of its assets in bonds if the fund is a bond fund or 80% of its assets in preferred stock if the funds is a preferred stock fund, *in normal market conditions* . . ." We are not proposing that any types of derivatives be exempt from the 20% threshold calculation because such exemptions could potentially cause such a breach in the aggregate. For both tests we recommend incorporating an assessment of counterparty risk into our Credit Risk Assessment.

3. Proposed Amendment – The text referencing the Investments in Funds is shown below, edits in red, as it would appear in the 2020 P&P Manual format.

[1] SEC Release No. IC-34084; File No. S7-24-15, p.11.

[2] In scope of *SSAP No. 26R- Bonds* and reported on Schedule D, Part 1.

[3] In scope of *SSAP No. 32 – Preferred Stock* and reported on Schedule D, Part 2, Section 1.

[4] In scope of *SSAP No. 48 – Joint Ventures, Partnerships and Limited Liability Companies* or *SSAP No. 97 – Investments in Subsidiary, Controlled and Affiliated Entities*, reported on Schedule BA.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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NAIC FIXED INCOME-LIKE SEC REGISTERED FUNDS LIST

Description

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- **Open End Management Company (OEMC)** – An OEMC sell redeemable shares, directly or through a broker, on a continuous basis at the fund's approximate net asset value (NAV) per share and invests the proceeds in highly liquid bonds. Investors redeem shares of an OEMC fund by selling them back to the fund or to a broker. OEMC's may include exchange-traded funds.
- **Closed End Fund (CEFC)** – A CEFC lists its shares on a stock exchange or trades in the over-the-counter market. The assets of a CEFC are professionally managed in accordance with the fund's investment objectives and policies. The market price of a CEFC share is determined by supply and demand in the marketplace. Because a CEFC does not maintain cash reserves or sell securities to meet redemptions, it can invest in less-liquid portfolio securities. A CEFC has a stated termination date.
- **Unit Investment Trust (UIT)** – A UIT issues a fixed number of securities called "units" in a public offering and uses the proceeds to buy a diversified professionally selected portfolio of securities. UITs have a preset termination date tied to its portfolio investments and investment goals. The portfolio is held for the life of the UIT; but is not actively managed or traded. Although UITs are required by law to redeem outstanding units, the UIT sponsor usually maintains a secondary market so investors can sell units back and other investors can buy units. UIT's may include exchange-traded funds.

- **Exchange-Traded Fund (ETF)** – An ETF is an investment company that is registered under the Investment Company Act of 1940 either as an OEMC or as a UIT. An ETF combines the valuation feature of an OEMC or UIT, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value.

Regulatory Treatment of Eligible Funds

270. An SEC registered fund on the NAIC Fixed Income-Like SEC Registered Funds List is in the scope of *SSAP No. 30R—Unaffiliated Common Stock* and reported on Schedule D, Part 2, Section 2 with an NAIC Designation. The NAIC Designation for such funds may reflect assessments of risk other than credit risk, including market risk and liquidity risk. ~~These investments are reported at fair value although reporting at net asset value is permitted if there is no readily determinable fair value.~~

. . .

REQUIRED DOCUMENTATION, ANALYTICAL PROCEDURES AND ELIGIBILITY CRITERIA

Objective

277. The objective of the SVO's review is to assess whether for NAIC regulatory purposes discussed above, the fund's portfolio will generate predictable and periodic cash flows so similar to a bond (or a preferred stock) that it should be assigned an NAIC Designation and obtain applicable risk-based capital charges.

Definitions

278. **Bond** – For fund investment purposes, Bond means debt securities defined or encompassed within *SSAP No. 26R–Bonds* and *SSAP No. 43R–Loan-Backed and Structured Securities*.

279. **Credit Risk Assessment** – A calculation of the credit risk of a fund's underlying investment portfolio using a weighted average rating factor methodology (WARF). The WARF factor for each portfolio security (issue/security specific) is determined by first translating its NAIC CRP rating into an NAIC Designation. For securities that are unrated but have an NAIC Designation, the Designation is used. The WARF factor for that NAIC Designation is then market value-weighted. The weighted factor for each investment is summed to determine the fund's credit rating which is then translated into the equivalent NAIC Designation. For funds which use derivatives transactions, the WARF analysis will incorporate the derivative counterparties and the credit risk assessment will include an estimate of the fund's obligations to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise.

280. **Derivative Transaction Exposure** – means the sum of the gross notional amounts of the fund's derivative instruments described in the definition of "Derivative Transactions".

281. **Derivative Transactions** – means any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or shall not be required, except in the case of exempt derivatives, to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise.

282. **Exempt Derivative** – means a (a) currency or interest rate derivative that hedges currency or interest rate risks associated with one or more specific investments held by the fund (which must be foreign-currency-denominated in the case of a currency derivative) and which shall not be speculative in nature or constitute a borrowing, (b) repurchase agreement, meaning a form of short-term borrowing by which the fund agrees to sell securities for cash and simultaneously agrees to repurchase the same or substantially similar securities at a stated price on a specified date, (c) forward or futures contract by which the fund contracts to purchase for a fixed price at a future date fixed-income securities or preferred stock it intends to hold in the fund portfolio, and for which the fund maintains until the settlement date, cash or other liquid assets sufficient to meet the purchase price and (d) non-margin borrowing for purposes other than investment.

~~283. **Financial Commitment Transactions** – Refers to reverse repurchase agreements, short sale borrowing, any firm or standby commitment or similar agreement as these terms are defined and as they may be subsequently amended by the SEC as part of proposed Rule 18-f-4.~~

284. **Fixed Income Like** – An SVO determination that a fund will generate predictable and periodic cash flows in a manner broadly similar to a situation where the holdings of bonds or of preferred stock of a known credit quality were held individually.

285. **Fundamental Policy** – A policy adopted by a fund that requires shareholder approval to change or a policy to provide at least 60 days' notice to fund shareholders of an intended change of a stated policy. The subject of the policy is that under normal circumstances the fund will invest at least 80% of its net assets plus any leverage for investment purposes in the type of bonds indicated by its name in compliance with Section 13 (a) of the Investment Company Act of 1940 and/or Rule 35d-1 of the 1940 Act. If the fund's prospectus does not state that this investment objective is a fundamental policy for the fund, the SVO will assume it is not.

286. **Look-through Assessment** – A qualitative and quantitative evaluation of the fund, encompassing the following criteria:

- Verify that the fund's portfolio, in the case of a bond fund or, preferred stock, in the case of a preferred stock fund *predominantly hold*s bonds or preferred stock.

- Confirm that the fund has adopted its investment objective as part of its *fundamental policy* and that other policies are consistent with fixed income investment.
- Review the fund's stated investment objective to ensure it is consistent with a fixed income investment, and evaluate the fund's investment policies and investment strategies for consistency with the investment objective and the fund's portfolio.
- Evaluate the extent to which the composition of the fund's portfolio can vary under normal market conditions given the fund's policies and investment strategies and the extent to which the composition of the fund's portfolio may vary under abnormal market conditions and the extent to which changes in composition of the fund's portfolio in abnormal market. conditions may persist given the fund's leverage profile or other relevant factors.

287. **Management Assessment –** The SVO may consider the fund's:

- management and organization, including key-man risk and investment and asset class experience;
- risk management and compliance infrastructure, including operational risk controls;
- credit management standards;
- credit research staff and capabilities;
- and, the derivatives risk management program, for funds required to adopt and implement a written derivatives risk management program pursuant to Rule 18f-4 under the Investment Company Act or 1940.

The SVO may notch the final NAIC Designation down from the quantitative Credit Risk Assessment or, in its in its sole discretion and based on its analytical judgement, choose not to assign any NAIC Designation, based upon its Management Assessment.

288. **Predominantly Hold** – The fund will hold *at least* 80% of its assets in bonds if the fund is a bond fund or at least 80% of its assets in preferred stock if the fund is a preferred stock fund, *in normal market conditions* and will deviate from this policy only temporarily to respond to abnormal market conditions. In the case of an ETF, predominantly hold also means that the fund will track a specified bond or preferred stock index, if passively managed, or refers to the bond or preferred stock portfolio the fund will actually hold, if actively managed—under normal market conditions.

289. **Speculative Characteristics Analysis** – Means: ~~(a)~~ an assessment of the fund's use of ~~leverage, including, but not limited to, its use of derivatives, financial commitment~~ derivative transactions ~~and borrowings~~, to examine the impact ~~the fund's use of leverage~~ they may have on the fund's portfolio cash flow as assessed under the *credit risk assessment* under normal and abnormal market conditions~~; and (b) a review and evaluation of the fund's policy and approaches to covering leverage obligations in relation to current and potential future guidance on the issue provided by the SEC. As used herein potential future guidance refers to proposed SEC Rule 18-f-4, "Use of Derivatives by Registered Investment Companies and Business Development Companies, ICA Release No. 31933 (December 11, 2015) [17 CFR Parts 270 and 274] Proposed Rule 18-f-4."~~, such *derivative transaction exposure* not to exceed:

- (i) for funds other than funds on the NAIC Fixed Income-Like SEC Registered Funds List, 10% of the fund's net assets in normal market conditions, excluding, for purposes of determining derivatives transaction exposure, *exempt derivatives*;

and

- (ii) for funds on the NAIC Fixed Income-Like SEC Registered Funds List, 20% of the fund's net assets in normal market conditions.

~~NOTE:~~ For the avoidance of doubt, funds are not permitted to use (a) derivative instruments, under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise and (b) any short sale borrowing or other borrowings, except for exempt derivatives. Funds on the NAIC U.S. Government Money Market Fund List are not permitted to use any derivative instruments. ~~Examples of speculative characteristics may include the need to sell assets to meet leverage obligations at a loss; instability in the cash flow introduced by the use of leverage; the need to employ alternative portfolio management strategies as a result of the need to meet payment obligations; the extent to which changes in the composition of the fund's portfolio in response to abnormal market conditions may persist given the fund's leverage profile or other relevant factors. The purpose of an analysis of speculative characteristics is to determine whether the fund's cash flow is inconsistent with a fixed income like determination.~~

Methodology*

290. The SVO shall:

- Conduct a *look-through assessment*
- Conduct a *credit-risk assessment* to determine the credit risk of the fund's cash flows.
- Conduct a *management assessment*
- Conduct a *speculative characteristics analysis*.

- Determine whether the fund's cash flow can or cannot be appropriately characterized as *fixed income like* for regulatory purposes.

- For funds on the NAIC Fixed Income-Like SEC Registered Funds List, conduct an assessment of other, non-credit risks, including market and liquidity risk.

- If the SVO determines that the fund's cash flow can be appropriately characterized as fixed income for regulatory purposes, it assigns an NAIC Designation to reflect the credit risk associated with the fund's cash flow and includes the name of the fund on the appropriate NAIC List.** Since funds on the NAIC Fixed Income-Like SEC Registered Funds List are reported on Schedule D, Part 2, Section 2, in scope of *SSAP No. 30R-Unaffiliated Common Stock*, the NAIC Designation for such funds may reflect assessments of risks other than credit risk, including market risk and liquidity risk.

- If the SVO determines that the fund's cash flow cannot be appropriately characterized as fixed income for regulatory purposes it shall communicate the determination to the insurance company or fund sponsor in writing.

*** NOTE**: *Italicized text* indicates that the term used is a defined term. Please refer to the definition of the term for a description of SVO criteria associated with the methodology component being described.
**** NOTE**: The NAIC Designation does not address the fund's ability to meet payment obligations because the insurer/shareholder does not own the bonds in the portfolio; the NAIC Designation instead conveys the credit risk/quality of the fixed income like cash flow generated by the ETF.

Documentation

291. An insurance company or the sponsor of a bond or preferred stock fund that request that the SVO conduct the look through and credit assessment submits the following required documentation to the SVO:

- A completed RTAS Application (Information about the RTAS process is contained here: *www.naic.org/documents/svo_rtas_app.pdf*. Funds with derivatives may be considered a Highly Customized Transaction.

- For all funds subject to look-through and credit risk assessment and to speculative characteristics analysis: the Prospectus and Statement of Additional Information (SAI) for the fund.

- For funds which use derivative instruments or repurchase agreements, the applicable legal documentation.

- In the case of an ETF, copies of the Application, Notice and Order associated with the fund sponsor's request for Exemptive Relief from the SEC or a link to the SEC's EDGAR where the SVO can obtain the documents.

- In the case of a private equity fund, the Private Placement Memorandum, Limited Partnership Agreement or Limited Liability Company Agreement, the Subscription Agreement and the Form D, if one has been filed.

NOTE: The documentation provided must enable the SVO to conduct the analysis described below. Applicants are free to provide any supplemental material they believe will assist the SVO to:

- Verify that the fund has adopted a *fundamental (stated) policy* to *predominantly hold bonds* (or preferred stock).
- Evaluate the fund's use of leverage in relation to the management of portfolio risk and in relation to other purposes relevant to the *speculative characteristics analysis*.
- Understand the fund's policy and approaches to coverage of obligations arising from the use of leverage, in relation to SEC guidance on the subject.
- Schedules of the fund's portfolio securities and assets with a description of the security, the CUSIP or other security identifier and NRSRO credit ratings for the last four quarters of the fund's existence.
- A description of likely changes in the fund's composition under normal market conditions given the fund's investment objective and the strategies to be employed to attain it.

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ACLI Financial Security for Life

NASVA

PPiA
Private Placement investors Association
John Petchler, on behalf of the PPiA Board of Directors

Mike Monahan
Senior Director, Accounting Policy
(202) 624-2324
mikemonahan@acli.com

May 6, 2021

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Ms. Carrie Mears, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Add Additional Instructions to the Review of Funds

Dear Mr. Fry and Ms. Mears,

The American Council of Life Insurers ("ACLI")[1], Private Placement Investors Association ("PPiA")[2], and North American Securities Valuation Association ("NASVA")[3] (collectively, the "undersigned") appreciate the opportunity to comment on the proposed amendment to the P&P Manual.

The undersigned support these proposed amendments to the P&P Manual and believe they pragmatically address risks associated with derivatives, is consistent with the recent SEC guidance, and provides additional transparency.

---

[1] The *American Council of Life Insurers* ("ACLI") is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

[2] The *Private Placement Investors Association* ("PP*i*A") is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PP*i*A serves 63 member companies and works with regulators, NASVA, the American College of Investors Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace. Learn more at www.usppia.com.

[3] The *North American Securities Valuation Association* ("NASVA") is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes. Find more information here

We continue to support the SVO's stated (and regulator's) objective for funds to be assigned an NAIC Designation and obtain applicable risk-based capital charges, if the portfolio generates predictable and periodic cash flows so similar to a bond (or preferred stock).

We also continue to support extending such treatment for funds on the "NAIC Fixed Income-Like SEC Registered Funds List" that are currently in the scope SSAP No. 30R – Unaffiliated Common Stock and believe the SVO's proposed guidance provides appropriate clarity and reasonableness as a foundation toward achieving this end.

***

We thank the SVO, and regulators, for their continued dialogue on these and other important issues. We continue to stand ready and offer our assistance and input as needed.

Sincerely,

MMonahan   Tracey Lindsey   John Petchler

Mike Monahan	Tracey Lindsey	John Petchler
American Council of Life Insurer	NASVA	on behalf of PPiA Board of Directors

cc: Charles Therriault, Director, Securities Valuation Office

AI Anderson Insights, LLC

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5 May, 2021

Kevin Fry
Chair, NAIC Valuation of Securities (E) Task Force
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108

Via email

Re: Comments on Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Add Additional Instructions to the Review of Funds

Dear Mr. Fry and Task Force Members:

In reviewing the captioned Proposal, it is clear that insufficient attention has been paid to the derivative instruments that staff has recently stated are present in many, perhaps most, of the ETFs on the SVO's ETF Bond List. Derivatives held in any form deserve extra scrutiny, particularly when present in portfolios held by insurance companies. This letter discusses that phenomenon and makes recommendations regarding five specific provisions of the proposed language. The Proposal quotes selectively from the Securities and Exchange Commission's guidelines in Rule 18f-4 and contorts and redefines those guidelines. Rather than better controlling or monitoring the use of riskier derivative instruments in ETFs, the Proposal allows for greater freedom to use leverage to boost returns while increasing risk. I believe that a few key changes will make this Proposal far more effective in protecting insurance companies and hence policy holders. Derivatives have a very bad reputation for good reason and the SVO's Proposal must be improved to take this into account.

¶281 Derivative Transactions This section of the Proposal defines what exactly constitutes a derivative transaction. The staff is clearly using the SEC's Rule 18f-4. The wording in this section of the Proposal is a verbatim copy of SEC 18f-4, with two words changed. However, the staff does not disclose that it changed these words from the SEC rule, and this change literally inverts the SEC rule. Please see the difference highlighted below:

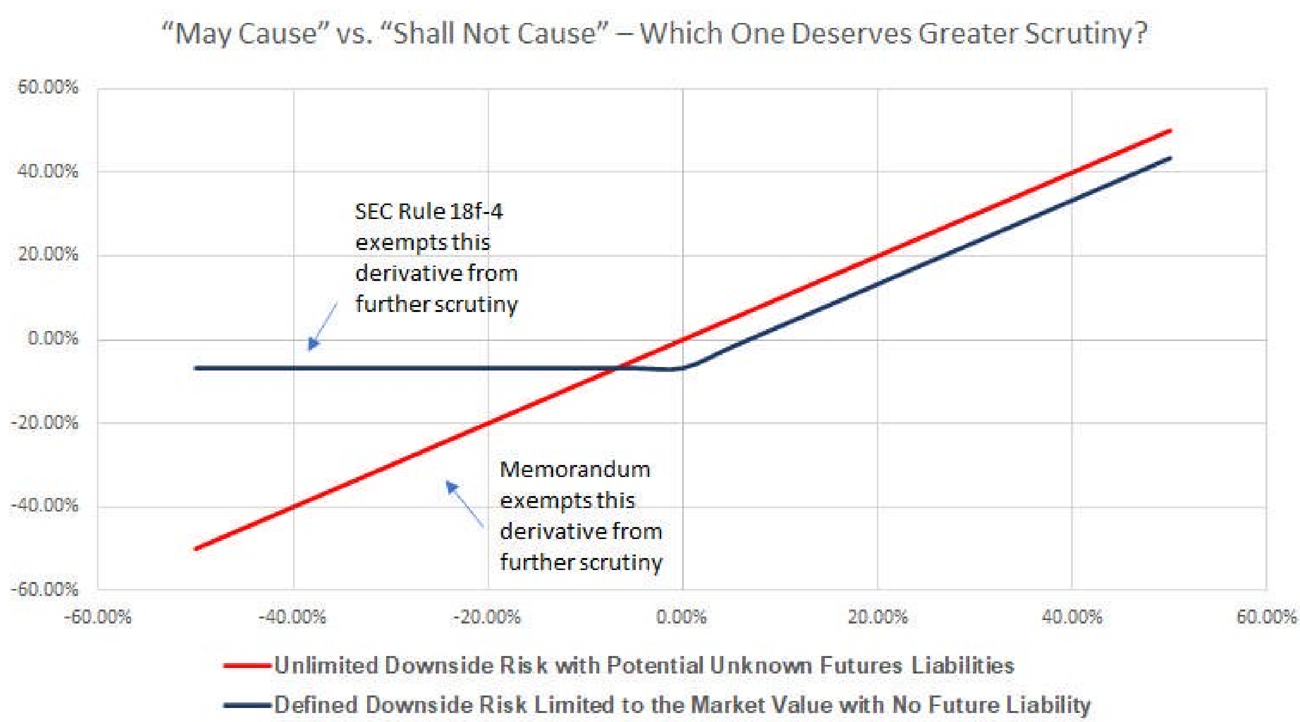
> SEC Rule 18f-4:
>
> "means any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise ... "

¶281 of the Proposal:

"means any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or ~~may~~ shall not be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise ... "

By changing these words, staff completely inverts the SEC definition in such a way as to cause it to include certain instruments that the SEC was purposefully trying to exclude. The goal of the definition in ¶281, according to the Proposal itself, is to limit funds from "...magnify(-ing) its gains and losses compared to the fund's investment, while also obligating the fund to make a payment or deliver assets to counterparty under specified future conditions." This is a reasonable and understandable goal. But by changing the SEC's language, this modified definition does exactly the opposite.

As an example, let us imagine two different derivative instruments:



In the chart above, the red line shows the payout from a derivative that "*may*" (the actual SEC18f-4 definition) cause its owner to make a future payment. As we can see, such derivatives are inherently riskier as their possible future losses are unknown and limitless. In fact, this is exactly the type of derivative owned by Archegos. It *did* cause its owner to make a future payment, in an amount greater than the company could pay. The same type of derivative brought down Barings Bank. This is precisely why derivatives that "may" force ETFs to make future payments are given greater scrutiny by the SEC under Rule 18f-4.

On the other hand, the blue derivative has defined and controlled downside risk that limits the risk to the market value of position. There is no obligation by the ETF to make a future payment.

Additionally, it is noted that staff used the unaltered language from SEC 18f-4 (reverting to the use of "may" in place of "shall not") in ¶289, thereby making the change here in ¶281 seem even more out of place. In essence, the Proposal literally contradicts itself by defining a derivative in diametrically different ways in two places. Yet, there is no acknowledgement of or justification for this very material modification which literally flips the meaning of 18f-4 on its head, even while retaining the actual SEC rule later in the document.

Recommendation: Adopt the SEC language without alteration in ¶281 just as staff has done in ¶289, because instruments that can cause magnification of gains/losses should continue to be defined as derivatives and those that are out of scope should be excluded as the SEC has determined.

¶282. Exempt Derivative

This section seeks to define which derivatives would be exempt from the Proposal. It is somewhat confusing as "derivative transactions" were just defined in the immediately preceding ¶281and derivatives that do not contain obligations in the future are already exempted by virtue of that definition.

Recommendation #1: Adopting the SEC language as written (as recommended for ¶281) would eliminate the need for this provision.

Recommendation #2: Staff should ensure that "exempt derivatives" are truly exempt. The SVO is uniquely positioned to make sure that ETF portfolios with exempt derivatives are able to document how their hedges are applied to other positions. For now, there appears to be little or no scrutiny at the position level to determine if "exempt derivatives" truly are complying with this language.

¶287 Management Assessment

This is a completely new provision, and it should be eliminated for several reasons.

First, given the priorities of the VOSTF it is difficult to imagine how directing the SVO to conduct management analyses of funds is a reasonable use of scarce resources. Management assessments are commonplace for rating agencies and examiners and they can assist significantly in the credit evaluation process. To the best of my knowledge, however, that the SVO does not perform such assessments currently and has not done so in the past at least not on any significant scale. If the SVO had the capacity, expertise and guidelines to begin these assessments, it would be far more logical to do so for "issuer obligations" where the role of management is much more significant and impactful than for funds.

Second, the SVO proposes for itself a new role evaluating the experience, management, compliance, and operations of ETF managers. All listed ETF Bond Funds are '40 Act Funds under the regulatory purview of the SEC, which has a vast staff with the resources, expertise and enforcement powers to evaluate management companies in a much more rigorous way. The SEC already monitors and evaluates all listed ETF managers for experience, management, compliance, and operations. It is unlikely that a review by the SVO would be anywhere near as thorough as an SEC examination. It would, however, divert staff and resources to a new mission which is already being performed by a regulatory agency with much greater investigative authority and capacity for this work.

Third, allowing the SVO "in its sole discretion" to override its own rules and procedures opens the NAIC and the entire process of rating funds up to legal risks. If the NAIC has gone through the trouble to write the P&P Manual, it should insist that its rules be followed. Either the rules are applied fairly and evenly to all, or they are not rules. Allowing the SVO to make a determination “in its sole discretion” without standards or review provisions is clearly bad policy and governance.

Recommendation #1: Remove ¶287. Developing an entirely new set of standards, mechanisms, review processes and controls to evaluate the managements of funds is unnecessary when such work is already done by the SEC. If the SVO believes its role is to evaluate management, it should first develop its methodology in other asset classes in which management plays a far more consequential role and submit them to the VOSTF for review and approval.

Recommendation #2: Additionally, remove the sentence “Conduct a management assessment” from ¶290 Methodology for conformity.

¶291 Documentation

Staff proposes that it be permitted to consider funds with derivatives to be considered as "Highly Customized Transactions". The SVO has been evaluating funds on the ETF Bond list for many years and recently acknowledged that "...most, if not all, ETFs have provisions in their prospectus allowing them (derivatives)." The effect of classifying an asset as a HCT is to exempt it from the SVO's published and approved fee schedule. In other words, under this Proposal the SVO may, on its own authority and with no review process, subject a filing to whatever fee it determines.

Recommendation: This new SVO authority should be reviewed very carefully by the VOSTF to determine whether, after many years of reviewing these transactions on a standard fee schedule, they should be subjected to new unpredictable fees solely because they contain derivative instruments. The SVO should consider specifying under which conditions it treats funds with derivatives as HCTs. It would be bad and risky policy simply to apply different fees to issuers without reasonable bases for doing so.

¶289 Speculative Characteristics Analysis

In the last paragraph of this Analysis section, it is observed that staff proposes a prohibition on the use of "...derivative instruments, under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise and (b) any short sale borrowing or other borrowings, except for exempt derivatives..." It is noted that that is an exact recitation of SEC 18f-4 as written.

This is a very reasonable proposal that will likely reduce the risk of ETFs on the bond list and reduce the use of risky, highly speculative instruments.

Recommendation: This provision is supported. Staff should be specifically charged to review the prospectus of each ETF fund on the bond list with regard to the specific derivative instruments that are authorized so that this provision will be effectively enforced. Is very likely that there are dozens of ETFs currently on the NAIC bond list which are in violation of this proposed rule and which may own Archegos-type derivatives in their portfolios. The SVO is uniquely positioned and qualified to monitor and enforce this provision.

Attachment Four – D
Valuation of Securities (E) Task Force
7/15/2021

In summary, I hope these suggestions will be received as the constructive comments they are intended to be and look forward to discussing them in any venue.

Sincerely,

Christopher Anderson

copy:
Mr. Charles Therriault, CFA
Ms. Denise Genao-Rosado

May 6, 2021

Kevin Fry, Chair, Valuation of Securities (E) Task Force (VOSTF)
Charles Therriault, Director, NAIC Securities Valuation Office (SVO)

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Add Additional Instructions to the Review of Funds

Dear Messrs. Fry and Therriault,

We appreciate the opportunity to comment on the proposal exposed by the VOSTF with a deadline of May 6, 2021. On behalf of Payden & Rygel and our insurance clients, we appreciate the general thesis of the proposal, but we do have some general concerns and comments.

The SVO references SEC Rule 18f-4 and their definition of a limited user of derivatives. This rule was adopted on October 28, 2020 and came into effect February 19, 2021. However, Fund companies do not need to fully comply until August 19, 2022. At this time, investment managers of the sponsored Funds are formulating best practices and have not fully digested the new rule. We recommend the VOSTF delay the final amendments to the P&P Manual until those best practices are determined.

In regards to Management Assessment, more concrete measurements are appreciated. The introduction of subjective measures into an NAIC Designation invites confusion and room for discrepancies. Additional detail related to what the SVO believes are best practices or deficiencies will help set expectations for Fund companies. Similarly, we would recommend the SVO create an outcome report related to their Management Assessment, especially if it leads to notching of the final NAIC Designation. Lastly, what is the resolution process if a filer disagrees with this notching?

If VOSTF and SVO are open to further consideration, we are happy to gather additional Fund management companies to formalize detailed feedback and ideas for your consideration.

Thank you,

Erinn R. King, CFA
Principal, Payden & Rygel

Eric M. Hovey, CFA
Senior Vice President, Payden & Rygel

cc: Denise Genao-Rosado, Marc Perlman, and Eric Kolchinsky

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NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Filing Exemption for Real Estate Lease-Backed Securities

DATE: May 27, 2021

Summary – The SVO staff drafted the attached amendment at the request of the Task Force, based on a proposal referred to the Task Force by the Statutory Accounting Principles (E) Working Group (the Working Group) chairs, intended to clarify the difference between Credit Tenant Loans and real estate lease-backed securities for purposes of amending the Filing Exemption eligibility for each. Initially, at the Task Force's request, the SVO drafted an amendment to the P&P to permit Credit Tenant Loan (CTL) and Ground Lease Financing (GLF) transactions to use NAIC Credit Rating Provider ratings in the Filing Exemption process and update the residual asset exposure from the current 5% limitation to 50%. If these transactions have greater than a 50% residual asset exposure, they would be ineligible for Filing Exemption. The Working Group chairs proposed an alternate amendment intended to achieve a similar outcome but without requiring the Task Force to opine on acceptable residual thresholds, which is under the purview of the Working Group.

The Working Group chairs contend that the original intent of the CTL provisions when adopted in the 1990s was to allow certain mortgage loans, as currently defined in SSAP No. 37, to be reported on Schedule D-1 as opposed to Schedule B due to the reliance on the creditworthiness of a credit tenant. CTLs have evolved from direct "mortgage loan" structures to "securities" which are expressly excluded from the definition of "mortgage loan" in SSAP No. 37. As such, the Working Group chairs proposed modifying the P&P definition of CTL by clarifying that CTLs only refer to "mortgage loans in scope of SSAP No. 37," and, by default, not "securities," which would be in scope of SSAP Nos. 26R or 43R. Real estate lease-backed securities would include CTL-like transactions which meet all the CTL guidelines in the P&P but for a feature making it a security, such as a trust issued certificate, CTL-like securities with balloon payments in excess of 5%, and ground lease financings which do not include a direct mortgage loan from the investor.

Pursuant to the proposed amendment the Working Group would not need to opine on a residual threshold at this time and the Task Force could make its own determination about the Filing Exempt status of these transactions. At the request of the Task Force the amendment would only require CTLs with mortgage loans in scope of SSAP No. 37 to be filed with the SVO for review and potential assignment of an NAIC Designation. All other real estate lease-backed transactions which meet the definition of a "security" would be eligible for Filing Exemption, and have the option to file with the SVO.

Proposed Amendment - The text impacting Credit Tenant Loan and Ground Lease Financing Transactions is shown below, addition edits in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2020 P&P Manual format.

PART ONE

POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE

CREDIT TENANT LOANS

CTL Categories

100. Mortgage loans, in the scope of SSAP No. 37, that are made primarily in reliance on the credit standing of a major tenant, structured with an assignment of the rental payments to the lender with real property pledged as collateral in the form of a first lien, are referred to as a Credit Tenant Loan. Four categories of CTLs are recognized as eligible for reporting on Schedule D: Bond Lease Based CTLs; Credit Lease Based CTLs; Acceptable CTL Variants (ACVs); and Multiple Property Transactions (MPTs).

...

GROUND LEASE FINANCING TRANSACTIONS

...

108. The ground lease itself typically meets the Credit Tenant Loan (CTL) criteria for Bond Lease Based or Credit Lease Based CTLs in this Manual and is in scope of SSAP No. 37 – Mortgage Loans. Additionally, there can be one or several space tenants or business operators (which (a) may or may not be NAIC CRP rated entities or (b) whose credit worthiness can or cannot be evaluated by the SVO) making lease payments under separate space leases (which may or may not meet the CTL criteria) or a business operation. As such, the SVO cannot rely solely on the CTL criteria for its analysis of GLF transactions and instead must rely on a combination, as necessary and available, of the CTL criteria, the CMBS criteria, the documented analysis of NAIC CRPs, and the SVOs own analytic judgement.

...

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

PROCEDURE APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL) RATING SECURITIES

...

FE SECURITIES

Filing Exemption

3. Bonds, within the scope of SSAP No. 26R and SSAP No. 43R (excluding RMBS and CMBS subject to financial modeling) and Preferred Stock within scope of SSAP No. 32, that have been assigned an Eligible NAIC CRP Rating, as described in this Manual, are exempt from filing with the SVO (FE securities) with the exception of Bonds and/or Preferred Stock explicitly excluded below.

Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

. . .

- **Credit Tenant Loan (CTL)** – A CTL is a mortgage loan, in scope of SSAP No. 37, made primarily in reliance on the credit standing of a major tenant, structured with an assignment of the rental payments to the lender with real property pledged as collateral in the form of a first lien. This Manual identifies four categories of CTLs as eligible for reporting on Schedule D conditioned on an SVO determination that the transaction meets the criteria specified by the VOS/TF for Schedule D treatment. A transaction that purports to be a Credit Tenant Loan, including one that is assigned a credit rating by an NAIC CRP, is not eligible for Schedule D reporting unless the SVO confirms that the transaction is eligible for Schedule D reporting and assigns the transaction an NAIC Designation. A security which resembles a CTL but is not in scope of SSAP No. 37 – Mortgage Loans, can be filed with the SVO for an NAIC Designation and, if appropriate, the SVO can apply the CTL guidelines in this Part to its review.

  . . .

- **Ground Lease Financing Transactions** – A Ground Lease Financing (GLF) transaction typically has two components: (a) a ground lease for a long period (e.g., 99 years) between a ground lessor who owns the land and a ground lessee who attains a leasehold for the purpose of developing the land; and (b) the subleasing of space or operation of a business such as a hotel, warehouse, intermodal facility, etc., in an existing or to-be-constructed building to one or more tenants (space tenants) under shorter (e.g., 5–15 year) leases (space leases) or to the operator of a business such as a hotel, warehouse, intermodal facility, etc., under a franchise agreement or other arrangement. GLF transactions, in scope of SSAP No. 37 – Mortgage Loans, are not eligible for filing exemption. The GLF section in this Part provides further guidance on how the SVO analyzes GLF transactions for purposes of determining Schedule D eligibility and whether the SVO can assign an NAIC Designation. A security which resembles a GLF transaction but is not in scope of SSAP No. 37 – Mortgage Loans, can be filed with the SVO for an NAIC Designation and, if appropriate, the SVO can apply the GLF guidelines in this Part to its review.

CREDIT TENANT LOANS

...

GENERAL

SVO Procedure

85. Upon receipt of an Evaluation Form, the SVO analyst shall first review the Evaluation Form and other documents submitted by an insurer to verify that the transaction reflects appropriate CTL criteria. If the information provided on the Evaluation Form suggests that the transaction is likely to reflect all appropriate CTL criteria, the analyst shall proceed to determine either: (a) the transaction reflects risk consistent with the definition and other criteria for the category; or (b) the transaction contains risks different from those normally associated with Schedule D transactions.

86. Where, in the opinion of the analyst and where otherwise appropriate, the risk presented by the transaction is inconsistent with the definition and other criteria for the CTL category but is consistent with ~~Schedule D~~ reporting a security with an NAIC Designation, the analyst may reflect the additional risk by adjusting the Designation for the transaction downward and away from the credit rating category assigned to the lessee. ~~If the analyst concludes that the transaction contains risks different from those normally associated with Schedule D, the transaction shall be rejected as ineligible for Schedule D reporting.~~

ACCEPTABLE CTL VARIANTS

...

Guidelines for Acceptable CTL Variants

97. Transactions that exhibit the following variations from the definitions of Bond Lease or Credit Lease Based CTL contained above will nevertheless be eligible for Schedule D treatment in accordance with these guidelines and the definitions if the following standards are met:

. . .

- Use of collateral trustee and issuance of trust certificates. The use of a collateral trustee, or trust certificates, has no impact on eligibility for CTL treatment if the transaction continues to be a mortgage loan in scope of SSAP No. 37. Staff will, of course, review appropriate documentation associated with the arrangement.

GROUND LEASE FINANCING TRANSACTIONS

…

DEFINITION AND OVERVIEW

Ground Lease Financing Transaction – Definition and Overview

108. A ground lease financing (GLF) transaction is in scope of SSAP No. 37 – Mortgage Loans and typically has two components: (a) a ground lease for a long period (e.g., 99 years) between a ground lessor who owns the land and a ground lessee who attains a leasehold for the purpose of developing the land; and (b) the subleasing of space or operation of a business such as a hotel, warehouse, intermodal facility, etc., in an existing or to-be-constructed building to one or more tenants (space tenants) under shorter (e.g., 5–15 year) leases (space leases) or to the operator of a business such as a hotel, warehouse, intermodal facility, etc., under a franchise agreement or other arrangement.

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NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force

FROM: Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group
Carrie Mears, Vice-Chair of the Statutory Accounting Principles (E) Working Group

RE: Proposed VOSTF Attachment B – Filing Exemption for CTLs

DATE: May 21, 2021

After a detailed review of the proposed revisions within Attachment B of the Valuation of Securities (E) Task Force meeting materials for Monday, May 24, it appears that the proposed revisions go beyond providing a filing exemption to allow non-SVO assigned designations. Rather, the edits also appear to modify the structural requirements for credit tenant loans (CTLs), and would thus permit direct mortgage loans, in scope of SSAP No. 37 and reported on *Schedule B—Mortgage Loans*, to be reclassified from Schedule B to *Schedule D-1—Long-Term Bonds* with up to 50% residual risk and a CRP rating, without any SVO structural assessments.

From prior review of the history of the CTL provisions, the original intent was to permit mortgage loans, captured on Schedule B, to be reclassified to Schedule D-1 based on the credit standing of a major tenant, but only if there was very limited residual risk (5%). Over time, the structure of these investments has shifted, but not the name used, and it is believed that most designs now meet the definition of a **security** and not a **mortgage** loan. Further, since the scope of *SSAP No. 37—Mortgage Loans* specifically excludes securities, these revised investment designs would not be captured in scope of SSAP No. 37 and not reported on Schedule B. Rather, under the existing guidance in the *Accounting Practices and Procedures Manual*, securities that reflect a creditor relationship, whereby there is a fixed schedule for one or more future payments, are captured in scope of *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities* and reported on Schedule D-1.

Although the process to assess whether **securities** with underlying real estate risk shall be subject to filing exempt provisions or be submitted to the NAIC SVO for a credit assessment is a decision of the Task Force, as noted above, the current proposed revisions do not appear to be limited to that aspect. To prevent inadvertent application of the proposed revisions to direct **mortgage** loans, and to clarify that **securities** (SSAP No. 26R/SSAP No. 43R) shall be reported in accordance with existing AP&P Manual guidance, it is suggested that the Task Force reconsider the proposed exposure of Attachment B. Instead, it is recommended that the Task Force expose proposed edits to the *Purposes and Procedures Manual* to clarify that in all instances in which a CTL is defined, it is noted to be a **mortgage** loan "in scope of SSAP No. 37." It is noted that this limited edit would clarify that the application of the structural assessment of CTLs is limited to direct **mortgage** loans and relates to the potential reclassification from Schedule B to Schedule D for those investments. Furthermore, it would clarify that **securities** are not subject to the CTL structural assessments and

should continue to be reported in accordance with the scope provisions of the guidance within the AP&P Manual.
Examples of the proposed recommendations are shown below:

P&P Manual, Page 101 – FE Securities:

> **Credit Tenant Loan (CTL)** – A CTL is a mortgage loan, in scope of SSAP No. 37, made primarily in reliance on the credit standing of a major tenant, structured with an assignment of the rental payments to the lender with real property pledged as collateral in the form of a first lien. This Manual identifies four categories of CTLs as eligible for reporting on Schedule D conditioned on an SVO determination that the transaction meets the criteria specified by the VOS/TF for Schedule D treatment. A transaction that purports to be a Credit Tenant Loan, including one that is assigned a credit rating by an NAIC CRP, is not eligible for Schedule D reporting unless the SVO confirms that the transaction is eligible for Schedule D reporting and assigns the transaction an NAIC Designation.

P&P Manual, Page 29 – Credit Tenant Loans:

CTL Categories

> 100. Mortgage loans, in scope of SSAP No. 37, that are made primarily in reliance on the credit standing of a major tenant, structured with an assignment of the rental payments to the lender with real property pledged as collateral in the form of a first lien, are referred to as a Credit Tenant Loan. Four categories of CTLs are recognized as eligible for reporting on Schedule D: Bond Lease Based CTLs; Credit Lease Based CTLs; Acceptable CTL Variants (ACVs); and Multiple Property Transactions (MPTs).

If the limited edits, as shown above, are incorporated, than further revisions to the P&P Manual, particularly to the structural assessment for CTLs and the existing 5% residual risk threshold, are not expected to be needed at this time. It is also believed that this will resolve the current uncertainty and inconsistency with regards to the reporting of **securities** that have underlying elements of mortgage loan or real estate risk. Although these revisions will clarify the current ability to report **securities** that represent a creditor relationship under the existing bond definition, it is noted that a current project is underway to establish principles to clarify what should be considered a bond for reporting on Schedule D-1. Once that project is finalized, **security** structures that do not qualify under those bond principles will be reclassified to a more appropriate schedule.

Thank you for considering this revised proposal. Please contact Dale Bruggeman, or Carrie Mears, SAPWG Chair and Vice Chair, with any questions on this memorandum.

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ACLI
Financial Security for Life

NASVA

PPiA
Private Placement investors Association
John Petchler, on behalf of the PPiA Board of Directors

June 28, 2021

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Ms. Carrie Mears, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) on Filing Exemption for Real Estate Lease-Backed Securities

Dear Mr. Fry and Ms. Mears,

The American Council of Life Insurers ("ACLI")[1], Private Placement Investors Association ("PPiA")[2], and North American Securities Valuation Association ("NASVA")[3] (collectively, the "undersigned") appreciate the opportunity to comment on the above-referenced proposed amendment to the P&P Manual.

The undersigned appreciate all the effort of the Valuation of Securities Task Force ("VOSTF") and Securities Valuations Office ("SVO") on Credit Tenant Loans and other Real Estate Lease-Backed Securities over the last several years.

As these securities are valuable investments for insurers, and ultimately regulators and policyowners, we would like to offer our full support for the proposed changes as outlined in the exposure. We believe the exposure is the culmination of a years' long joint effort, in both collaboration and information sharing,

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[1] The *American Council of Life Insurers* ("ACLI") is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

[2] The *Private Placement Investors Association* ("PP*i*A") is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PP*i*A serves 63 member companies and works with regulators, NASVA, the American College of Investors Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace. Learn more at www.usppia.com.

[3] The *North American Securities Valuation Association* ("NASVA") is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes. Find more information here

that appropriately treats these securities consistent with other similar securities and is also consistent with Statutory Accounting Principles Working Group's (SAPWG's) recently exposed definition of a bond for purposes of Schedule D reporting.

We again sincerely thank the VOSTF, SVO, and regulators for their sustained dialogue on this important matter and we continue to stand ready to offer our assistance and input as needed.

Sincerely,

	Tracey Lindsey	*John Petchler*
Mike Monahan	Tracey Lindsey	John Petchler
American Council of Life Insurer	NASVA	on behalf of PPiA Board of Directors

cc: Charles Therriault, Director, Securities Valuation Office

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Lease-Backed Securities Working Group

To: Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Ms. Carrie Mears, CFA®, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

June 25, 2012

Re: **Proposed Amendments to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) Regarding Filing Exemption for Real Estate Lease-Backed Securities.**

The members of the Lease-Backed Securities Working Group wholly support the changes which have been proposed to the *Purposes and Procedures Manual of the NAIC Investment Office* (P&P Manual) clarifying that any real-estate lease-backed transactions issued in the form of securities are eligible for Filing Exempt status in a manner similar to any other bonds.

We strongly agree with the comments which have been submitted in a joint letter from ACLI, the PPiA and NASVA regarding this exposure, which appropriately treats these securities consistent with other similar securities, and is also consistent with Statutory Accounting Principles Working Group's (SAPWG's) recently exposed definition of a bond for purposes of Schedule D reporting.

This exposure is the culmination of a years' long joint effort, in both collaboration and information sharing between regulators and the investment community. We applaud the work that has been done by the members of both the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force, as well as the staff at the Securities Valuation Office, to bring about these changes, which we believe will provide much-needed clarity to the investor community and allow markets which are essential to providing capital to mission critical facilities and infrastructure to reopen once again.

We greatly appreciate your continued time, efforts, and consideration of the proposed changes and clarifications to the P&P Manual and look forward to their speedy adoption.

Sincerely,

JMGarrison

John M. Garrison
On behalf of the *Lease-Backed Securities Working Group*

Cc: Charles Therriault
Mike Monahan
Mike Reis
Brian Keating
John Petchler
Tracey Lindsay

National Association of Insurance Commissioners
The Center for Insurance Policy and Research

MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Incorporate Updates Made to SSAP No. 105R – Working Capital Finance Investments.

DATE: September 10, 2020

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1. **Summary –** The Statutory Accounting Principles (E) Working Group adopted updates to SSAP No. 105R Working Capital Finance Investments on May 20, 2020. Key revisions are summarized as follows:

- Functionally Equivalent Foreign Regulators - Removed the requirement that the Securities Valuation Office (SVO) determine if the International Finance Agent is the functional equivalent of the U.S. regulator.
- Commingling Prohibitions - Removed the finance agent prohibitions on commingling.
- Investor Rights Edit - Removed duplicative text regarding exercising of investor rights.
- Requirements for filer to Certify Perfected Interest – Removed requirements, with revisions allowing the SVO to determine if a first priority perfected interest has been obtained.
- Finance Agent Validation Requirements – Broadened the independent review requirements to allow independent review of the finance agent by either audit or through an internal control report.
- Default Date - Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent.
- Possible Domestic Regulator Approval – Removed the statement that the reporting entity may need to seek approval from the domestic regulator.

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2. **Revisions -** The SVO submitted a proposed amendment to the Valuation of Securities (E) Task Force (the Task Force), dated June 15, 2020, to amend the Working Capital Finance Investments (WCFI) section of the P&P Manual to remove any inconsistencies with SSAP No. 105R, as revised. The proposed amendment was received and exposed on July 1, 2020 for a 45-day public comment period that ended on August 17, 2020. The American Council of Life Insurers (ACLI) submitted a detailed comment letter, dated August 17, 2020, recommending additional updates to this section. The SVO staff has reviewed the ACLI's recommendations and has attached an updated proposed amendment that reflects where the SVO agrees with the ACLI and, as explained below, where it does not.

Generally, the ACLI's recommendations fall into two categories: (1) those which remove inconsistencies between SSAP No. 105R and the WCFI section of the P&P Manual, thereby adhering to the original purpose of this amendment and, (2) those which would amend WCFI provisions in the P&P Manual which are not identified in SSAP No. 105R and which would impede the SVO's ability to assess investment risk in WCFI transactions. These analytic provisions were intentionally included in the P&P Manual's WCFI guidelines to enable the SVO to more accurately assess investment risk in WCFI transactions and they reflect the functional differences between the Accounting Practices & Procedures Manual (AP&P), which is intended to define accounting standards, and the P&P Manual, which is intended guide the assessment of investment risk. The AP&P is not intended to be a substitute for the P&P Manual as only the Task Force is charged to, "… establish and maintain all aspects of the NAIC's credit assessment process for insurer-owned securities." The SVO staff has identified the analytical issues below that should be retained in the P&P Manual. These changes are outside of the scope of the SSAP 105R revisions and are necessary for the SVO to perform its responsibility to assess investment risk.

a. **A Certification** (paragraph 102, bullet 5) from the insurance company Investment Officer that the insurance company, in its capacity as an Investor, is not affiliated with the Obligor or with any Supplier in the Working Capital Finance Program, and that the Working Capital Finance Program does not include any insurance or insurance related assets. *This certification relates to the requirements of SSAP No. 105R, paragraph 19 and provides a means by which the SVO can verify that a transaction meets those requirements.*

b. **Process and Methodology (**paragraphs 121) - An NAIC Designation shall be assigned to a Working Capital Finance Program on the basis of a thorough assessment of credit, dilution, operational and other risks, an assessment of protections provided by operative documents to the Investor and the quality of transaction participants. *The assessments of credit, dilution and operational risk are core components of the SVO investment risk assessment for WCFI transactions and none of them conflict with SSAP No. 105R.*

c. **Credit Risk (**paragraphs 122) – The NAIC Designation for a Working Capital Finance Program shall be linked to the credit quality of the Obligor, which may be determined by reference to a credit rating assigned by a NAIC CRP or by an NAIC Designation assigned by the SVO. Credit risk is assessed by the SVO analyst in accordance with any permitted methodology set forth in this Manual for corporate obligors. *The assessments of credit is a core component of the SVO investment risk assessment for WCFI transactions and does not conflict with SSAP No. 105R.*

d. **Dilution Risk** (paragraphs 107, 121, and 123) – *This element of the SVO's analysis is crucial for an accurate assessment of investment risk because it is necessary for the SVO to consider the risk that disputes or certain contractual provisions may reduce the amount of the obligation owed by the obligor to the supplier and thereby impact the insurance company investor.*

e. **Operational Risk (**paragraphs 111, 121, and 124) – *This element of the SVO's analysis is crucial for an accurate assessment of investment risk because it is necessary for the SVO to consider the risk that the parties involved in the program will not fulfill their contractual responsibilities. This is a common investment analysis consideration as reflected in the methodology to review Power Generation Projects in Part Three of the P&P Manual.*

3. **Recommendation** – The SVO staff recommends re-exposure of this amendment with the changes recommended by the ACLI, excluding the analytically necessary items identified above, to align with the adopted updates to *SSAP No. 105R – Working Capital Finance Investments.*

4. **Proposed Amendment –** The following shows the proposed revisions in Part Three with text in red identifying the changes proposed on July 15, 2020 and additional revisions and comment letter responses in yellow highlight.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

WORKING CAPITAL FINANCE INVESTMENTS

NOTE: See "Specific Populations of Securities Not Eligible for Filing Exemption" in "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" above.

Initial Filing Requirements

102. An insurance company requesting an analysis of a proposed Working Capital Finance Program shall provide the SVO with the documentation described in this subparagraph:

- An RTAS Application.
- The Obligor's Audited Financial Statements, if the Obligor is not rated for credit risk by a NAIC CRP.
- The insurance company's Investment Committee Memorandum for the proposed Working Capital Finance Program.
- ~~The audited consolidated financial statements of the group of which the Finance Agent for the Working Capital Finance Program is a part, and o~~One of the following:
  - An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment.
  - An annual audit of the financial statement and internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weakness related to servicing working capital financial investments.
- A Certification from ~~an the~~ insurance company's ~~Chief~~ Investment Officer that the insurance company, in its capacity as an Investor, is not affiliated with the Obligor or with any Supplier in the Working Capital Finance Program, and that the Working Capital Finance Program does not include any insurance or insurance related assets.
- ~~A Certification from the insurance company's Legal Counsel~~.
- ~~**In the case of a participation**, that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code's standards for creating and preserving first priority security interests in the payments due and in the Confirmed Supplier Receivables.~~

- ~~**In the case of a certificate**, note or other manifestation, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, that it has a commercially reasonable belief that the documents establishing and governing the Working Capital Finance Program create and preserve interests in the Confirmed Supplier Receivables capable of being enforced by the trustee or other entity holding Confirmed Supplier Receivables as first priority perfected security interests under the Uniform Commercial Code.~~

  ~~**NOTE**: Please refer to *SSAP No. 105—Working Capital Finance Investments* for the definition of a "commercially reasonable belief."~~

- A copy of:
  - The document(s) that create the Working Capital Finance Investments (i.e., the short-term receivables) that is the subject of the RTAS – Emerging Investment Vehicle Service Application, and establishes the obligations of the Obligor to, and the protection afforded owners of, Working Capital Finance Investments (including the Investors). This agreement is sometimes referred to as the Invoice Payment Terms Acknowledgement, the Payable Services Agreement or the Paying Services Agreement.

    NOTE: Please refer to "The Regulatory Treatment Analysis Service – Emerging Investment Vehicle" in Part Two for guidance regarding the filing of an RTAS Application with the SVO.
  - The agreement(s) between the Obligor and the Finance Agent governing the administration of the Working Capital Finance Program and the Working Capital Finance Investments issued thereunder. These agreements may be included in the documents mentioned above or may be a stand-alone agreement which are sometimes referred to as the Settlement Services Agreement or the Invoice-Related Electronic Services Agreement.
  - The agreement governing the sale of the Working Capital Finance Investments from the Supplier to the Finance Agent. This agreement is sometimes referred to as the Receivables Purchase Agreement or the Supplier Agreement. The agreement governing the ongoing purchase of Working Capital Finance Investments or an interest in Working Capital Finance Investments by the Investor from the Finance Agent. This agreement is sometimes referred to as the Agency Agreement, the Participation Agreement or the Program Trust Agreement.

Subsequent Filing Requirements

103. Subsequent filing requirements include:

- Copies of any of the documents originally submitted with the RTAS Application subsequently amended.
- ~~The audited consolidated financial statements of the group of which the Finance Agent for the Working Capital Finance Program is a part, and o~~One of the following:
    - An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment; or
    - An annual audit of the financial statements and internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weakness related to servicing working capital financial investments.

Definitions in *SSAP No. 105R—Working Capital Finance Investments*

104. Please refer to *SSAP No. 105R—Working Capital Finance Investments*, for the definitions and associated definitional guidance insurance companies must understand and comply with before applying for an NAIC Designation for Working Capital Finance Programs that would permit them to purchase Working Capital Finance Investments.

105. With the exception of the definitions for Dilution Risk and Operational Risk below, the definitions shown below are summaries of those contained in *SSAP No. 105R—Working Capital Finance Investments* intended only to facilitate a discussion and in all cases subordinate to the definitions in SSAP No. 105R.

Summary of Key Definitions

106. **Confirmed Supplier Receivable** – A receivable sold by a Supplier to a Finance Agent or Investor (or by a Finance Agent to an Investor) under a Working Capital Finance Program designated by the SVO that requires the Obligor to confirm to the Finance Agent or Investor, prior to the sale of the receivable from the Supplier to the Finance Agent or Investor, that it has no defenses to payment of the monetary obligation represented by the receivable against the Supplier and, therefore, no defenses to payment of the same monetary obligation to the Finance Agent and/or Investor after such sale. The confirmation by the Obligor that it has no defenses to payment includes confirmation that the Obligor does not have a right to refuse payment that it may have acquired with respect to underlying commercial trade transaction and that, if it has such a right, it will not assert such defenses against the Finance Agent or Investor.

107. **Dilution Risk** – With respect to any Working Capital Finance Program, dilution risk refers to disputes or contractual provisions that may reduce the amount of the obligation owed by the Obligor to the Supplier under the original receivable or the obligation owed by the Obligor to the Finance Agent and/or Investor under the Confirmed Supplier Receivable. Examples of dilution risk are credit for returns of defective goods or an allegation of fraud, such as that the invoice is not legitimate or is a duplicate invoice.

108. **Finance Agent** – A bank, financial institution, financial intermediary or service provider that facilitates the Working Capital Finance Program that arranges the sale, assignment or transfer of the Confirmed Supplier Receivable to the Investor and administers payment.

109. **Investor** – The insurance company that files the RTAS Application with the SVO in order to obtain an NAIC Designation for a proposed Working Capital Finance Program.

110. **Obligor** – An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable—and which Obligor has, or can be designated, **NAIC 1** or **NAIC 2** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP.

111. **Operational Risk** – With respect to any Working Capital Finance Program, operational risk refers to the combined effect of the procedures and parties employed to implement the program and their responsibility under the documents and to the determination by the SVO of whether these procedures and parties will ensure full and timely performance by the Obligor of the payment obligation to the Investor. An example of an operational risk is the confirmation process employed to verify that the Obligor has no defenses to payment.

112. **Supplier** – The entity that sells the goods or services to the Obligor, obtains a receivable from the Obligor in exchange and subsequently chooses to sell the right to receive the payment associated with the receivable to the Finance Agent or Investor under the terms of a Working Capital Finance Program designated **NAIC 1** or **NAIC 2** by the SVO.

113. **Working Capital Finance Program** – The program created for the Obligor and its Suppliers by a Finance Agent the terms of which permits Suppliers to the Obligor to negotiate the sale of a right to receive payment from the Obligor (which is associated with and evidenced by a receivable) to the Finance Agent or an Investor.

114. **Working Capital Finance Investment** – The right to receive the payment associated with a Confirmed Supplier Receivable purchased by an Investor under a Working Capital Finance Program designated **NAIC 1** or **NAIC 2** by the SVO and is the subject of *SSAP No. 105R—Working Capital Finance Investments*.

NOTE: *SSAP No. 105R—Working Capital Finance Investments* imposes reporting and statutory accounting requirements on insurance company investments in Working Capital Finance Investments~~ and specifies analytical procedures to be applied or analytical controls to be verified by the SVO that are not detailed above~~. Insurance companies are strongly advised to become familiar with SSAP No. 105R before filing an RTAS Application with the SVO.

Direction and Program Parameters

115. The SVO may assign an NAIC Designation to a Working Capital Finance Program that would generate Working Capital Finance Investment that meet the criterion and standards identified in this Section.

116. **RTAS Submission Required** – A request that the SVO assign an NAIC Designation to a Working Capital Finance Program is made by filing an RTAS Application. The RTAS Application is available at www.naic.org/documents/svo_rtas_app.pdf.

117. Upon completion of its risk assessment, the SVO will issue an RTAS Letter indicating a preliminary NAIC Designation; i.e., the NAIC Designation that would be assigned if the Investor enters into a Working Capital Finance Program with a Finance Agent and sought to report it to the SVO.

NOTE: A preliminary NAIC Designation cannot be used for statutory reporting purposes.

118. The SVO shall issue a final NAIC Designation to the Investor for the Working Capital Finance Program and the Working Capital Finance Investments generated thereunder upon receipt of fully executed final copies of the required documentation.

Variations in Structure

119. Working Capital Finance Programs may differ in structure and in the protection afforded the Investor. Structural strength and weaknesses of various structures in such programs will be reflected in the NAIC Designation assigned by the SVO.

Program Quality

120. The SVO shall only assign an NAIC Designation to Working Capital Finance Programs that can be designated **NAIC 1** or **NAIC 2**. Credit quality is measured by reference to a NAIC CRP credit rating or an NAIC Designation assigned by the SVO. The SVO shall withdraw the NAIC Designation assigned to a Working Capital Finance Program on the date the Obligor's NAIC CRP credit rating or NAIC Designation is downgraded to **NAIC 3** or its NAIC CRP equivalent.

NOTE: *SSAP No. 105R—Working Capital Finance Investments* provides that Working Capital Finance Investments generated under a Working Capital Finance Program of an Obligor that falls below the equivalent of **NAIC 1** or **NAIC 2** becomes nonadmitted.

Process and Methodology

121. An NAIC Designation shall be assigned to a Working Capital Finance Program on the basis of a thorough assessment of credit, dilution, operational and other risks, an assessment of protections provided by operative documents to the Investor and the quality of transaction participants.

Risk-Assessment Process

122. **Credit Risk** – The NAIC Designation for a Working Capital Finance Program shall be linked to the credit quality of the Obligor, which may be determined by reference to a credit rating assigned by a NAIC CRP or by an NAIC Designation assigned by the SVO. Credit risk is assessed by the SVO analyst in accordance with any permitted methodology set forth in this Manual for corporate obligors.

123. **Dilution Risk** – To achieve an **NAIC 1** or **NAIC 2** Designation, the Working Capital Finance Program must eliminate dilution risk in the Working Capital Finance Investment proposed to be eligible for purchase by the Investor. The terms governing the Investor's Working Capital Finance Investment must eliminate Obligor recourse to its Supplier as a condition to payment of the obligation to the Investor so as to result in an unconditional right to receive payment on a full and timely basis.

124. **Operational Risk** – To achieve an **NAIC 1** or **NAIC 2** Designation, all operational risks shall be identified and assessed. Key participants shall have a NAIC CRP credit rating or an NAIC Designation assigned by the SVO at a level at least that of the Obligor.

Legal, Structural and Regulatory Considerations

125. Events of default remedies should provide the Investor at least those rights and privileges, unimpaired, of a trade creditor upon default with no Obligor defenses that could cause dilution of principal.

126. The SVO shall verify that either, (i) the Finance Agent is ~~must be~~ an entity regulated or supervised by a financial regulator in one of the countries in the List of Foreign (non-US) Jurisdictions Eligible for Netting for Purposes of Determining Exposures to Counterparties for Schedule DB, Part D, Section 1 ~~and that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC)~~. ~~In the alternative~~, or (ii) ~~the SVO shall verify that~~ payments due the Investor are made directly by the Obligor (a) to the Investor or (b) into an account maintained by a regulated financial institution for the benefit of Investors in the Working Capital Finance Program~~.~~, and, in either case, the Finance Agent cannot be the beneficiary of such payment. ~~with no commingling of funds or assets with those of the Obligor, Supplier, Servicer or Trust Administrator or other Investors.~~

127. The SVO will verify that the Certification from the insurance company's Chief Investment Officer confirms that the Investor is not affiliated with Obligor and that Working Capital Finance Investment excludes insurance or insurance-related assets.

128. ~~The SVO will verify that the Certification from the insurance company's Legal Counsel confirms the existence of a commercially reasonable belief that the documents establishing and governing the Working Capital Finance Program establishes the rights and UCC code standard for preserving first priority perfected interest in Confirmed Supplier Receivables.~~

129. The remedies available to the participants in the Working Capital Finance Program should be expressly identified in the documentation for the Working Capital Finance Investment.

130. Characteristics that shall be present in a proposed Working Capital Finance Investment include, but are not limited to, the following, or a substantial equivalent:

131. ~~The Obligor makes payments directly to the (a) Investor; (b) Finance Agent; or (c) servicer for the Working Capital Finance Program~~.

132. ~~The Investor must have the option, and not an obligation, to purchase subsequent Working Capital Finance Investment so as to ensure the Investor can exit the Working Capital Finance Investment by permitting existing investments to mature.~~

133. *SSAP No. 105R—Working Capital Finance Investments* provides that the documentation governing Working Capital Finance Programs must provide that disputes arising under the agreements shall be submitted to a court of competent jurisdiction in the U.S. or be subject to an alternative dispute resolution process sanctioned by state law. Given the nature of Working Capital Finance Programs, the SVO anticipates that documentation governing Working Capital Finance Investments will be subject to the laws and jurisdiction of the courts of California, Delaware or New York, or a similar legal jurisdiction with significant exposure to sophisticated institutional financial transactions.

134. Events of default must be clearly defined, and provide a mechanism that gives the Investor the ability to pursue collection unfettered by actions taken or not taken by participants such as the Servicer or Trustee, or other named persons performing similar functions.

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National Association of Insurance Commissioners
The Center for Insurance Policy and Research

TO: Kevin Fry (IL), Chair of the Valuation of Securities (E) Task Force

FROM: Dale Bruggeman (OH), Chair of the Statutory Accounting Principles (E) Working Group

DATE: June 4, 2020

RE: Updates to Working Capital Finance Program Requirements

During its May 20, 2020 conference call, the Statutory Accounting Principles (E) Working Group finalized consideration of a referral from the Valuation of Securities (E) Task Force, pertaining to Working Capital Finance program requirements. With the action taken, the Working Group adopted substantive revisions to *SSAP No. 105R—Working Capital Finance Investments* and *Issue Paper No. 163—Working Capital Finance Investments Updates*. The revisions incorporate seven of industry requested modifications to the Working Capital Finance Investments program requirements and are effective on June 30, 2020. Key revisions, which are reflected as tracked changes in the attached, are summarized as follows:

1. **Functionally Equivalent Foreign Regulators -** Removed the requirement that the Securities Valuation Office (SVO) determine if the International Finance Agent is the functional equivalent of the U.S. regulator.

2. **Commingling Prohibitions** - Removed the finance agent prohibitions on commingling.

3. **Investor Rights Edit -** Removed duplicative text regarding exercising of investor rights.

4. **Requirements for filer to Certify Perfected Interest –** Removed requirements, with revisions allowing the SVO to determine if a first priority perfected interest has been obtained.

5. **Finance Agent Validation Requirements –** Broadened the independent review requirements to allow independent review of the finance agent by either audit or through an internal control report.

6. **Default Date -** Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent.

7. **Possible Domestic Regulator Approval –** Removed the statement that the reporting entity may need to seek approval from the domestic regulator.

With the action taken, the Working Group also directed notification to the Valuation of Securities (E) Task Force for purposes of coordinating corresponding revisions to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). Please contact NAIC staff of the Statutory Accounting Principles (E) Working Group with any questions.

Cc: Charles A. Theriault, Julie Gann, Robin Marcotte, Jim Pinegar, Fatima Sediqzad and Jake Stultz

Attachment: SSAP No. 105R.

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Statement of Statutory Accounting Principles No. 105R

Working Capital Finance Investments

STATUS

Type of Issue	Common Area
Issued	December 15, 2013; Substantively revised May 20, 2020
Effective Date	January 1, 2014; Substantive revisions documented in Issue Paper No. 163 effective June 30, 2020
Affects	No other pronouncements
Affected by	No other pronouncements
Interpreted by	INT 06-07
Relevant Appendix A Guidance	None

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for working capital finance investments held by reporting entities. This statement amends *SSAP No. 20—Nonadmitted Assets* (SSAP No. 20) to allow working capital finance investments as admitted assets to the extent they conform to the requirements of this statement.

SUMMARY CONCLUSION

2. Working capital finance investments represent a confirmed short-term obligation[1] to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program currently designated by the NAIC Securities Valuation Office. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third party investor.

3. Working capital finance investments held by a reporting entity represent a right of the reporting entity to receive future payment. This Statement provides accounting and reporting guidelines for the right to receive payment under working capital finance programs that meet particular criteria.

Working Capital Finance Program - Definitions and Conditions

4. A "working capital finance program" is an open account program under which an investor may purchase interests, or evidence thereof, in commercial non-insurance receivables. A working capital finance program is created for the benefit of a commercial investment-grade obligor and its suppliers of goods or services, and facilitated by a finance agent.

5. A working capital finance program transfers a right to payment to an investor from a short term obligation and arises from transactions among:

a. a buyer of goods or services that becomes an obligor to the supplier of goods or services,

b. the supplier(s) of those goods or services,

c. a finance agent, and

d. an investor.

6. A "working capital finance investment" is an interest in payment(s) from a confirmed supplier receivable issued pursuant to a working capital finance program. The payment (maturity) date must not exceed one year from the date of invoice from the supplier to the obligor. This investment is created when the investor purchases from a working capital finance program that is currently designated as NAIC "1" or "2" by the NAIC Securities Valuation Office, any of the following:

a. One or more confirmed supplier receivables;

b. in case of a participation, a participation interest in one or more confirmed supplier receivables issued by the finance agent or lead lender holding confirmed supplier receivables; or

c. a certificate, note or other interest manifestation, documented in a way that is verifiable ~~by regulators~~, representing a legally enforceable interest in a right to ~~payment~~ payment either directly to the investor or from a trust, other special purpose entity or pool holding confirmed supplier receivables.

7. "Obligor" is the party that purchases the goods or services that generates the original supplier receivable ~~(and~~ which is the payable for that~~the~~ Obligor). The obligor must ~~be a single entity, which has~~have an NAIC designation of "1" or "2" or a Credit Rating Provider equivalent. The obligor must confirm the supplier receivable described in paragraph 11 as described in the confirmation process in paragraphs 12-13~~14~~.

[1] All references to short-term obligations in this statement to refer to obligations not exceeding one year.

8. "Supplier" is the party that sells the goods or services to the obligor. The supplier sells the confirmed supplier receivable in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office at a price agreed to by the finance agent and/or investor.

9. "Investor" is the party purchasing a working capital finance investment in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office.

10. The "finance agent" is a bank, financial institution, other financial intermediary, or service provider that facilitates the working capital finance program, arranges the sale, assignment or transfer of the confirmed supplier receivable to the investor for a fee and administers the payment mechanism. In the case of participation, the finance agent must inform the reporting entity investor of a default or event of default as soon as it becomes aware of such default or event of default. For the working capital finance program to qualify under this SSAP, the finance agent must meet the requirements of either paragraph 10.a. or 10.b.:

a. The finance agent is directly regulated by, or falls under the supervision of, a financial regulator of its domiciliary country provided that such country appears on the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* List of Jurisdictions Eligible for Netting~~ and that the Securities Valuation Office determines that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation~~; or

b. Payments from the obligor must ~~1) ~~be paid directly to the reporting entity (investor) or into an account maintained by a regulated financial institution for the benefit of investors in the working capital finance program and, in either case, ~~cannot flow through~~ the finance agent cannot be the beneficiary of such payment~~and 2) there can be no commingling of payments or assets with those of the obligor, supplier, servicer or trust administrator or other investors~~.

11. A "confirmed supplier receivable" is a first priority perfected security interest or right to payment of a monetary obligation from the obligor arising from the sale of goods or services from the supplier to the obligor the payment of which has been confirmed by the obligor committing and stating that the obligations under the agreement and any payment shall not be affected by the invalidity, unenforceability, existence, performance or non-performance of the underlying commercial trade transaction or any related contract or undertaking nor that it will not protest, delay, or deny, nor offer nor assert any defenses, personal or otherwise, against payment to the supplier or any party taking claims, interests, or rights to payments made by the supplier.

a. The confirmed supplier receivable must be sold, assigned or otherwise transferred in a manner that results in an absolute, irrevocable and legally enforceable obligation that has been confirmed by the Obligor.

b. In the case of a participation, the certificates or other evidence of participation provide an absolute, irrevocable, and legally enforceable obligation of the finance agent or holder of the confirmed supplier receivable to pay to the reporting entity investor all of the amounts due to it under the confirmed supplier receivable, without reduction or delay arising from any claims that the finance agent may have against the reporting entity investor. ~~The reporting entity investor's ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to the discretion of the finance agent or other lenders or investors. ~~The reporting entity investor's ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to, other than during a cure period not to exceed thirty days, the discretion of the finance agent or other lenders or investors.

Confirmation Process

12. In the case of a purchase, the investor shall verify, prior to the sale that the obligor has confirmed the respective amounts, payment dates and related invoice numbers' specified dates and has waived all defenses to

payment. In the case of a participation, the finance agent must verify that the obligor has confirmed the respective amounts, payment dates and related invoice reference numbers' specified due dates, and has waived all defenses to payment in accordance with the confirmation process.

13. The obligor must commit and state that upon confirmation of a supplier receivable it is obligated to pay to the investor, the finance agent, or any third party acting as agent or trustee for the investor, a sum equal to the full amount of that confirmed supplier receivable(s) on a date certain stated in the confirmation and that it waives any right of setoff or other defenses to avoid or delay the full and timely payment of that Confirmed Supplier Receivable. The documents establishing the working capital finance program or the confirmation must state and confirm that the obligation to pay must be independent of any other contracts or claims that might be raised in defense arising from any transaction financed in connection with the ~~WCFP~~WCFI program, the confirmed supplier receivable, or any other courses of performance or courses of dealing with the supplier.

~~14. In the case of participation, the investor must certify that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code's standards for creating and preserving first priority security interests in the payments due and in the confirmed supplier receivables. Commercially reasonable belief shall mean the SVO deems the investor's belief reasonable in light of the systems, policies, or practices commonly recognized in the field of investing in participations. The investor must be able to demonstrate to a regulator or to the SVO, upon either's request, the basis for its commercially reasonable belief that the WCFP creates and preserves the investor's ability to enforce a first priority perfected security interest in the confirmed supplier receivables.~~

~~15. In the case of a certificate, note, or other manifestation, capable of verification, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, the investor must certify that it has a commercially reasonable belief that the documents establishing and governing the working capital finance program create and preserve interests in the confirmed supplier receivables capable of being enforced by the trustee or other entity holding confirmed supplier receivables as first priority perfected security interests under the Uniform Commercial Code. The investor must be able to demonstrate the basis for such belief to a regulator or to the SVO upon either's request. Commercially reasonable belief shall mean the SVO deems the investor's belief reasonable in light of the systems, policies, and practices commonly recognized in the field of investing in securitizations, loan-backed, structured, or trust-issued securities.~~

Program Requirements

~~16.~~14. The working capital finance program investor must provide in its annual filing with the Securities Valuation Office ~~an annual audit of the consolidated financial statements of which the finance agent is part, which does not report any qualifications related to servicing, and~~ one of the following:

a. An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment; or

b. An annual audit of the financial statements and internal controls of the consolidated group of which the finance agent is part, which does not note any material weaknesses related to servicing working capital financial investments.

The NAIC Securities Valuation Office would review the materiality of the report findings in making their determination of the assignment of a designation.

~~17.~~15. If the credit rating of the working capital finance program or obligor falls to non-investment grade (below the equivalent of NAIC designation "1" or "2"), the reporting entity shall nonadmit, the working capital finance investments obtained under the related working capital finance program and/or the related obligor. Due to the short-term nature of these investments, once an investment is nonadmitted due to the credit rating of the working capital finance program or the obligor, those investments will continue to be nonadmitted.

~~18.~~16. Reporting entity investors must have the ability to monitor the working capital finance program and the credit-related activities of the obligor. Reporting entity investors must provide information as requested to the state of domicile indicating that they have the ability to monitor on an ongoing basis the activities of the working capital finance program. ~~Initial permission to invest in Working Capital Finance Investment Programs may be required by the domiciliary commissioner.~~

~~19.~~17. All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that if a dispute arises among any of the parties under any of the contracts or agreements that are a part of or that together constitute the working capital finance program, each party agrees that the dispute will be submitted to a court of competent jurisdiction in the United States or a constituent state thereof or of an alternative dispute resolution process recognized thereby. All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that any dispute arising under any of the contracts or agreements that are a part of or that together constitute the working capital finance program must be resolved pursuant to the laws of the United States or a constituent state thereof that address the substance of the dispute but excluding those laws addressing conflicts of law.

Exclusions

~~20.~~18. A working capital finance investment excludes any receivables financed through:

a. Factoring: the purchase of receivables in bulk from a supplier where the receivables represent the payment obligations of potentially thousands of buyers to a single supplier, in which the buyers have no relationship with or contractual obligation to pay the factor and retain all legal defenses to payment they may have against the supplier;

b. Forfaiting: the purchase of one or a series of receivables from exporters by a forfaiter to enable the exporter (seller) to finance a commercial transaction with a buyer in which the Obligor has no relationship with or contractual obligation to pay the forfaiter and retains all legal defenses to pay it may have against the seller; or

c. Invoice discounting: the advancement of funds by a finance company to a business entity with the funds advanced limited to a defined percentage of the business entity's eligible and outstanding receivables.

~~21.~~19. Eligible Confirmed Supplier Receivables must not:

a. Include insurance or insurance related assets;

b. Be impaired or in default at the time of purchase;

c. Have a payment (maturity) date longer than one year from the date of the invoice from the Supplier to the Obligor giving rise to the confirmed supplier receivable, and the maturity date must not be subject to change or rolling; nor

d. Include any receivable of any parent or affiliate of the reporting entity investor, and neither the Obligor nor any Supplier may be affiliated with the reporting entity investor. Working Capital Finance Investments that have obligors or vendors that are affiliated with the investor are ineligible, and therefore, nonadmitted assets.

Accounting and Reporting

~~22.~~20. The right to receive payment generated by a working capital finance investment issued under a working capital finance program is considered to meet the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets*, and is an admitted asset to the extent the investment conforms to the requirements set forth in this Statement and the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. For programs that comply with all of these elements, working capital finance investments shall be valued and reported in accordance with this Statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the NAIC Valuations of Securities product. Programs that do not comply with the elements set forth in this Statement, or the provisions set forth in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* are nonadmitted. Working capital finance investments are reported as other invested assets in the financial statements.

~~23.~~21. A working capital finance investment shall be recorded on the trade date. At acquisition, the Working Capital Finance Investment shall be initially reported at cost, excluding brokerage and other related fees, and all other costs (internal costs, or costs paid for origination, purchase or commitment to purchase such investments), which shall be expensed as incurred.

~~24.~~22. After initial acquisition, the Working Capital Finance Investment shall be reported at amortized cost until the specified maturity date, unless the investment, or a portion thereof, is deemed uncollectible or when an other-than-temporary impairment has occurred. In the event that a working capital finance investment is purchased by a reporting entity investor at a premium (amount to be received by the entity under the confirmed supplier receivable is less than the price paid for the investment), the excess paid by the reporting entity investor in comparison to the amount receivable under the confirmed supplier receivable must be immediately expensed.

~~25.~~23. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses from working capital finance investments shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an IMR, realized gains and losses from working capital finance investments shall be reported as net realized capital gains or losses in the statement of income. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

~~26.~~24. A Working Capital Finance Investment may provide for a prepayment penalty or acceleration fee in the event the working capital finance investment is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

~~27.~~25. *SSAP No. 34—Investment Income Due and Accrued* shall be followed for determining and recording investment income earned on working capital finance investments acquired at a discount. In accordance with *SSAP No. 34—Investment Income Due and Accrued*, investment income shall be reduced for amounts that have been determined to be uncollectible, however amounts more than 15 days overdue are nonadmitted.

Default

~~28.~~26. A working capital finance investment payment that is uncollected by the reporting entity within ~~fifteen~~ thirty days after the due date shall be considered in default and nonadmitted. If the reporting entity has any other working capital finance investment assets from the same defaulting counterparty, all other working capital finance investments from that counterparty shall be nonadmitted. All working capital finance investments from a counterparty identified in default shall be evaluated for impairment.

Impairment

~~29.~~27. An other-than-temporary impairment(INT 06-07) shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a confirmed supplier receivable including the payment on the established due date. Pursuant to this guidance, assessment of other-than-temporary impairment shall include an evaluation of the financial condition and short-term prospects of the obligor. If it is determined that a decline in the fair value of a working capital finance investment below book/adjusted carrying value is due to an other-than-temporary impairment, an impairment loss shall be recognized as a realized loss equal to the entire difference between the working capital finance investment's carrying value and fair value as of the reporting period for which the assessment is made. Fair value shall be determined in accordance with *SSAP*

No. 100R—Fair Value (SSAP No. 100R), and reflect the price to sell the asset in an orderly market between market participants. As such, the fair value shall reflect the assumptions market participants will use in pricing the asset, including assumptions about risk.

~~30.~~28. For reporting entities required to maintain an AVR/IMR, the entire amount of the realized loss from the other-than-temporary impairment shall be recorded through the AVR, in accordance with SSAP No. 7.

~~31.~~29. Upon recognition of an other-than-temporary impairment, the fair value of the working capital finance investment on the measurement date shall become the new cost basis of the working capital finance investment and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Once an investment is determined to be other-than-temporarily impaired, until all expected payments are received, the reporting entity must re-evaluate the investment quarterly and reassess fair value, with recognized realized losses for the difference between the book/adjusted carrying value and the current fair value. This process shall continue until either all expected payments are received, or the entity has recognized a realized loss for the entire uncollected carrying value.

Disclosures

~~32.~~30. The financial statements shall include the following disclosures:

a. Fair value in accordance with SSAP No. 100R.

b. Concentrations of credit risk in accordance with SSAP No. 27—*Off-Balance-Sheet and Credit Risk Disclosures* (SSAP No. 27) in the annual audited statutory financial reports only.

c. Information regarding the aggregate book/adjusted carrying value of working capital finance investment by designation including gross assets with nonadmitted and net admitted amounts annually. (Note that programs designated 3-6 are nonadmitted.)

	Gross Asset CY	Non-Admitted Asset CY	Net Admitted Asset CY
WCFI Designation 1			
WCFI Designation 2			
WCFI Designation 3			
WCFI Designation 4			
WCFI Designation 5			
WCFI Designation 6			
Total			

d. Annual and quarterly information regarding the aggregate book/adjusted carrying value maturity distribution on the underlying working capital finance investments by the categories of maturities up to 180 days and 181 to 365 days.

e. Any events of default of working capital finance investments during the reporting period.

~~33.~~31. Refer to the Preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

~~34.~~32. This statement is effective for years on or after January 1, 2014. Substantive revisions documented in *Issue Paper No. 163—Working Capital Finance Investments Updates* are effective for financial reporting periods on or after June 30, 2020. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 147—Working Capital Finance Investments*
- *Issue Paper No. 163— Working Capital Finance Investments Updates*

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January 27, 2021

Mr. Kevin Fry, Chairman
Ms. Carrie Mears, Vice Chair
Valuation of Securities (E) Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Incorporate Updates Made to SSAP No. 105R – Working Capital Finance Investments AND Comments on Proposed referral to The Statutory Accounting Principles (E) Working Group for consideration of a directive to the SVO to rely on unrated subsidiaries in WCFI transactions.

Dear Mr. Fry:

ACLI appreciates the ongoing engagement on the exposure draft released for comment by the Valuation of Securities Task Force regarding The Statutory Accounting Principles (E) Working Group adopted updates to SSAP No. 105R Working Capital Finance Investments on May 20, 2020. At the November 18, 2020 meeting Staff presented a draft for changes to the P&P Manual that in turn the Committee voted to expose. Separately, Staff reviewed their Memorandum dated October 16, 2020 regarding Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) regarding a possible Valuation of Securities (E) Task Force directive to the SVO to rely on unrated subsidiaries in WCFI transactions, which Regulators agreed to expose in advance of sending that proposed directive to the Statutory Accounting Principles (E) Working Group. This comment letter addresses the issues associated with both topics and the investment overall.

We believe it important to reiterate some key points that provide context to our specific comments on the P&P revisions and unrated subsidiaries proposals from the learnings of the now 11+ years that this investment has been in development:

- This is a high-quality investment:

  - In $10 Billion filed and settled investments, there have been no impairments or default.
  - The investment pays considerably more than comparable duration and risk-based investments.

- Adoption of the asset class by industry since NAIC adoption has been limited and we believe there are so few filers, or attempted filers, because the rules are complicated, and there is still regulatory uncertainty for the investment.
- ACLI was requested over 4 years ago to provide input about changes that could be made to make adoption successful which resulted in a series of 10 recommendations of which 7 have been reflected in both SSAP 105R and the proposed P&P revisions referenced herein.
- Even with these seven changes broad adoption likely will not occur because:
- Schedule BA reporting is and remains a substantive obstacle for most companies because most resist investments reported there as it generates unwanted scrutiny from ratings agencies and state examiners. Schedule DA reporting would alleviate that concern.
  - Uncertainty around acceptable investments for filing given a lack of definitions and insight into analysis, broadly and noted in this letter, hinders investment willingness which we attempt to address in part below.

Staff have requested a referral to SAPWG for their consideration of directing SVO to accept unrated subsidiaries as Staff position is that no methodology can be created to address unrated subsidiary risk substitution by a rated affiliate. While we have shared with the SVO rating agency materials for addressing unrated subsidiary affiliate risks as well as have proposed a methodology, as the SVO maintains they cannot develop a methodology, ACLI supports referral of the unrated subsidiaries issue to SAPWG to specifically request the Working Group to direct the SVO to accept unrated subsidiaries to assign ratings equivalents. We note, however, some challenges with this approach:

- SSAP No. 105R is specifically limited to NAIC 1 and NAIC 2 designations for program filings and that the SVO currently excludes the unrated subsidiaries from their approvals.
- Notching unrated subsidiaries downward to a lower rating category, than that of a rated parent that is NAIC 2 rated, such as to an NAIC 3, will make these programs ineligible and will increase filing uncertainty.
- One possible solution is that the "notching" to an NAIC 3 should not make the investment ineligible. We would be happy to work with the VOSTF/SAPWG on the required mechanics if such a position was supported by regulators. Another alternative could be for the instruction from SAPWG to limit notching below NAIC 2 specifically for these investments.

With regard to the P&P we note that neither "Key Participants" nor operational and credit risk are specifically defined in SSAP No. 105R. Lacking specific definitions as well as lacking insight into Staff investment analysis introduces filing uncertainty and potential costs to filers. Given this and the unrated subsidiaries referral, ACLI proposes changes to the to the P&P Manual exposure draft as follows:

"124. Operational Risk – To achieve an NAIC Designation, all operational risks shall be identified and assessed. One of the key Obligor participants shall have a NAIC CRP credit rating or an NAIC Designation assigned by the SVO at a level at least that of the required CRP and NAIC designation for the Obligor for it and its affiliated entities. For the purposes of this requirement, Finance Agents are not Key Participants requiring a CRP rating."

These revisions resolve conflicts with changes already made to SSAP No. 105R as finance agents may not have CRP ratings, can be designated as "Key Participants" and because the limitation to NAIC 1 or NAIC 2 Obligor Designation is being modified through SAPWG directive to accept unrated subsidiaries.

We thank you for your continued engagement on the topic.

Sincerely,

MMonahan

Mike Monahan
Senior Director, Accounting Policy

cc: Mr. Charles Therriault, Director, Securities Valuation Office

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National Association of Insurance Commissioners
& The Center for Insurance Policy and Research

MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) regarding a possible Valuation of Securities (E) Task Force directive to the SVO to rely on unrated subsidiaries in WCFI transactions.

DATE: October 16, 2020 (Updated June 14, 2021)

1. **Summary** – The SVO has received comments by some insurers and other industry participants that it should assign NAIC Designations to issues of non-guaranteed, unrated subsidiaries of NAIC Credit Rating Provider (CRP) rated parent entities, based on implied support from the parent to the subsidiary. This topic is most relevant to Working Capital Finance Investments (WCFI) with unrated obligors which are wholly owned, but not guaranteed, by CRP rated parent entities. Without legally-binding support, such as a guarantee, parental support of a subsidiary is entirely discretionary and ultimately reliant on the best interest of the parent. The SVO contends that no generally accepted analytical technique or methodology supports the assumption that a parent entity will necessarily support its subsidiary in times of financial distress. The SVO has reached this conclusion based on its previous legal study of support obligations and on its examination of CRP methodologies and examples of parents not supporting subsidiaries.

2. **CRP and NAIC Methodologies** – Rating agencies are generally consistent in their approach to rating parents and subsidiaries. To give credit to one entity's relationship with another it is necessary to first determine the stand-alone credit profile of both entities and then to notch up or down based on various factors explained in the various rating agency methodologies[1]. These factors include, among others, determinations of the parent's willingness and ability to support its subsidiary (Moodys[2]), strategic importance and core versus non-core businesses (S&P[3]), and

[1] Fitch Ratings provides one exception to this general approach. Pursuant to Fitch Ratings methodology it is possible to rate a subsidiary issuer without standalone financial information or a parent guarantee when an issuer (subsidiary) had long-term public bonds outstanding at the time it was acquired by an acquiring company (parent). Fitch clarifies that this exception is not meant to be an alternative to its general parent-subsidiary linkage methodology, nor does it apply to new debt issues. ("Parent and Subsidiary Linkage Rating Criteria," Fitch Ratings, 26 August 2020.)

[2] "Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003. Though originally published in 2003, Moody's maintains this article on its website.

[3] "Parent and Subsidiary Ratings," S&P Global, August 29, 2000. Though originally published in 2000, S&P Global maintains this article on its website.

legal, operational and strategic ties between the parent and its subsidiary (Fitch[4]). Neither S&P nor Fitch directly addresses the question of whether an unrated, non-guaranteed subsidiary should or should not be assigned a rating based on implied support from its parent. Rather, they make the determination of stand-alone rating a key starting point for determining parent and subsidiary ratings, meaning a subsidiary for which they cannot determine a stand-alone rating would receive no benefit from its parent. Moody's, however, provides a persuasive explanation of the problems with implying a parent's support for its subsidiary in the absence of a legally-binding support agreement:

> During 2002, there were four instances[5] in which highly rated parent companies opted to maximize shareholder value by curtailing investment in wholly or partially owned subsidiaries that failed to produce or show any prospects of generating satisfactory returns on investment. As a consequence, the subsidiaries ultimately defaulted on their debt despite, in several cases, public assurances by the parent of continuing support given the ongoing strategic importance of the underlying subsidiary to its parent. While the subsidiaries ultimately defaulted, it should be noted that the cessation of funding weak non-return producing subsidiaries was ultimately a positive credit event at the parent level[6].

In its methodology Moody's draws on the empirical evidence of four examples of parents letting their respective subsidiaries fail, to demonstrate that non-legally binding promises of support are entirely discretionary and should not be the basis for a rating. Moody's further adds that in each of the four examples, "the parent company elected to discontinue support notwithstanding having: (1) made sizable initial and, in some cases, certain follow-on investments and (2) publicly articulated the 'strategic' nature and ongoing support for their subsidiary issuers."

Reliance on implied support of a parent for its subsidiary also conflicts with the "Credit Substitution" guidelines in Part Three of the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "Purposes and Procedures Manual") which were developed from a legal study of the enforceability of various types of support obligations. These guidelines plainly state that for the SVO to rely on the creditworthiness of an entity other than the issuer, a credit substitution instrument, such as a guarantee or letter of credit must be in place. The Credit Substitution guideline further align with Moody's methodology in that both distinguish between guarantees and non-legally binding support, such as comfort letters, keep-well agreements or other such statements of intended support. While guarantees, when consistent with the Purposes and Procedures Manual guidance, can allow for full credit substitution, comfort letters, by which an entity promises support of a limited kind to an affiliate or subsidiary, only allows the SVO to notch-up from the stand-alone NAIC designation of the issuer, and even then, only in limited circumstances. Moody's writes, ". . . the fact that some parent companies decided to discontinue investment in their subsidiaries after determining that such funding would fail to produce satisfactory return illustrates the low intrinsic value of non-legally binding support such as comfort letters, keep-well agreements, letters of moral intent, or verbal support."

The general rule among rating agencies that the strength of a parent can, at best, be used to *notch up the subsidiary's stand-alone rating* supports the similar approach found in the Purposes and Procedures Manual's credit substitution guidelines. This rule precludes the SVO from analytically deriving a designation for a subsidiary from its parent when the subsidiary has no stand-alone CRP rating or NAIC designation or for which the SVO cannot derive one.

3. Examples -

The following are examples provided by Moody's to support its determination not to imply a rated parent's support for its unrated, non-guaranteed subsidiary.

Decisions by the parents to cease support were based on the following:

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[4] "Parent and Subsidiary Linkage Rating Criteria" Fitch Ratings, 26 August 2020.

[5] BCE Inc.; AT&T Corp.; Verizon Communications, Inc.; and TXU Corp.

[6] Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003

• BCE Inc. decided after a review of strategic alternatives that the incremental investment required to support its subsidiary, Teleglobe Inc., to a self-sustaining status in the deteriorating long-haul telecommunications sector was very unclear, and therefore so was the likelihood of earning an adequate return on its marginal investment.

• AT&T Corp. decided not to make further marginal investments in its partly owned subsidiary, AT&T Canada Inc., (ATTC) likely because the facilities based competitive local exchange carrier (CLEC) business was unable to support existing debt levels. Moreover, regulatory pricing changes in 2002 did not make economic the reselling of the incumbent telcos' own networks by ATTC.

• Verizon Communications, Inc. made a decision to curtail further investment in Genuity Inc., a leading provider of enterprise IP networking services. Verizon opted not to exercise its option to acquire and reintegrate Genuity after reevaluating Genuity's growth prospects in light of the significant slowdown in IT spending and order rates.

• TXU Corp. discontinued financial support for its subsidiary, TXU Europe Ltd., despite publicly stating its willingness to do so, after determining that further funding of TXU Europe would not maximize shareholder value and recognizing that TXU Europe Ltd. was putting the ratings of its other subsidiaries at tremendous risk. TXU Europe's operations were hampered by the effects of increasing competition following deregulation of UK power markets, declining wholesale power prices, and contracts to purchase power at prices above market[7].

4. **Recommendation and proposed amendment** – The SVO is aware that some industry participants and certain regulators have a different opinion than the SVO on the likelihood of parental support for their unrated, non-guaranteed subsidiaries and think such implied support exists and should be recognized in NAIC designations. Therefore, if the Task Force deems it essential that the SVO be able assign designations to WCFI transactions with unrated, non-guaranteed obligors, the SVO offers the following proposed amendments to Part One and Part Three of the Purposes and Procedures Manual. Pursuant to the amendment the Task Force would, in Part One, direct the SVO, in regards to WCFI transactions with unrated obligors, to rely upon the NAIC designation or the NAIC designation equivalent of a CRP rating of the obligor's parent entity but authorizes the SVO, based on its analytical judgement and in its sole discretion, to notch such NAIC designation. In Part Three the definition of WCFI "Obligor" would be revised to permit the SVO to follow the directive in Part One. The following text in red shows the proposed revisions in Part One and Part Three.

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[7] Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003

PART ONE

POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE

WORKING CAPITAL FINANCE INVESTMENTS (WCFI)

Description

116. As described in *SSAP No. 105R - Working Capital Finance Investment*s, WCFI represents a confirmed short-term obligation to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program for which an NAIC Designation is assigned by the SVO. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third-party investor.

Obligor

117. The Obligor for WCFI transactions is the party that purchases the goods or services that generates the original supplier receivable (which is the payable for that Obligor). The obligor must have an NAIC Designation of "1" or "2" or an ~~Eligible~~ NAIC Credit Rating Provider (CRP) Rating equivalent.

Unrated Subsidiaries

118. Many WCFI programs are structured in a way whereby unrated subsidiaries of a rated parent entity are involved as transaction participants, including as the Obligor. Such programs may have strong operational and strategic linkages between the rated parent entity and its unrated subsidiaries.

119. Given (i) the short-term (less than one year) payment terms of each of the underlying receivables arising from the sale of goods or services, (ii) WCFI investors' option to stop funding a working capital finance program, and (iii) the necessity of working capital finance programs to obligors due to obligors' reliance on their suppliers, the Task Force has concluded there is a low probability of default of WCFI investments. Accordingly, the Task Force deems it reasonable to establish a principle to direct the SVO, in its assessment of WCFI programs, to rely upon a parent entity's rating for purposes of determining the NAIC Designation of the overall WCFI program.

120. Solely for purposes of WCFI transactions, the Task Force directs the SVO to rely upon the NAIC Designation or ~~Eligible~~ NAIC CRP Rating equivalent of the obligor, subsidiary or affiliate's parent entity if~~:~~

~~a)~~ the obligor, subsidiary or affiliate does not have an ~~Eligible~~ NAIC CRP Rating and the SVO cannot assign an NAIC Designation to it~~, and~~

b) ~~each relevant obligor, subsidiary or affiliate constitutes a substantial portion of its parent entity's operations representing at least twenty-five percent (25%) or greater of the parent entity's assets, revenue and net income~~.

~~121. The Task Force authorizes the SVO, based on its analytical judgement and in its sole discretion, to notch such NAIC Designation based on factors including, but not limited to, whether:~~

~~a) the unrated subsidiaries or affiliates that serve as key transaction participants can reasonably perform the functions expected of them; and/or~~

~~b) the rated entity has documented operational control over the performance of the unrated subsidiaries or affiliates that also serve as obligors in the program; and/or~~

~~c) there is documentary evidence in the program documents or appended thereto that sufficiently demonstrates the importance of the inter-relationship between the rated entity and the unrated subsidiaries or affiliates.~~

122. For the avoidance of doubt, ~~while~~ though the Task Force directs the SVO to use the NAIC Designation or ~~Eligible~~ NAIC CRP rating equivalent of the obligor's parent entity, due to the SVO's authority to notch such NAIC Designation or rating, the SVO, based on its analytical judgement and in its sole discretion, may assign an NAIC Designation to the obligor which differs from the correlated ~~Eligible~~ NAIC CRP rating equivalent of the obligor's parent entity or choose not to assign any NAIC Designation to the working capital finance program, based on aspects of the working capital finance program which are unrelated to the relationship between the obligor, subsidiary or affiliate and its parent entity. ~~Also, for the avoidance of doubt, the SVO may, based on its analytical judgement and in its sole discretion, choose not to assign any NAIC Designation to the working capital finance program, based on other attributes of the working capital finance program which are unrelated to the obligor or its parent entity.~~

123. The Task Force acknowledges that reliance upon the NAIC Designation or ~~Eligible~~ NAIC CRP rating equivalent of the obligor's parent entity in the absence of a binding legal obligation for the parent to assume the financial obligations of the obligor, such as a guarantee, is not a generally accepted technique or methodology (as explained in "Use of Generally Accepted Techniques or Methodologies" in Part One of this Manual) and is inconsistent with the credit substitution guidelines detailed in "Credit Substitution" in Part Three of this manual, but it is directing the SVO to so rely.

NOTE: See "Working Capital Finance Investments" in Part Three for filing instructions, documentation requirements, definitions and methodology applicable to Working Capital Finance Investments.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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110. **Obligor** – An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable—and which Obligor has, or can be designated, **NAIC 1** or **NAIC 2** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP or, if not so designated, the SVO can imply such designation, as directed by the VOS/TF pursuant to the "Working Capital Finance Investments (WCFI)" section in Part One of this Manual.

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National Association of Insurance Commissioners
& The Center for Insurance Policy and Research

MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) regarding a possible Valuation of Securities (E) Task Force directive to the SVO to rely on unrated subsidiaries in WCFI transactions.

DATE: October 16, 2020

1. **Summary** – The SVO has received comments by some insurers and other industry participants that it should assign NAIC Designations to issues of non-guaranteed, unrated subsidiaries of NAIC Credit Rating Provider (CRP) rated parent entities, based on implied support from the parent to the subsidiary. This topic is most relevant to Working Capital Finance Investments (WCFI) with unrated obligors which are wholly owned, but not guaranteed, by CRP rated parent entities. Without legally-binding support, such as a guarantee, parental support of a subsidiary is entirely discretionary and ultimately reliant on the best interest of the parent. The SVO contends that no generally accepted analytical technique or methodology supports the assumption that a parent entity will necessarily support its subsidiary in times of financial distress. The SVO has reached this conclusion based on its previous legal study of support obligations and on its examination of CRP methodologies and examples of parents not supporting subsidiaries.

2. **CRP and NAIC Methodologies** – Rating agencies are generally consistent in their approach to rating parents and subsidiaries. To give credit to one entity's relationship with another it is necessary to first determine the stand-alone credit profile of both entities and then to notch up or down based on various factors explained in the various rating agency methodologies[1]. These factors include, among others, determinations of the parent's willingness and ability to support its subsidiary (Moodys[2]), strategic importance and core versus non-core businesses (S&P[3]), and

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3. Examples -

The following are examples provided by Moody's to support its determination not to imply a rated parent's support for its unrated, non-guaranteed subsidiary.

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Decisions by the parents to cease support were based on the following:

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4. **Recommendation and proposed amendment** – The SVO is aware that some industry participants and certain regulators have a different opinion than the SVO on the likelihood of parental support for their unrated, non-guaranteed subsidiaries and think such implied support exists and should be recognized in NAIC designations. Therefore, if the Task Force deems it essential that the SVO be able assign designations to WCFI transactions with unrated, non-guaranteed obligors, the SVO offers the following proposed amendments to Part One and Part Three of the Purposes and Procedures Manual. Pursuant to the amendment the Task Force would, in Part One, direct the SVO, in regards to WCFI transactions with unrated obligors, to rely upon the NAIC designation or the NAIC designation equivalent of a CRP rating of the obligor's parent entity but authorizes the SVO, based on its analytical judgement and in its sole discretion, to notch such NAIC designation. In Part Three the definition of WCFI "Obligor" would be revised to permit the SVO to follow the directive in Part One. The following text in red shows the proposed revisions in Part One and Part Three.

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PART ONE

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Description

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117. The Obligor for WCFI transactions is the party that purchases the goods or services that generates the original supplier receivable (which is the payable for that Obligor). The obligor must have an NAIC Designation of "1" or "2" or an Eligible NAIC Credit Rating Provider (CRP) Rating equivalent.

Unrated Subsidiaries

118. Many WCFI programs are structured in a way whereby unrated subsidiaries of a rated parent entity are involved as transaction participants, including as the Obligor. Such programs may have strong operational and strategic linkages between the rated parent entity and its unrated subsidiaries.

119. Given (i) the short-term (less than one year) payment terms of each of the underlying receivables arising from the sale of goods or services, (ii) WCFI investors' option to stop funding a working capital finance program, and (iii) the necessity of working capital finance programs to obligors due to obligors' reliance on their suppliers, the Task Force has concluded there is a low probability of default of WCFI investments. Accordingly, the Task Force deems it reasonable to establish a principle to direct the SVO, in its assessment of WCFI programs, to rely upon a parent entity's rating for purposes of determining the NAIC Designation of the overall WCFI program.

120. Solely for purposes of WCFI transactions, the Task Force directs the SVO to rely upon the NAIC Designation or Eligible NAIC CRP Rating equivalent of the obligor, subsidiary or affiliate's parent entity if:

a) the obligor, subsidiary or affiliate does not have an Eligible NAIC CRP Rating and the SVO cannot assign an NAIC Designation to it, and

b) each relevant obligor, subsidiary or affiliate constitutes a substantial portion of its parent entity's operations representing at least twenty-five percent (25%) or greater of the parent entity's assets, revenue and net income.

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a) the unrated subsidiaries or affiliates that serve as key transaction participants can reasonably perform the functions expected of them; and/or

b) the rated entity has documented operational control over the performance of the unrated subsidiaries or affiliates that also serve as obligors in the program; and/or

c) there is documentary evidence in the program documents or appended thereto that sufficiently demonstrates the importance of the inter-relationship between the rated entity and the unrated subsidiaries or affiliates.

122. For the avoidance of doubt, while the Task Force directs the SVO to use the NAIC Designation or Eligible NAIC CRP rating equivalent of the obligor's parent entity, due to the SVO's authority to notch such NAIC Designation or rating, the SVO, based on its analytical judgement and in its sole discretion, may assign an NAIC Designation to the obligor which differs from the correlated Eligible NAIC CRP rating equivalent of the obligor's parent entity. Also, for the avoidance of doubt, the SVO may, based on its analytical judgement and in its sole discretion, choose not to assign any NAIC Designation to the working capital finance program, based on other attributes of the working capital finance program which are unrelated to the obligor or its parent entity.

123. The Task Force acknowledges that reliance upon the NAIC Designation or Eligible NAIC CRP rating equivalent of the obligor's parent entity in the absence of a binding legal obligation for the parent to assume the financial obligations of the obligor, such as a guarantee, is not a generally accepted technique or methodology (as explained in "Use of Generally Accepted Techniques or Methodologies" in Part One of this Manual) and is inconsistent with the credit substitution guidelines detailed in "Credit Substitution" in Part Three of this manual, but it is directing the SVO to so rely.

NOTE: See "Working Capital Finance Investments" in Part Three for filing instructions, documentation requirements, definitions and methodology applicable to Working Capital Finance Investments.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

WORKING CAPITAL FINANCE INVESTMENTS

…

110. **Obligor** – An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable—and which Obligor has, or can be designated, **NAIC 1** or **NAIC 2** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP or, if not so designated, the SVO can imply such designation, as directed by the VOS/TF pursuant to the "Working Capital Finance Investments (WCFI)" section in Part One of this Manual.

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Mike Monahan
Senior Director, Accounting Policy
(202) 624-2324 t
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January 27, 2021

Mr. Kevin Fry, Chairman
Ms. Carrie Mears, Vice Chair
Valuation of Securities (E) Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Incorporate Updates Made to SSAP No. 105R – Working Capital Finance Investments AND Comments on Proposed referral to The Statutory Accounting Principles (E) Working Group for consideration of a directive to the SVO to rely on unrated subsidiaries in WCFI transactions.

Dear Mr. Fry:

ACLI appreciates the ongoing engagement on the exposure draft released for comment by the Valuation of Securities Task Force regarding The Statutory Accounting Principles (E) Working Group adopted updates to SSAP No. 105R Working Capital Finance Investments on May 20, 2020. At the November 18, 2020 meeting Staff presented a draft for changes to the P&P Manual that in turn the Committee voted to expose. Separately, Staff reviewed their Memorandum dated October 16, 2020 regarding Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) regarding a possible Valuation of Securities (E) Task Force directive to the SVO to rely on unrated subsidiaries in WCFI transactions, which Regulators agreed to expose in advance of sending that proposed directive to the Statutory Accounting Principles (E) Working Group. This comment letter addresses the issues associated with both topics and the investment overall.

We believe it important to reiterate some key points that provide context to our specific comments on the P&P revisions and unrated subsidiaries proposals from the learnings of the now 11+ years that this investment has been in development:

- This is a high-quality investment:

- In $10 Billion filed and settled investments, there have been no impairments or default.
- The investment pays considerably more than comparable duration and risk-based investments.

- Adoption of the asset class by industry since NAIC adoption has been limited and we believe there are so few filers, or attempted filers, because the rules are complicated, and there is still regulatory uncertainty for the investment.
- ACLI was requested over 4 years ago to provide input about changes that could be made to make adoption successful which resulted in a series of 10 recommendations of which 7 have been reflected in both SSAP 105R and the proposed P&P revisions referenced herein.
- Even with these seven changes broad adoption likely will not occur because:
- Schedule BA reporting is and remains a substantive obstacle for most companies because most resist investments reported there as it generates unwanted scrutiny from ratings agencies and state examiners. Schedule DA reporting would alleviate that concern.
    - Uncertainty around acceptable investments for filing given a lack of definitions and insight into analysis, broadly and noted in this letter, hinders investment willingness which we attempt to address in part below.

Staff have requested a referral to SAPWG for their consideration of directing SVO to accept unrated subsidiaries as Staff position is that no methodology can be created to address unrated subsidiary risk substitution by a rated affiliate. While we have shared with the SVO rating agency materials for addressing unrated subsidiary affiliate risks as well as have proposed a methodology, as the SVO maintains they cannot develop a methodology, ACLI supports referral of the unrated subsidiaries issue to SAPWG to specifically request the Working Group to direct the SVO to accept unrated subsidiaries to assign ratings equivalents. We note, however, some challenges with this approach:

- SSAP No. 105R is specifically limited to NAIC 1 and NAIC 2 designations for program filings and that the SVO currently excludes the unrated subsidiaries from their approvals.
- Notching unrated subsidiaries downward to a lower rating category, than that of a rated parent that is NAIC 2 rated, such as to an NAIC 3, will make these programs ineligible and will increase filing uncertainty.
- One possible solution is that the "notching" to an NAIC 3 should not make the investment ineligible. We would be happy to work with the VOSTF/SAPWG on the required mechanics if such a position was supported by regulators. Another alternative could be for the instruction from SAPWG to limit notching below NAIC 2 specifically for these investments.

With regard to the P&P we note that neither "Key Participants" nor operational and credit risk are specifically defined in SSAP No. 105R. Lacking specific definitions as well as lacking insight into Staff investment analysis introduces filing uncertainty and potential costs to filers. Given this and the unrated subsidiaries referral, ACLI proposes changes to the to the P&P Manual exposure draft as follows:

"124. Operational Risk – To achieve an NAIC Designation, all operational risks shall be identified and assessed. One of the key Obligor participants shall have a NAIC CRP credit rating or an NAIC Designation assigned by the SVO at a level at least that of the required CRP and NAIC designation for the Obligor for it and its affiliated entities. For the purposes of this requirement, Finance Agents are not Key Participants requiring a CRP rating."

These revisions resolve conflicts with changes already made to SSAP No. 105R as finance agents may not have CRP ratings, can be designated as “Key Participants” and because the limitation to NAIC 1 or NAIC 2 Obligor Designation is being modified through SAPWG directive to accept unrated subsidiaries.

We thank you for your continued engagement on the topic.

Sincerely,

MMonahan

Mike Monahan
Senior Director, Accounting Policy

cc: Mr. Charles Therriault, Director, Securities Valuation Office

FitchRatings

Parent and Subsidiary Linkage Rating Criteria

Cross-Sector

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This report updates and replaces *Parent and Subsidiary Linkage Rating Criteria*¸dated 18 August 2020.

Scope

This report outlines the methodology Fitch Ratings uses when assigning new or reviewing existing Issuer Default Ratings (IDRs) or National Long-Term Ratings (NLTRs) for non-financial companies linked by a parent and subsidiary relationship. References to "notching" within this paper refer only to the relationships between IDRs and not to specific debt issues.

The criteria set out in this report supplement and are applied in conjunction with Corporate Rating Criteria for the Corporates sector and Infrastructure and Project Finance Rating Criteria for the Infrastructure and Project Finance sector. These criteria do not apply to subsidiaries of non-financial corporates with substantial financial services-style operations, often for capital goods companies or retailers. These companies are covered by the Non-Bank Financial Institutions Rating Criteria.

These criteria also do not apply to credit ratings assigned to entities covered by the Government-Related Entities Rating Criteria. However, subsidiaries of government-related entities (GREs) will generally be rated using the present criteria. The notching we apply to issuers rated on the national scale may vary from these criteria in order to preserve the ranking of risk within the country in question after considering national relativities.

Key Rating Drivers

Linkage strength determines if the consolidated credit profile or Standalone Credit Profile (SCP) is more or less important when assigning IDRs. On the one hand, both the parent and subsidiary will be rated at the consolidated level, irrespective of their SCP, if their linkage is very strong. On the other hand, both entities can be rated at their standalone level if their linkage is very weak, particularly when dealing with fully ring-fenced structures.

Parent-Subsidiary Linkage (PSL) Relationship: Fitch determines if ownership by the parent constitutes sufficient control or recourse that linkage should be considered.

Relative Credit Quality: The consolidated credit profile and the SCP of the parent and its subsidiary are used to determine the final ratings.

Linkage Strength: Fitch analyses the legal, operational and strategic ties between the parent and its subsidiary. Legal ties constitute specific, contractual linkage between the parent and subsidiary. Legal ties are generally the most important of the three categories since they may constitute specific and tangible linkage between the parent and subsidiary. The presence of a strong legal tie could outweigh a lack of operational and strategic ties and result in a close linking of ratings.

However, Fitch may still assess overall ties as strong, even in the absence of legal ties, if operational and strategic ties are robust. Strategic ties are less important when the subsidiary is stronger as we assume that a weaker parent will draw support from a stronger subsidiary, if it is able, regardless of the strategic importance of the subsidiary.

Linkage Considerations Framework

The following section outlines the steps Fitch takes when determining whether or not to link the IDRs of a parent and its subsidiary. The steps collectively form a Linkage Considerations Framework (LCF). The four steps are:

Related Criteria

Corporate Rating Criteria (May 2020)
Infrastructure and Project Finance Rating Criteria (March 2020)
Government-Related Entities Rating Criteria (November 2019)

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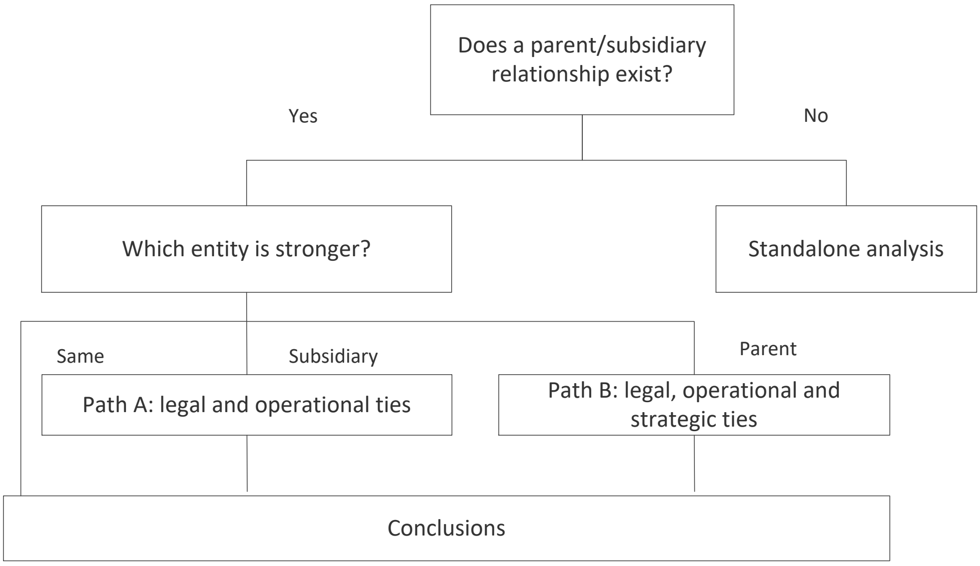
1. determine if a parent-subsidiary relationship exists
2. determine the relative SCPs of the parent and its subsidiary as well as the consolidated credit profile
3. determine the strength of any parent and subsidiary relationship by assessing any legal, operational and strategic ties, and
4. form a conclusion.

An abridged flow chart below summarises these steps. Please see *Appendix 1* for a more detailed chart.



Source: Fitch Ratings

Step 1: Determine if a Parent-Subsidiary Relationship Exists

Fitch examines the relationship between a parent and its subsidiary to see whether the parent has sufficient control for such a relationship to exist before determining if the IDRs of a parent and its subsidiary should be linked. Sufficient control is typically indicated by the parent having majority (direct or indirect) economic or voting control over the subsidiary, which would normally mean the subsidiary is consolidated in the parent's group financial statements. The criteria also treat minority ownership scenarios in the same manner when there is evidence of control.

An associate or joint-venture relationship exists when a parent (or investor) holds an equity stake in another company (vehicle or investee) with some influence but no control over the investee's strategic decisions. Such relationships are typically indicated by equity accounting or joint-venture proportional consolidation. There is normally no rating linkage in such situations but we may assume linkage if we determine that a stronger investor is likely to support a weaker investee in financial distress for strategic or reputational reasons, for example.

We follow steps two to four of the LCF to determine the degree of appropriate linkage where a parent-subsidiary (or relevant investor-investee) relationship exists. We rate entities based on their SCPs if no relationship exists.

We rate corporate subsidiaries of private equity (PE) vehicles, or similar financial investors, based on SCPs and do not generally assume parent-subsidiary or relevant investor-investee relationship under these criteria as:

- such owners may not be relied upon to be providers of financial support in the long term;
- the influence of weaker PE or owners with a strong desire for cash would normally be reflected in our assumptions of dividends and the recognition that lenders generally require covenant protection with restricted payment conditions when an issuer is controlled by PE owners; and
- such investors may be aggressive on one deal but supportive on another, weakening the value of any systematic support or constraint judgements.

Step 2: Determine Standalone Credit Strengths

If Fitch determines that linkage (as defined in Step 1 of the criteria) exists in a non-regulated industry, the next step is to determine the parent's and subsidiary's SCP using Fitch's Corporate Rating Criteria.

The parent's and subsidiary's IDRs will be the same, although technically not linked, if the companies' SCPs are the same. In other words, neither company's credit strength relies on that of the other to meet its obligations. Our assessment of a parent's SCP is not restricted to its unconsolidated financials but also includes cash flow and diversification benefits from other relevant group activities, although we would exclude activities of the assessed subsidiary. There is no need to proceed to Path A or Path B of the LCF for non-linked identical IDRs in a group.

Path A of the LCF is used to determine the legal and operational relationship that exists if the parent's SCP is weaker than that of its subsidiary. Path B of the LCF is used if the parent has higher credit quality than its subsidiary.

For subsidiaries of entities rated under the GRE rating criteria, the parent credit profile used in the PSL assessment will generally be the parent GRE's IDR (including government support). However, if Fitch believes that government support is unlikely to flow to the subsidiary (for example, if the subsidiary does not undertake any public service or other activities that drive government support for the parent GRE), the parent GRE's SCP (excluding support) will be used as a starting point.

Elements taken into consideration are:

- the consequences of a default of the subsidiary on the GRE parent's operations;
- whether the subsidiary's operations are integral to the provision of the public service or economic activity that drives support of the government to the GRE. For example, a foreign subsidiary of the GRE, even if very large, is unlikely to benefit from support from the government.

The parent GRE is defined as the highest entity in the group responsible for operational management and setting strategic goals for the whole group. The following types of entities will therefore not be regarded as parent GREs, meaning Fitch may "look through" these entities, i.e. apply GRE criteria using the sovereign as the parent, rather than these criteria with an entity as the parent:

- sovereign wealth funds or similar institutions
- intermediate holding companies, with no material operations or debt, used by the government to hold its investments.

When the PSL approach cannot be used because the parent GRE is not rated, Fitch will assess government support by applying the GRE criteria directly to the subsidiary, provided that Fitch is confident that entities upstream in the ownership chain would not prevent the subsidiary from receiving timely government support. In such a case, the SCP taken into account in the application of the GRE criteria would be that of the subsidiary.

See *Appendix 2* for a discussion on instances where there is a lack of financial information on the subsidiary.

Step 3: Analyse Legal, Operational and Strategic Ties

Fitch analyses various aspects of the relationship between the parent and subsidiary to assess the degree of linkage and therefore the extent to which the IDRs are correlated.

Legal Ties

Legal ties are generally the most important of the three major LCF sub-components since they may constitute specific and tangible linkage between the parent and subsidiary. Strong legal ties often result in an equalisation of ratings. The presence of legal ties could outweigh a lack of operational and strategic ties and result in a close linking of ratings. Conversely, the absence of formal agreements would not necessarily supersede the presence of strong operational and strategic ties. Below is an analysis of the main legal ties examined by Fitch.

Guarantees

A close relationship between IDRs is indicated if a stronger entity guarantees all the debt obligations of its weaker related entity. The senior unsecured rating of the parent's guaranteed debt is usually the same as that of its subsidiary if the subsidiary guarantees payment of a substantial portion of its parent's unsecured debt obligations on an irrevocable, unconditional, unsecured basis.

If the weaker parent defaults, the bonds' rating would not be affected provided that the subsidiary meets its obligations under its guarantee. However, if the stronger guarantor defaults, the rating of the parent's guaranteed debt would drop to a level consistent with the parent's IDR. The guarantor's IDR, meanwhile, would reflect the burden of the guarantee obligation as well as its own debt liabilities. In certain legal jurisdictions, upstream guarantees are not enforceable and hurdles of "corporate benefit" or "adequate consideration" have to be evidenced. Equally, some jurisdictions have legal limits on recourse to the guarantor.

When only certain subsidiaries guarantee the parent's debt, Fitch assesses the independent credit profile of the subsidiaries and their contribution to the relevant rating. This analysis also considers whether guarantees are granted on a joint and several basis. Generally, a significant joint obligation should exist to equalise the parent's IDR with the group's consolidated risk profile; for example, when subsidiaries representing at least 80% of group EBITDA or assets guarantee the parent's debt. However, to be prudent, investors should assume subsidiaries that are not guarantors in such group structures would not contribute to this support, although they may have some ability to provide upstream support through dividends.

A weaker entity that has only a portion of its debt guaranteed by a stronger entity may have a lower IDR than the stronger entity, despite specific guaranteed debt instruments having ratings identical to the stronger guarantor's IDR.

Public or private letters of support, comfort letters and "keep well" agreements do not constitute legal guarantees. However, some capital call agreements do create a funding obligation and would therefore be taken into consideration when applicable.

Dividend and Inter-Company Loan Restrictions

Fitch generally undertakes separate analyses of a parent's and subsidiary's vulnerability to default where cash flows between the two are restricted (one component of ring-fencing). Fitch will usually expect to assign different IDRs if the two entities have different SCPs. Such ring-fencing mechanisms can take the form of restricted dividend covenants or minimum financial ratios before paying subordinated inter-company loan obligations.

Various provisions may ring-fence an entity, thereby protecting it from contamination from other group entities. Provisions may include:

- separate financing, including no cross-default or cross-acceleration conditions and no external guarantees;
- separate liquidity (cash management, availability under credit facilities, cash pooling and treasury management);
- covenanted dividend restrictions;
- covenanted, or company policy, mitigating related-party transactions and other potential conflicts of interest (for example, in feedstock and shared services);
- non-common ownership;
- separate management and active, independent board representation consistent with a separate company.

The presence of one or more of these factors could result in a subsidiary being rated higher than its parent. This covenanted insulation could benefit the subsidiary's IDR by hampering the flow of cash to a weaker parent at a time of stress. Ring-fencing that improves the credit profile of a stronger subsidiary is likely to weaken the parent's credit strength, as the parent's access to subsidiary cash flows is restricted to a permitted dividend stream or loan. These cash flows are usually junior in payment priority to subsidiary debt and therefore may be significantly more volatile than subsidiary operating cash flows. The tighter the ring-fence (i.e. the more likely that cash flows leaving a subsidiary are restricted), the greater the potential for a notching differential between the parent and subsidiary.

In the absence of tight subsidiary ring-fencing, we take into account the parent's need for cash flows from the subsidiary to meet its debt service requirements when assessing the stronger subsidiary's SCP. For example, if a parent has few other sources of cash to meet interest and principal obligations, our assessment of the subsidiary's SCP will reflect that dividends and other inter-company payments are quasi-debt service and reflect a burden or additional fixed-charge obligation.

Fitch also takes into consideration the position of covenants, as restricted-access covenants in public bond documentation typically support long-lasting adherence to such mechanisms. However, Fitch would not rely too much on such arrangements in private bank financings, which can be easily refinanced or the covenants waived if breached. Fitch recognises, however, that issuers can remove constraints imposed on them by ring-fencing covenants even in public debt obligations by refinancing the relevant bonds. Fitch would take into account the likelihood of such refinancing, including the size of the debt needing to be refinanced, as well as the record and announced intentions of the relationship between a parent and subsidiary as they relate to cash flow movement between the entities.

Cross Defaults

Cross-default clauses generally provide that a non-negligible default within an entity's capital structure or a related party's debt instrument triggers an event of default in its other debt instruments. Debtholders can consider whether the relevant quorum should waive the uncured event of default while waiting for the grace period to expire or enforce it by accelerating the loan. The cross default enables all debtholders to simultaneously prepare to take action, whereas progressing to enforcement enables each one (or under cross-acceleration clauses, all relevant debtholders) to take more definitive action.

Cross defaults may lead to equalising or near-equalising of ratings on an ex-ante basis when viewed as a form of legal linkage and as a statement of intent by both debtor parties. We take into account materiality, including any carve-outs for cross defaults and the size of the debt instrument relative to the cross-default threshold. Cross defaults may, at the very least, provide the opportunity for creditor classes, who may have stakes in both entities, to link the fates of the entities at a point of stress. For example, lenders to the parent could exert pressure on management to either support or not support the subsidiary with parent cash flows, depending on whether those lenders are also lending at the subsidiary level.

Fitch's assessment of linkage when cross-default clauses exist is dynamic, as documentation changes can affect ratings. For example, the parent may remove its subsidiary out of a "restricted" or "principal" subsidiary definition as the subsidiary approaches financial distress to prevent it from triggering the cross-default clause.

Sector-Specific Considerations

We assess whether there are any sector-specific legal or regulatory hurdles that would affect credit linkage. For example, regulation in insurance, financial institution and public-utility sectors may restrict a corporate parent's full access to subsidiary cash, despite ties being strong in all other respects.

Different Jurisdictions

In some jurisdictions, subsidiaries – despite their financial strength – may not benefit a consolidated group's profile, even if contractual guarantees or cross defaults exist, because of impediments (legal or otherwise) that prevent enforcement of contractual terms.

We may limit the benefit derived from a financial guarantee if the subsidiary is domiciled in a country where we have concerns about the stability, timeliness or enforceability of law, in a similar fashion to the considerations employed in our Country-Specific Treatment of Recovery Ratings Rating Criteria. This extends to Fitch's assessment of support when there is no full financial guarantee or cross-default clause and potential support could be negatively affected by restrictions on the cross-border transfer of funds. The latter would also encompass Fitch's Country Ceilings Criteria, particularly if the guarantor is overseas.

Operational Ties

The criteria for linkage determined by operational ties differ depending on whether the parent is stronger or weaker than its subsidiary. Common management and decision-making is important in establishing linkage when the parent is weaker, as the parent would likely draw on the stronger subsidiary's resources, assuming that no ring-fencing exists. This is a less important consideration when the parent is stronger. Similarly, operational integration is not relevant when the subsidiary is stronger, as the weaker parent would likely be less interested in synergies with the subsidiary than in obtaining its cash flows – again, assuming no ring-fencing is in operation, as detailed in the *Legal Ties* section above.

Management Control and Commonality

The level of control and commonality between the management of a parent and its subsidiary is an important factor in determining linkage when the parent is weaker. For example, effective parental control of the subsidiary's board may indicate strong linkage and two companies may operate as if they were a single entity, despite separate legal status. Conversely, a low level of senior management overlap, with the parent and subsidiary having separate CEOs, CFOs, directors or marketing functions, would typically indicate weak linkage.

Centralised Treasury

Fitch examines the degree of integration between the parent's and subsidiary's financing operations to determine the degree of linkage when the parent is weaker than its subsidiary.

Fitch deems that strong linkage exists when all external funding is channelled through the parent, which acts as the subsidiary's central treasury and on-lends funds to its subsidiaries, which do not raise funds on their own account. All cash for both entities in this scenario would be held in an account in the name of the parent. Conversely, Fitch would deem financial integration linkage to be weak when funding is entirely decentralised, with all significant group companies operating their own treasury functions and raising funds (including liquidity facilities) on their own accounts, with no involvement from the parent.

Operational Overlap and Integration

The first two operational ties outlined above address the weaker parent/stronger subsidiary analysis under Path A of the LCF, while operational overlap and integration is generally only relevant under the stronger parent Path B scenario.

Strong linkage under these criteria would reflect subsidiary operations that are integral to the parent's core business. For example, in the case of an oil and gas company that owns subsidiaries operating in the downstream petrochemicals sector. long-term off-take agreements between the two parties and an absence of alternative off-takers or suppliers would provide evidence of strong interdependence. More moderate levels of integration, with considerable avoidance costs arising for one year after the parent's decision to replace its subsidiary, would represent weak-to-moderate linkage.

Strategic Ties

Strategic ties are a key consideration when determining the linkage between a financially strong parent and a weaker subsidiary due to the parent's ability to financially support its subsidiary if it makes strategic sense. This section of the analysis is broken into two sections: *Strategic Importance* and *Tangible Support*.

Strategic ties are only considered when the parent is stronger. A weaker parent, in the absence of legal or contractual restrictions, will use cash flow from its stronger subsidiary regardless of strategic relationships.

Strategic Importance

A financially weak subsidiary is deemed to be highly important to its financially stronger parent if the parent's performance is contingent upon the success of the subsidiary. Ratings may be equalised if the strategic importance is so high that it potentially affects the parent's survival.

Parent and subsidiary ratings would be based on their own credit fundamentals if a subsidiary's operations or business strategy were distinctly different from the core operations of its financially stronger parent and of little financial or commercial value to the parent's direction. This reflects Fitch's view that the parent would not hesitate to sell the subsidiary or allow it to fail if doing so made economic sense. In between these two scenarios are situations where a subsidiary has some strategic importance to its parent but not to the degree that it is a foregone conclusion that the parent would help the subsidiary to meet its debt obligations in a timely manner.

Tangible Support

The higher the degree of demonstrated tangible support between a financially stronger parent and its subsidiary, the more likely that the ratings will be closely linked. Examples of tangible support include frequent cash-based equity injections and occasional (preferably subordinated) intercompany loans, and regular provision of low- or zero-cost land from the sovereign to a state-supported free-zone developer. Weak strategic ties tend to be reflected in an absence of tangible support or the presence of only soft support letters to banks.

In the situation of a newly formed subsidiary where a record of support is not available, Fitch would take into account the event risk related to the subsidiary, the degree of isolation of the entity from the rest of the organisational structure and the management's intentions for the structure.

Operations with riskier business profiles are often placed in a subsidiary that is isolated from the rest of the organisation. This could imply a lower intention of support if the entity fails.

Step 4: Conclusion and Notching

The ultimate decision on whether to link IDRs and apply notching depends on whether Path A or Path B of the LCF is followed. Identical IDRs are a possibility under four of the five options in the decision tree and differing IDRs would be based on each entity's SCP and the consolidated credit profile.

Path A (Weaker Parent)

We assess the legal and operational linkages outlined above, weighting as necessary. The assessment's effect on IDRs is as follows:

- **Strong or Moderate Linkage** – weaker parents can usually extract cash or assets from stronger subsidiaries they control. Therefore, the most likely case is for IDRs to be assigned at the same level (generally that of the consolidated group). For example, if the parent's SCP is 'BB' and that of the subsidiary is 'BBB', both IDRs are likely to be based on the consolidated credit profile, which would probably be somewhere between the two SCPs, depending on the subsidiary's size.
- **Weak Linkage** – the subsidiary's IDR may be rated higher than the consolidated profile, and the parent may be notched down from the consolidated profile by at least a notch, in relatively uncommon situations where ties are weak, i.e. where the parent's access to its subsidiary's cash or assets is limited by legal or operational means.

  The general rating guideline is for a subsidiary to be rated a maximum of two notches higher than the consolidated profile if weak linkage is established – for example, when there is no or little common management, no guarantees and no inter-company trading or lending. Wider notching may be warranted in certain circumstances, such as:

  - when a parent is in bankruptcy and the subsidiary continues to operate without risk of consolidated bankruptcy filing; or
  - if there is robust contractual ring-fencing which protects the subsidiary's cash flows and assets from a weaker parent. A robust ring-fence would lead to both parent and subsidiary being rated on at its SCP.

Fitch assesses the relative importance of the factors that determine potential notching of a subsidiary's IDR above that of its parent on a case-by-case basis. Individual factors may carry more weight in certain situations, but generally the presence of documentary or legal protection for the subsidiary's cash flows is the most important factor.

Path B (Stronger Parent)

The following general criteria apply in determining the parent's and subsidiary's IDRs, based on legal, operational and strategic linkages, if the balance of answers indicates:

- **Strong Linkage** – the stronger the degree of linkage between the two entities, the more probable that the IDRs will be closely related. However, this is not to say they will be identical. Even if the links are strong, the subsidiary's IDR may be notched below that of the parent, typically within a range of three notches. Fitch would expect most of the following sub-set criteria to be met for two entities' IDRs to be rated at the same level:
  - Comprehensive cross-default provisions affecting parent and subsidiary across all major lending groups and public debt obligations.
  - Subsidiary is operationally integral to the parent's core business.
  - Subsidiary is strategically important to the direction of the group's operations, potentially providing long-term fiscal benefits or access to markets the parent could not otherwise access.
  - The parent provides tangible financial support to the subsidiary via an ongoing cash subsidy or guarantee, and the level of the parent's investment in the subsidiary is deemed significant relative to the scale of the group and its financial resources.
  - A publicly declared or Fitch-notified group strategy regarding the parent's treatment of its subsidiary.

Our analytical judgment determines the level of downward notching to apply to the subsidiary's IDR if we assess linkages are strong but insufficient to warrant equalisation.

We take a bottom-up approach, as follows, if we assess the links as weak or moderate:

- **Weak Linkage** – the parent's and subsidiary's IDRs will not be linked if Fitch deems there to be a weak linkage relationship under Path B of the LCF outline, in which case the IDRs will be based on the respective SCPs of the two entities.
- **Moderate Linkage** – Fitch may notch the subsidiary's rating above its SCP when the links are not strong enough to warrant a top-down approach but we believe parental support will be available in a time of crisis. A single-notch uplift is most common in these circumstances, while a two-notch uplift is less common and a notching greater than two is rare. Notching up of the subsidiary is predicated on there being little credit risk overlap of the parent and subsidiary to ensure the parent will not itself be in financial trouble when the subsidiary is likely to need support.

  This approach reflects instances when it would be a greater burden for the parent to allow the subsidiary to declare bankruptcy than to maintain capital calls; for example, the reputational risk associated with allowing the allowing the subsidiary to go bankrupt.

Criteria Disclosures

In Fitch's rating action commentaries and rating reports, Fitch expects to disclose, as applicable, how these criteria have been applied, including:

- the approach taken, i.e. strong parent/weak subsidiary, weak parent/strong subsidiary or equally strong parent and subsidiary;
- assessment of the strength of the overall linkage and individual legal, operational and strategic (where relevant) linkage as strong, moderate or weak;
- key elements of the legal, operational and strategic (where relevant) ties that drive the overall linkage assessment; and
- the notching approach: top-down or bottom-up, the number of notches and the anchor rating for the notching (i.e. the rating from which we notch, be it parent SCP, subsidiary SCP or consolidated).

Variations from Criteria

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

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

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

Limitations

Ratings (including Rating Watches and Outlooks) assigned by Fitch are subject to the limitations specified in Fitch's Ratings Definitions, found at https://www.fitchratings.com/products/rating-definitions.

In addition, ratings within the scope of these criteria are subject to limitations in the master criteria Corporate Rating Criteria.

Rating Sensitivities

Ratings are sensitive to legal, operational and strategic links, with higher importance accorded to legal links. We may also revise our assessment of the legal, operational or strategic ties. Revisions are usually driven by new evidence. For example, stronger ties might be indicated by a parent providing equity support or guaranteeing a subsidiary; selling off assets, leading to a rated-subsidiary becoming more significant to the group; or taking greater management control of a subsidiary.

Conversely, weaker ties might be indicated if a parent announces the sale of a rated subsidiary or deems it non-core in a revised strategy; if a stronger subsidiary is refinanced with non-recourse lending containing robust ring-fencing mechanisms; or if a subsidiary does not receive the parental support we expected.

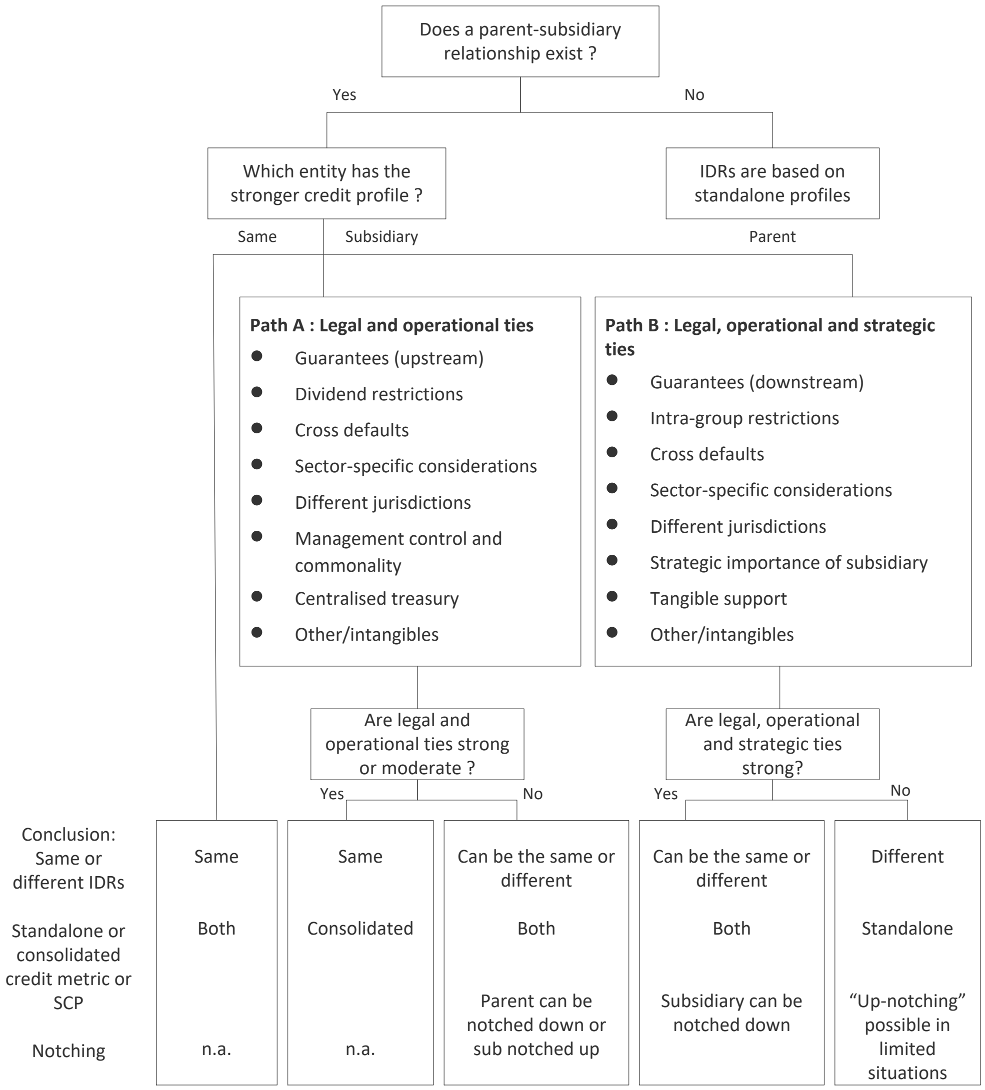
Data Sources

Key rating assumptions for the criteria are informed by Fitch's analysis of various corporate finance ratings over many years; analytical discussions with issuers and obligors; information received from participants across fixed-income markets; and general market observations determined by experienced analytical rationale. When performing its assessment on the existence and strength of a linkage between a parent and a subsidiary, Fitch uses public information and information received from the issuer, as required under the relevant path (Path A or Path B).

Such information can include annual accounts (to determine the consolidation method), debt documents or summaries thereof (such as guarantee terms and restrictive covenants), and information regarding decision-making between the entities (management board composition) or treasury policies and practises or evidence of past support.

Appendix 1

LCF Outline



n.a.: not applicable
Source: Fitch Ratings

Appendix 2

Guidelines for Rating a Subsidiary Without Standalone Financial Information or a Parent Guarantee

A subsidiary may sometimes have long-term public bonds outstanding but neither publish standalone financial statements nor benefit from a downstream parental guarantee. This typically occurs when a debt-issuer (subsidiary) is acquired and the acquiring company (parent) is not obligated to guarantee the bonds or provide ongoing financial statements of the subsidiary.

Reasons for a parent not refinancing subsidiary debt at the parent level include a short maturity, attractive coupon or an expensive make-whole provision, among others. Factors for a parent not guaranteeing the debt include additional administrative and filing costs and flexibility for an evolving business structure.

Fitch uses the factors below as a guideline for maintaining and determining the subsidiary's ratings in these instances. This methodology does not apply to subsidiaries that generate the majority of group cash flows if Fitch can reasonably determine the subsidiary's financial status without separate financial statements being filed. Importantly, the guidelines are not meant as an alternative to the PSL methodology used in the main body of these criteria, nor are they meant for new debt issues.

Step 1: Considerations for Maintaining the Subsidiary's Ratings

Management Rationale or Intention

Fitch would be unlikely to maintain ratings if the management's rationale for not guaranteeing subsidiary debt focused on wanting flexibility for an evolving business model. This would signify that the parent and acquired company may not be a long-term strategic fit and the subsidiary's financial status could change. Alternatively, if the decision were due to additional administrative costs or burdens, Fitch would move on to the following remaining factors.

Ability to Support the Subsidiary

Fitch would consider the parent's financial stability on a fully consolidated pro forma basis. The subsidiary ratings are more likely to be maintained when the parent is investment-grade or in the 'BB' rating category. A parent rating in the 'B' category or lower would result in Fitch withdrawing the subsidiary rating.

Record of the Management's Treatment of Bondholders

Fitch will often not rate the subsidiary if the parent's management, whether in the current company or in previous roles, had ever allowed a subsidiary to default on debt or spun-off a debt-issuing subsidiary that resulted in the subsidiary having a significantly weaker credit profile. The remaining factors below are still taken into account, as the management's past action on one subsidiary may not be relevant or likely for other subsidiaries.

Operational or Strategic Integration

Fitch would be more likely to maintain a subsidiary's ratings if a parent executes a vertical or horizontal acquisition with the intention of fully integrating manufacturing, distribution, purchasing, treasury, billing, customer service and product brands, among other functions. This would signify that the consolidated financial statements reliably represent the company's future financial profile and indicate a lower risk of subsidiary spin-offs. Complementary acquisitions that provide potential for revenue synergy offer similar evidence. Fitch would be less likely to continue rating the acquired subsidiary if it remained a separable asset, be it from a product, brand, supply chain or geographical perspective, unless there were strong complementary ties.

Other Considerations

Expectation for Bond-Market Access

A parent's need for bond-market access due to expected refinancing or a history of debt-financed acquisitions would support the maintenance of a subsidiary rating. A parent's maturity schedule spanning the subsidy's entire maturity schedule is seen as a strong incentive for the parent to maintain bond-market access and therefore support subsidiary debt.

Legal, Cross-Default or Material Subsidiary Cross-Default Language

The maintenance of a subsidiary's ratings would be supported when the acquired subsidiary qualifies as a "subsidiary", "material subsidiary", "principal subsidiary" or similar language described in the events-of-default section in the parent's public-debt covenant package. Such language often declares a parent default in the instance of a subsidiary default. The maturity date of the applicable parent bonds would have to extend beyond the subsidiary debt maturities to maintain the ratings. Historical usage of this language and current outstanding borrowings must also be taken into account, since such language is most common in bank credit agreements and bonds. The language itself, however, may not be enough to justify maintaining the subsidiary ratings as long-term strategic importance and operational integration should also be considered.

Reputational Risk

Reputational risk is a potential incentive for a parent to support the subsidiary, for example when the subsidiary has been rebranded to mirror the parent or a parent is using the subsidiary as an access point for a new country or market.

Step 2: Methodology for Determining Such Ratings

The methodology Fitch uses when rating a subsidiary without standalone financial information or a parent guarantee is outlined below. It is based on the parent's credit profile on a fully consolidated basis and pro forma for the applicable acquisition if it has not yet occurred. This step only applies if Fitch determines that a subsidiary's ratings can be maintained based on the considerations outlined in Step 1 above.

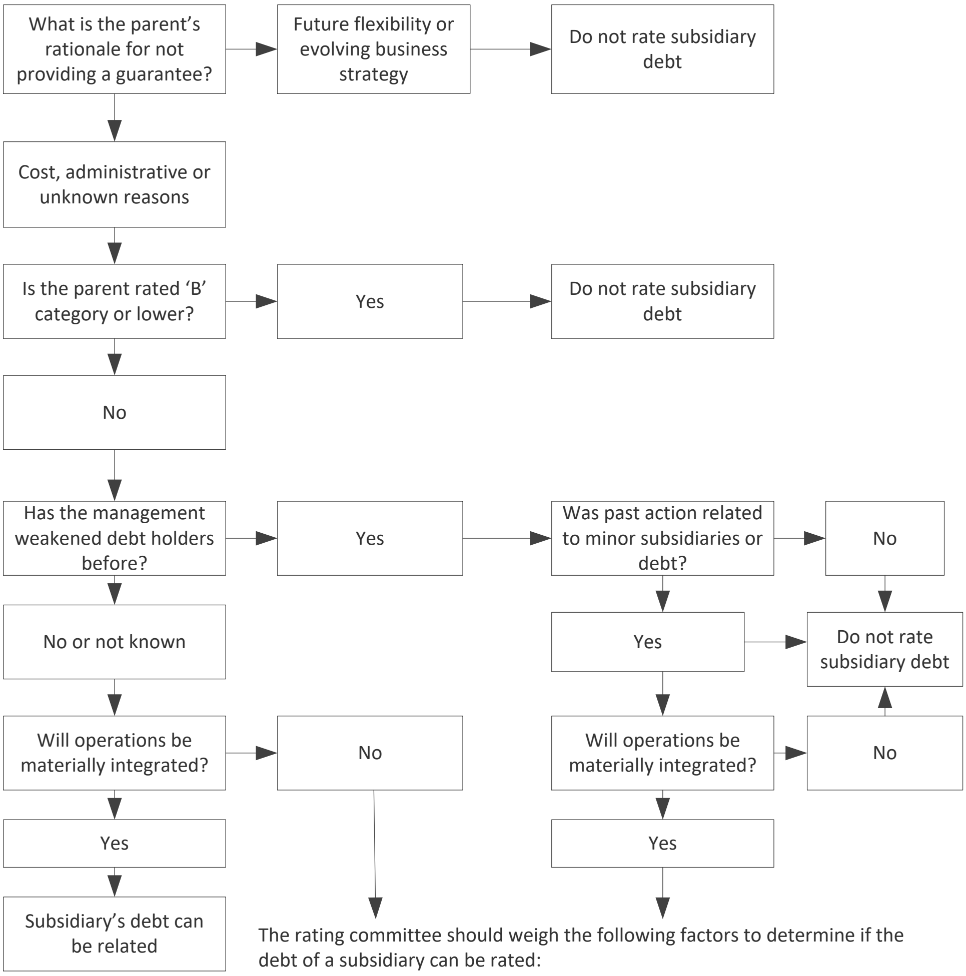
Step 2: Methodology for Determining Such Ratings

Parent rating	Methodology for subsidiary rating
Investment-grade and 'BB' rating category	Generally, the subsidiary's IDR and unsecured and subordinated debt instrument ratings will be equal to the parent's IDR and unsecured and subordinated debt ratings. However, the rating committee has the discretion to rate the subsidiary one notch below the parent. The subsidiary's secured debt would probably equal the subsidiary IDR. However, the committee has discretion to rate it one notch higher if there is substantial asset-coverage at the subsidiary level at the time of the acquisition, debt maturity is less than five years, and it expects business operations to be stable.
'B' rating category or below	Subsidiary ratings would be withdrawn.

Source: Fitch Ratings

Appendix 2 Flow Chart

Rating subsidiary debt without standalone financial information or a parent guarantee



The rating committee should weigh the following factors to determine if the debt of a subsidiary can be rated:

- Need for future bond market access
- Material subsidiary cross-default language
- Reputational risk
- Overall credit strength of the parent (a 'BB' parent may get less than an 'A' category)
- Stated public intentions of the management (if any)
- Material of existing subsidiary debt compared to previous negative actions (if applicable)

Source: Fitch Ratings

(/en_US/web/guest/home) Criteria | Corporates | General: Corporate Methodology

19-Nov-2013 17:23 EST

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(**Editor's Note:** On April 30, 2020, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.)

1. These criteria present S&P Global Ratings' methodology for rating corporate industrial companies and utilities. The criteria organize the analytical process according to a common framework and articulate the steps in developing the stand-alone credit profile (SACP) and issuer credit rating (ICR) for a corporate entity. For the related guidance article, see "Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)."

2. This article is related to our criteria article "Principles Of Credit Ratings (/en_US/web/guest/article/-/view/sourceId/6485398)."

SUMMARY OF THE CRITERIA

3. The criteria describe the methodology we use to determine the SACP and ICR for corporate industrial companies and utilities. Our assessment reflects these companies' business risk profiles, their financial risk profiles, and other factors that may modify the SACP outcome (see "General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating (/en_US/web/guest/article/-/view/sourceId/6219375)," for the definition of SACP). The criteria provide clarity on how we determine an issuer's SACP and ICR and are more specific in detailing the various factors of the analysis. The criteria also provide clear guidance on how we use these factors as part of determining an issuer's ICR. S&P Global Ratings intends for these criteria to provide the market with a framework that clarifies our approach to fundamental analysis of corporate credit risks.

4. The business risk profile comprises the risk and return potential for a company in the markets in which it participates, the competitive climate within those markets (its industry risk), the country risks within those markets, and the competitive advantages and disadvantages the company has within those markets (its competitive position). The business risk profile affects the amount of financial risk that a company can bear at a given SACP level and constitutes the foundation for a company's expected economic success. We combine our assessments of industry risk, country risk, and competitive position to determine the assessment for a corporation's business risk profile.

5. The financial risk profile is the outcome of decisions that management makes in the context of its business risk profile and its financial risk tolerances. This includes decisions about the manner in which management seeks funding for the company and how it constructs its balance sheet. It also reflects the relationship of the cash flows the organization can achieve, given its business risk profile, to the company's financial obligations. The criteria use cash flow/leverage analysis to determine a corporate issuer's financial risk profile assessment.

6. We then combine an issuer's business risk profile assessment and its financial risk profile assessment to determine its anchor (see table 3). Additional rating factors can modify the anchor. These are: diversification/portfolio effect, capital structure, financial policy, liquidity, and management and governance. Comparable ratings analysis is the last analytical factor under the criteria to determine the final SACP on a company.

7. These criteria are complemented by sector-specific provisions, included in industry-specific criteria articles called Key Credit Factors (KCFs) or in the guidance related to this criteria article ("Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)"). The KCFs describe the industry risk assessments associated with each sector and may identify sector-specific criteria that supersede certain factors of these criteria in the analysis. "Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)" also provides guidelines on the analytical factors we consider when applying "Corporate Methodology" to certain sectors.

SCOPE OF THE CRITERIA

8. This methodology applies to nonfinancial corporate issuer credit ratings globally. Please see "Recovery Rating Criteria For Speculative-Grade Corporate Issuers (/en_US/web/guest/article/-/view/sourceId/9831306)," and "Reflecting Subordination Risk In Corporate Issue Ratings (/en_US/web/guest/article/-/view/sourceId/10212700)," for further information on our methodology for determining issue ratings. This methodology does not apply to the following sectors, based on the unique characteristics of these sectors, which require either a different framework of analysis or substantial modifications to one or more factors of analysis: project finance entities, project developers, commodities trading, investment holding companies and companies that maximize their returns by buying and selling equity holdings over time, Japanese general trading companies, corporate securitizations, nonprofit and cooperative organizations (other than agricultural cooperatives, and other entities whose cash flows are primarily derived from partially owned equity holdings.

9. This paragraph has been deleted.

10. This paragraph has been deleted.

METHODOLOGY

A. Corporate Ratings Framework

11. The corporate analytical methodology organizes the analytical process according to a common framework, and it divides the task into several factors so that S&P Global Ratings considers all salient issues. First we analyze the company's business risk profile, then evaluate its financial risk profile, then combine those to determine an issuer's anchor. We then analyze six factors that could potentially modify our anchor conclusion.

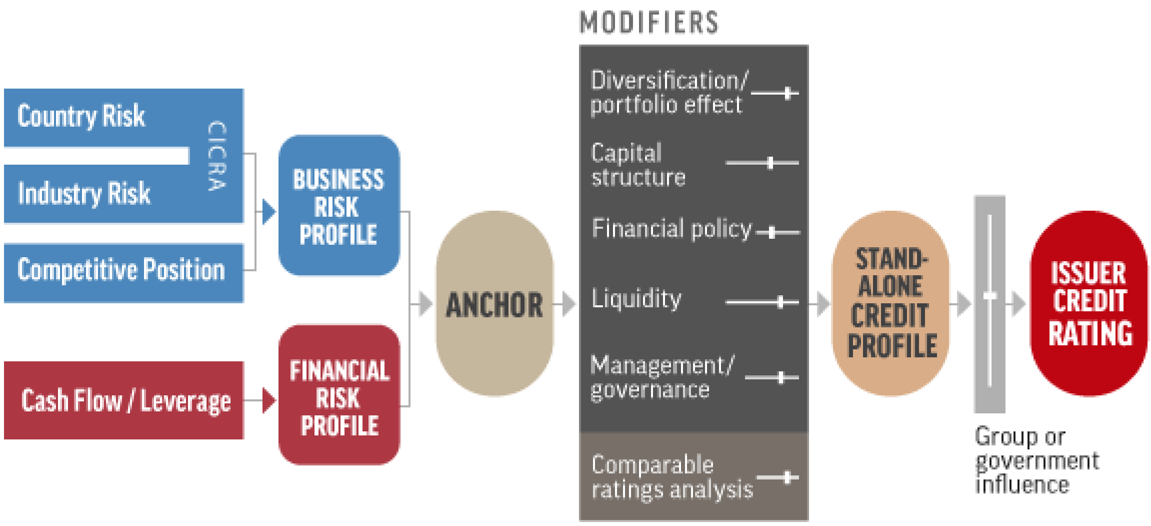
12. To determine the assessment for a corporate issuer's business risk profile, the criteria combine our assessments of industry risk, country risk, and competitive position. Cash flow/leverage analysis determines a company's financial risk profile assessment. The analysis then combines the corporate issuer's business risk profile assessment and its financial risk profile

assessment to determine its anchor. In general, the analysis weighs the business risk profile more heavily for investment-grade anchors, while the financial risk profile carries more weight for speculative-grade anchors.

13. After we determine the anchor, we use additional factors to modify the anchor. These factors are: diversification/portfolio effect, capital structure, financial policy, liquidity, and management and governance. The assessment of each factor can raise or lower the anchor by one or more notches--or have no effect. These conclusions take the form of assessments and descriptors for each factor that determine the number of notches to apply to the anchor.

14. The last analytical factor the criteria call for is comparable ratings analysis, which may raise or lower the anchor by one notch based on a holistic view of the company's credit characteristics.

Corporate Criteria Framework



15. The three analytic factors within the business risk profile generally are a blend of qualitative assessments and quantitative information. Qualitative assessments distinguish risk factors, such as a company's competitive advantages, that we use to assess its competitive position. Quantitative information includes, for example, historical cyclicality of revenues and profits that we review when assessing industry risk. It can also include the volatility and level of profitability we consider in order to assess a company's competitive position. The assessments for business risk profile are: 1, excellent; 2, strong; 3, satisfactory; 4, fair; 5, weak; and 6, vulnerable.

16. In assessing cash flow/leverage to determine the financial risk profile, the analysis focuses on quantitative measures. The assessments for financial risk profile are: 1, minimal; 2, modest; 3, intermediate; 4, significant; 5, aggressive; and 6, highly leveraged.

17. The ICR results from the combination of the SACP and the support framework, which determines the extent of the difference between the SACP and the ICR, if any, for group or government influence. Extraordinary influence is then captured in the ICR. Please see "Group Rating Methodology (/en_US/web/guest/article/-/view/sourceId/8336067)," and "Rating Government-Related Entities: Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceId/9032821)," for our methodology on group and government influence.

18. Ongoing support or negative influence from a government (for government-related entities), or from a group, is factored into the SACP (see "SACP criteria"). While such ongoing support/negative influence does not affect the industry or country risk assessment, it can affect any other factor in business or financial risk. For example, such support or negative influence can affect: national industry analysis, other elements of competitive position, financial risk profile, the liquidity assessment, and comparable ratings analysis.

19. The application of these criteria will result in an SACP that could then be constrained by the relevant sovereign rating and transfer and convertibility (T&C) assessment affecting the entity when determining the ICR. In order for the final ICR to be higher than the applicable sovereign rating or T&C assessment, the entity will have to meet the conditions established in

"Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceId/8343660)."

1. Determining the business risk profile assessment

20. Under the criteria, the combined assessments for country risk, industry risk, and competitive position determine a company's business risk profile assessment. A company's strengths or weaknesses in the marketplace are vital to its credit assessment. These strengths and weaknesses determine an issuer's capacity to generate cash flows in order to service its obligations in a timely fashion.

21. Industry risk, an integral part of the credit analysis, addresses the relative health and stability of the markets in which a company operates. The range of industry risk assessments is: 1, very low risk; 2, low risk; 3, intermediate risk; 4, moderately high risk; 5, high risk; and 6, very high risk. The treatment of industry risk is in section B.

22. Country risk addresses the economic risk, institutional and governance effectiveness risk, financial system risk, and payment culture or rule of law risk in the countries in which a company operates. The range of country risk assessments is: 1, very low risk; 2, low risk; 3, intermediate risk; 4, moderately high risk; 5, high risk; and 6, very high risk. The treatment of country risk is in section C.

23. The evaluation of an enterprise's competitive position identifies entities that are best positioned to take advantage of key industry drivers or to mitigate associated risks more effectively--and achieve a competitive advantage and a stronger business risk profile than that of entities that lack a strong value proposition or are more vulnerable to industry risks. The range of competitive position assessments is: 1, excellent; 2, strong; 3, satisfactory; 4, fair; 5, weak; and 6, vulnerable. The full treatment of competitive position is in section D.

24. The combined assessment for country risk and industry risk is known as the issuer's Corporate Industry and Country Risk Assessment (CICRA). Table 1 shows how to determine the combined assessment for country risk and industry risk.

Table 1

Determining The CICRA

	--Country risk assessment--					
Industry risk assessment	**1 (very low risk)**	**2 (low risk)**	**3 (intermediate risk)**	**4 (moderately high risk)**	**5 (high risk)**	**6 (very high risk)**
1 (very low risk)	1	1	1	2	4	5
2 (low risk)	2	2	2	3	4	5
3 (intermediate risk)	3	3	3	3	4	6
4 (moderately high risk)	4	4	4	4	5	6
5 (high risk)	5	5	5	5	5	6
6 (very high risk)	6	6	6	6	6	6

25. The CICRA is combined with a company's competitive position assessment in order to create the issuer's business risk profile assessment. Table 2 shows how we combine these assessments.

Table 2

Determining The Business Risk Profile Assessment

	--CICRA--					
Competitive position assessment	**1**	**2**	**3**	**4**	**5**	**6**
1 (excellent)	1	1	1	2	3*	5
2 (strong)	1	2	2	3	4	5
3 (satisfactory)	2	3	3	3	4	6
4 (fair)	3	4	4	4	5	6
5 (weak)	4	5	5	5	5	6
6 (vulnerable)	5	6	6	6	6	6

*See paragraph 26.

26. A small number of companies with a CICRA of 5 may be assigned a business risk profile assessment of 2 if all of the following conditions are met:

The company's competitive position assessment is 1.
The company's country risk assessment is no riskier than 3.

The company produces significantly better-than-average industry profitability, as measured by the level and volatility of profits.
The company's competitive position within its sector transcends its industry risks due to unique competitive advantages with its customers, strong operating efficiencies not enjoyed by the large majority of the industry, or scale/scope/diversity advantages that are well beyond the large majority of the industry.
27. For issuers with multiple business lines, the business risk profile assessment is based on our assessment of each of the factors--country risk, industry risk, and competitive position--as follows:

Country risk: We use the weighted average of the country risk assessments for the company across all countries where companies generate more than 5% of sales or EBITDA, or where more than 5% of fixed assets are located.
Industry risk: We use the weighted average of the industry risk assessments for all business lines representing more than 20% of the company's forecasted earnings, revenues or fixed assets, or other appropriate financial measures if earnings, revenue, or fixed assets do not accurately reflect the exposure to an industry.
Competitive position: We assess all business lines identified above for the components competitive advantage, scope/scale/diversity, and operating efficiency (see section D). They are then blended using a weighted average of revenues, earnings, or assets to form the preliminary competitive position assessment. The level of profitability and volatility of profitability are then assessed based on the consolidated financials for the enterprise. The preliminary competitive position assessment is then blended with the profitability assessment, as per section D.5, to assess competitive position for the enterprise.

2. Determining the financial risk profile assessment

28. Under the criteria, cash flow/leverage analysis is the foundation for assessing a company's financial risk profile. The range of assessments for a company's cash flow/leverage is 1, minimal; 2, modest; 3, intermediate; 4, significant; 5, aggressive; and 6, highly leveraged. The full treatment of cash flow/leverage analysis is the subject of section E.

3. Merger of financial risk profile and business risk profile assessments

29. An issuer's business risk profile assessment and its financial risk profile assessment are combined to determine its anchor (see table 3). If we view an issuer's capital structure as unsustainable or if its obligations are currently vulnerable to nonpayment, and if the obligor is dependent upon favorable business, financial, and economic conditions to meet its commitments on its obligations, then we will determine the issuer's SACP using "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings (/en_US/web/guest/article/-/view/sourceId/7554329)." If the issuer meets the conditions for assigning 'CCC+', 'CCC', 'CCC-', and 'CC' ratings, we will not apply Table 3.

Table 3

Combining The Business And Financial Risk Profiles To Determine The Anchor

	--Financial risk profile--					
Business risk profile	**1 (minimal)**	**2 (modest)**	**3 (intermediate)**	**4 (significant)**	**5 (aggressive)**	**6 (highly leveraged)**
1 (excellent)	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
2 (strong)	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
3 (satisfactory)	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
4 (fair)	bbb/bbb-	bbb-	bb+	bb	bb-	b
5 (weak)	bb+	bb+	bb	bb-	b+	b/b-
6 (vulnerable)	bb-	bb-	bb-/b+	b+	b	b-

30. When two anchor outcomes are listed for a given combination of business risk profile assessment and financial risk profile assessment, an issuer's anchor is determined as follows:

When a company's financial risk profile is 4 or stronger (meaning, 1-4), its anchor is based on the comparative strength of its business risk profile. We consider our assessment of the business risk profile for corporate issuers to be points along a possible range within its category (e.g., "strong"). Consequently, each of these assessments that ultimately generate the business risk profile for a specific issuer can be at the upper or lower end of such a range. Issuers with a stronger business risk profile for the range of anchor outcomes will be assigned the higher anchor. Those with a weaker business risk profile for the range of anchor outcomes will be assigned the lower anchor.
When a company's financial risk profile is 5 or 6, its anchor is based on the comparative strength of its financial risk profile. Issuers with stronger cash flow/leverage ratios for the range of anchor outcomes will be assigned the higher anchor. Issuers with weaker cash flow/leverage ratios for the range of anchor outcomes will be assigned the lower anchor. For example, a company with a business risk profile of (1) excellent and a financial risk profile of (6) highly leveraged would generally be

assigned an anchor of 'bb+' if its ratio of debt to EBITDA was 8x or greater and there were no offsetting factors to such a high level of leverage.

4. Building on the anchor

31. The analysis of diversification/portfolio effect, capital structure, financial policy, liquidity, and management and governance may raise or lower a company's anchor. The assessment of each modifier can raise or lower the anchor by one or more notches--or have no effect in some cases (see tables 4 and 5). We express these conclusions using specific assessments and descriptors that determine the number of notches to apply to the anchor. However, this notching in aggregate can't lower an issuer's anchor below 'b-' (see "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings (/en_US/web/guest/article/-/view/sourceId/7554329)," for the methodology we use to assign 'CCC' and 'CC' category SACPs and ICRs to issuers).

32. The analysis of the modifier diversification/portfolio effect identifies the benefits of diversification across business lines. The diversification/portfolio effect assessments are 1, significant diversification; 2, moderate diversification; and 3, neutral. The impact of this factor on an issuer's anchor is based on the company's business risk profile assessment and is described in Table 4. Multiple earnings streams (which are evaluated within a firm's business risk profile) that are less-than-perfectly correlated reduce the risk of default of an issuer (see Appendix D). We determine the impact of this factor based on the business risk profile assessment because the benefits of diversification are significantly reduced with poor business prospects. The full treatment of diversification/portfolio effect analysis is the subject of section F.

Table 4

Modifier Step 1: Impact Of Diversification/Portfolio Effect On The Anchor

	--Business risk profile assessment--					
Diversification/portfolio effect	**1 (excellent)**	**2 (strong)**	**3 (satisfactory)**	**4 (fair)**	**5 (weak)**	**6 (vulnerable)**
1 (significant diversification)	+2 notches	+2 notches	+2 notches	+1 notch	+1 notch	0 notches
2 (moderate diversification)	+1 notch	+1 notch	+1 notch	+1 notch	0 notches	0 notches
3 (neutral)	0 notches	0 notches	0 notches	0 notches	0 notches	0 notches

33. After we adjust for the diversification/portfolio effect, we determine the impact of the other modifiers: capital structure, financial policy, liquidity, and management and governance. We apply these four modifiers in the order listed in Table 5. As we go down the list, a modifier may (or may not) change the anchor to a new range (one of the ranges in the four right-hand columns in the table). We'll choose the appropriate value from the new range, or column, to determine the next modifier's effect on the anchor. And so on, until we get to the last modifier on the list--management and governance. For example, let's assume that the anchor, after adjustment for diversification/portfolio effect but before adjusting for the other modifiers, is 'a'. If the capital structure assessment is very negative, the indicated anchor drops two notches, to 'bbb+'. So, to determine the impact of the next modifier--financial policy--we go to the column 'bbb+ to bbb-' and find the appropriate assessment--in this theoretical example, positive. Applying that assessment moves the anchor up one notch, to the 'a- and higher' category. In our example, liquidity is strong, so the impact is zero notches and the anchor remains unchanged. Management and governance is satisfactory, and thus the anchor remains 'a-' (see chart following table 5).

Table 5

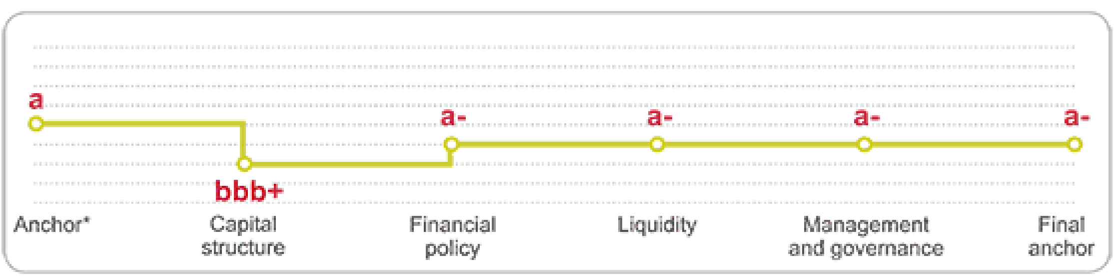
Modifier Step 2: Impact Of Remaining Modifier Factors On The Anchor

	--Anchor range--			
	'a-' and higher	**'bbb+' to 'bbb-'**	**'bb+' to 'bb-'**	**'b+' and lower**
Factor/Assessment				
Capital structure (see section G)				
1 (Very positive)	2 notches	2 notches	2 notches	2 notches
2 (Positive)	1 notch	1 notch	1 notch	1 notch
3 (Neutral)	0 notches	0 notches	0 notches	0 notches
4 (Negative)	-1 notch	-1 notch	-1 notch	-1 notch
5 (Very negative)	-2 or more notches	-2 or more notches	-2 or more notches	-2 notches
Financial policy (FP; see section H)				
1 (Positive)	+1 notch if M&G is at least satisfactory	+1 notch if M&G is at least satisfactory	+1 notch if liquidity is at least adequate and M&G is at least satisfactory	+1 notch if liquidity is at least adequate and M&G is at least satisfactory

2 (Neutral)	0 notches	0 notches	0 notches	0 notches
3 (Negative)	-1 to -3 notches(1)	-1 to -3 notches(1)	-1 to -2 notches(1)	-1 notch
4 (FS-4, FS-5, FS-6, FS-6 [minus])	N/A(2)	N/A(2)	N/A(2)	N/A(2)
Liquidity (see section I)				
1 (Exceptional)	0 notches	0 notches	0 notches	+1 notch if FP is positive, neutral, FS-4, or FS-5 (3)
2 (Strong)	0 notches	0 notches	0 notches	+1 notch if FP is positive, neutral, FS-4, or FS-5 (3)
3 (Adequate)	0 notches	0 notches	0 notches	0 notches
4 (Less than adequate [4])	N/A	N/A	-1 notch(5)	0 notches
5 (Weak)	N/A	N/A	N/A	'b-' cap on SACP
Management and governance (M&G; see section J)				
1 (Strong)	0 notches	0 notches	0, +1 notches(6)	0, +1 notches(6)
2 (Satisfactory)	0 notches	0 notches	0 notches	0 notches
3 (Fair)	-1 notch	0 notches	0 notches	0 notches
4 (Weak)	-2 or more notches(7)	-2 or more notches(7)	-1 or more notches(7)	-1 or more notches(7)

(1) Number of notches depends on potential incremental leverage. (2) See "Financial Policy," section H.2. (3) Additional notch applies only if we expect liquidity to remain exceptional or strong. (4) See "Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers." SACP is capped at 'bb+.' (5) If issuer SACP is 'bb+' due to cap, there is no further notching. (6) This adjustment is one notch if we have not already captured benefits of strong management and governance in the analysis of the issuer's competitive position. (7) Number of notches depends upon the degree of negative effect to the enterprise's risk profile.

Example: How Remaining Modifiers Can Change The Anchor



*After adjusting for diversification/portfolio effect. See paragraph 33.

34. Our analysis of a firm's capital structure assesses risks in the firm's capital structure that may not arise in the review of its cash flow/leverage. These risks include the currency risk of debt, debt maturity profile, interest rate risk of debt, and an investments subfactor. We assess a corporate issuer's capital structure on a scale of 1, very positive; 2, positive; 3, neutral; 4, negative; and 5, very negative. The full treatment of capital structure is the subject of section G.

35. Financial policy serves to refine the view of a company's risks beyond the conclusions arising from the standard assumptions in the cash flow/leverage, capital structure, and liquidity analyses. Those assumptions do not always reflect or adequately capture the long-term risks of a firm's financial policy. The financial policy assessment is, therefore, a measure of the degree to which owner/managerial decision-making can affect the predictability of a company's financial risk profile. We assess financial policy as 1) positive, 2) neutral, 3) negative, or as being owned by a financial sponsor. We further identify financial sponsor-owned companies as "FS-4", "FS-5", "FS-6", or "FS-6 (minus)." The full treatment of financial policy analysis is the subject of section H.

36. Our assessment of liquidity focuses on the monetary flows--the sources and uses of cash--that are the key indicators of a company's liquidity cushion. The analysis also assesses the potential for a company to breach covenant tests tied to declines in earnings before interest, taxes, depreciation, and amortization (EBITDA). The methodology incorporates a qualitative analysis that addresses such factors as the ability to absorb high-impact, low-probability events, the nature of bank

relationships, the level of standing in credit markets, and the degree of prudence of the company's financial risk management. The liquidity assessments are 1, exceptional; 2, strong; 3, adequate; 4, less than adequate; and 5, weak. An SACP is capped at 'bb+' for issuers whose liquidity is less than adequate and 'b-' for issuers whose liquidity is weak, regardless of the assessment of any modifiers or comparable ratings analysis. (For the complete methodology on assessing corporate issuers' liquidity, see "Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers (/en_US/web/guest/article/-/view/sourceId/8956570).")

37. The analysis of management and governance addresses how management's strategic competence, organizational effectiveness, risk management, and governance practices shape the company's competitiveness in the marketplace, the strength of its financial risk management, and the robustness of its governance. The range of management and governance assessments is: 1, strong; 2, satisfactory; 3, fair; and 4, weak. Typically, investment-grade anchor outcomes reflect strong or satisfactory management and governance, so there is no incremental benefit. Alternatively, a fair or weak assessment of management and governance can lead to a lower anchor. Also, a strong assessment for management and governance for a weaker entity is viewed as a favorable factor, under the criteria, and can have a positive impact on the final SACP outcome. For the full treatment of management and governance, see "Methodology: Management And Governance Credit Factors For Corporate Entities (/en_US/web/guest/article/-/view/sourceId/7629699)."

5. Comparable ratings analysis

38. The anchor, after adjusting for the modifiers, could change one notch up or down in order to arrive at an issuer's SACP based on our comparable ratings analysis, which is a holistic review of a company's stand-alone credit risk profile, in which we evaluate an issuer's credit characteristics in aggregate. A positive assessment leads to a one-notch improvement, a negative assessment leads to a one-notch reduction, and a neutral assessment indicates no change to the anchor. The application of comparable ratings analysis reflects the need to 'fine-tune' ratings outcomes, even after the use of each of the other modifiers. A positive or negative assessment is therefore likely to be common rather than exceptional.

B. Industry Risk

39. The analysis of industry risk addresses the major factors that S&P Global Ratings believes affect the risks that entities face in their respective industries. (See "Methodology: Industry Risk (/en_US/web/guest/article/-/view/sourceId/8304862).")

C. Country Risk

40. The analysis of country risk addresses the major factors that S&P Global Ratings believes affect the country where entities operate. Country risks, which include economic, institutional and governance effectiveness, financial system, and payment culture/rule of law risks, influence overall credit risks for every rated corporate entity. (See "Country Risk Assessment Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceId/8313032).")

1. Assessing country risk for corporate issuers

41. The following paragraphs explain how the criteria determine the country risk assessment for a corporate entity. Once it's determined, we combine the country risk assessment with the issuer's industry risk assessment to calculate the issuer's CICRA (see section A, table 1). The CICRA is one of the factors of the issuer's business risk profile. If an issuer has very low to intermediate exposure to country risk, as represented by a country risk assessment of 1, 2, or 3, country risk is neutral to an issuer's CICRA. But if an issuer has moderately high to very high exposure to country risk, as represented by a country risk assessment of 4, 5, or 6, the issuer's CICRA could be influenced by its country risk assessment.

42. Corporate entities operating within a single country will receive a country risk assessment for that jurisdiction. For entities with exposure to more than one country, the criteria prospectively measure the proportion of exposure to each country based on forecasted EBITDA, revenues, or fixed assets, or other appropriate financial measures if EBITDA, revenue, or fixed assets do not accurately reflect the exposure to that jurisdiction.

43. Arriving at a company's blended country risk assessment involves multiplying its weighted-average exposures for each country by each country's risk assessment and then adding those numbers. For the weighted-average calculation, the criteria consider countries where the company generates more than 5% of its sales or where more than 5% of its fixed assets are located, and all weightings are rounded to the nearest 5% before averaging. We round the assessment to the nearest integer, so a weighted assessment of 2.2 rounds to 2, and a weighted assessment of 2.6 rounds to 3 (see table 6).

Table 6

Hypothetical Example Of Weighted-Average Country Risk For A Corporate Entity

Country	Weighting (% of business*)	Country risk§	Weighted country risk
Country A	45	1	0.45
Country B	20	2	0.4
Country C	15	1	0.15
Country D	10	4	0.4
Country E	10	2	0.2
Weighted-average country risk assessment (rounded to the nearest whole number)	--	--	2

*Using EBITDA, revenues, fixed assets, or other financial measures as appropriate. §On a scale from 1-6, lowest to highest risk.

44. A weak link approach, which helps us calculate a blended country risk assessment for companies with exposure to more than one country, works as follows: If fixed assets are based in a higher-risk country but products are exported to a lower-risk country, the company's exposure would be to the higher-risk country. Similarly, if fixed assets are based in a lower-risk country but export revenues are generated from a higher-risk country and cannot be easily redirected elsewhere, we measure exposure to the higher-risk country. If a company's supplier is located in a higher-risk country, and its supply needs cannot be easily redirected elsewhere, we measure exposure to the higher-risk country. Conversely, if the supply chain can be re-sourced easily to another country, we would not measure exposure to the higher risk country.

45. Country risk can be mitigated for a company located in a single jurisdiction in the following narrow case. For a company that exports the majority of its products overseas and has no direct exposure to a country's banking system that would affect its funding, debt servicing, liquidity, or ability to transfer payments from or to its key counterparties, we could reduce the country risk assessment by one category (e.g., 5 to 4) to determine the adjusted country risk assessment. This would only apply for countries where we considered the financial system risk subfactor a constraint on the overall country risk assessment for that country. For such a company, other country risks are not mitigated: economic risk still applies, albeit less of a risk than for a company that sells domestically (potential currency volatility remains a risk for exporters); institutional and governance effectiveness risk still applies (political risk may place assets at risk); and payment culture/rule of law risk still applies (legal risks may place assets and cross-border contracts at risk).

46. Companies will often disclose aggregated information for blocks of countries, rather than disclosing individual country information. If the information we need to estimate exposure for all countries is not available, we use regional risk assessments. Regional risk assessments are calculated as averages of the unadjusted country risk assessments, weighted by gross domestic product of each country in a defined region. The criteria assess regional risk on a 1-6 scale (strongest to weakest). Please see Appendix A, Table 26, which lists the constituent countries of the regions.

47. If an issuer does not disclose its country-level exposure or regional-level exposure, its individual country risk exposures or regional exposures will be estimated.

2. Adjusting the country risk assessment for diversity

48. We will adjust the country risk assessment for a company that operates in multiple jurisdictions and demonstrates a high degree of diversity of country risk exposures. As a result of this diversification, the company could have less exposure to country risk than the rounded weighted average of its exposures might indicate. Accordingly, the country risk assessment for a corporate entity could be adjusted if an issuer meets the conditions outlined in paragraph 49.

49. The preliminary country risk assessment is raised by one category to reflect diversity if all of the following four conditions are met:

If the company's head office, as defined in paragraph 51, is located in a country with a risk assessment stronger than the preliminary country risk assessment;
If no country, with a country risk assessment equal to or weaker than the company's preliminary country risk assessment, represents or is expected to represent more than 20% of revenues, EBITDA, fixed assets, or other appropriate financial measures;
If the company is primarily funded at the holding level, or through a finance subsidiary in a similar or stronger country risk environment than the holding company, or if any local funding could be very rapidly substituted at the holding level; and
If the company's industry risk assessment is '4' or stronger.

50. The country risk assessment for companies that have 75% or more exposure to one jurisdiction cannot be improved and will, in most instances, equal the country risk assessment of that jurisdiction. But the country risk assessment for companies that have 75% or more exposure to one jurisdiction can be weakened if the balance of exposure is to higher risk jurisdictions.

51. We consider the location of a corporate head office relevant to overall risk exposure because it influences the perception of a company and its reputation--and can affect the company's access to capital. We determine the location of the head office on the basis of 'de facto' head office operations rather than just considering the jurisdiction of incorporation or stock market listing for public companies. De facto head office operations refers to the country where executive management and centralized high-level corporate activities occur, including strategic planning and capital raising. If such activities occur in different countries, we take the weakest country risk assessment applicable for the countries in which those activities take place.

D. Competitive Position

52. Competitive position encompasses company-specific factors that can add to, or partly offset, industry risk and country risk--the two other major factors of a company's business risk profile.

53. Competitive position takes into account a company's: 1) competitive advantage, 2) scale, scope, and diversity, 3) operating efficiency, and 4) profitability. A company's strengths and weaknesses on the first three components shape its competitiveness in the marketplace and the sustainability or vulnerability of its revenues and profit. Profitability can either confirm our initial assessment of competitive position or modify it, positively or negatively. A stronger-than-industry-average set of competitive position characteristics will strengthen a company's business risk profile. Conversely, a weaker-than-industry-average set of competitive position characteristics will weaken a company's business risk profile.

54. These criteria describe how we develop a competitive position assessment. They provide guidance on how we assess each component based on a number of subfactors. The criteria define the weighting rules applied to derive a preliminary competitive position assessment. And they outline how this preliminary assessment can be maintained, raised, or lowered based on a company's profitability. S&P Global Ratings' competitive position analysis is both qualitative and quantitative.

1. The components of competitive position

55. A company's competitive position assessment can be: 1, excellent; 2, strong; 3, satisfactory; 4, fair; 5, weak; or 6, vulnerable.

56. The analysis of competitive position includes a review of:

Competitive advantage;
Scale, scope, and diversity;
Operating efficiency; and
Profitability.

57. We follow four steps to arrive at the competitive position assessment. First, we separately assess competitive advantage; scale, scope, and diversity; and operating efficiency (excluding any benefits or risks already captured in the issuer's CICRA assessment). Second, we apply weighting factors to these three components to derive a weighted-average assessment that translates into a preliminary competitive position assessment. Third, we assess profitability. Finally, we combine the preliminary competitive position assessment and the profitability assessment to determine the final competitive position assessment. Profitability can confirm, or influence positively or negatively, the competitive position assessment.

58. We assess the relative strength of each of the first three components by reviewing a variety of subfactors (see table 7). When quantitative metrics are relevant and available, we use them to evaluate these subfactors. However, our overall assessment of each component is qualitative. Our evaluation is forward-looking; we use historical data only to the extent that they provide insight into future trends.

59. We evaluate profitability by assessing two subcomponents: level of profitability (measured by historical and projected nominal levels of return on capital, EBITDA margin, and/or sector-specific metrics) and volatility of profitability (measured by historically observed and expected fluctuations in EBITDA, return on capital, EBITDA margin, or sector specific metrics). We assess both subcomponents in the context of the company's industry.

Table 7

Competitive Position Components And Subfactors

Component	Explanation	Subfactors
1. Competitive advantage (see Appendix B, section 1)	The strategic positioning and attractiveness to customers of a company's products or services, and the fragility or sustainability of its business model	• Strategy • Differentiation/uniqueness/product positioning/bundling • Brand reputation and marketing • Product and/or service quality • Barriers to entry and customers' switching costs • Technological advantage and capabilities and vulnerability to/ability to drive technological displacement • Asset base characteristics
2. Scale, scope, and diversity (see Appendix B, section 2)	The concentration or diversification of business activities	• Diversity of products or services • Geographic diversity • Volumes, size of markets and revenues, and market share • Maturity of products or services
3. Operating efficiency (see Appendix B, section 3)	The quality and flexibility of a company's asset base and its cost management and structure	• Cost structure • Manufacturing processes • Working capital management • Technology
4. Profitability		• Level of profitability (historical and projected return on capital, EBITDA margin, and/or sector-relevant measure) • Volatility of profitability

2. Assessing competitive advantage, scale, scope, and diversity, and operating efficiency

60. We assess competitive advantage; scale, scope, and diversity; and operating efficiency as: 1, strong; 2, strong/adequate; 3, adequate; 4, adequate/weak; or 5, weak. Tables 8, 9, and 10 provide guidance for assessing each component.

61. In assessing the components' relative strength, we place significant emphasis on comparative analysis. Peer comparisons provide context for evaluating the subfactors and the resulting component assessment. We review company-specific characteristics in the context of the company's industry, not just its narrower subsector. (See list of industries and subsectors in Appendix B, table 27.) For example, when evaluating an airline, we will benchmark the assessment against peers in the broader transportation-cyclical industry (including the marine and trucking subsectors), and not just against other airlines. Likewise, we will compare a home furnishing manufacturer with other companies in the consumer durables industry, including makers of appliances or leisure products. We might occasionally extend the comparison to other industries if, for instance, a company's business lines cross several industries, or if there are a limited number of rated peers in an industry, subsector, or region.

62. An assessment of strong means that the company's strengths on that component outweigh its weaknesses, and that the combination of relevant subfactors results in lower-than-average business risk in the industry. An assessment of adequate means that the company's strengths and weaknesses with respect to that component are balanced and that the relevant subfactors add up to average business risk in the industry. A weak assessment means that the company's weaknesses on that component override any strengths and that its subfactors, in total, reveal higher-than-average business risk in the industry.

63. Where a component is not clearly strong or adequate, we may assess it as strong/adequate. A component that is not clearly adequate or weak may end up as adequate/weak.

64. Although we review each subfactor, we don't assess each individually--and we seek to understand how they may reinforce or weaken each other. A component's assessment combines the relative strengths and importance of its subfactors. For any company, one or more subfactors can be unusually important--even factors that aren't common in the industry. The industry KCF articles or "Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)" can identify subfactors that are consistently more important, or happen not to be relevant, in a given industry.

65. Not all subfactors may be equally important, and a single one's strength or weakness may outweigh all the others. For example, if notwithstanding a track record of successful product launches and its strong brand equity, a company's strategy doesn't appear adaptable, in our view, to changing competitive dynamics in the industry, we will likely not assess its competitive advantage as strong. Similarly, if its revenues came disproportionately from a narrow product line, we might view this as compounding its risk of exposure to a small geographic market and, thus, assess its scale, scope, and diversity component as weak.

66. From time to time companies will, as a result of shifting industry dynamics or strategies, expand or shrink their product or service lineups, alter their cost structures, encounter new competition, or have to adapt to new regulatory environments. In such instances, we will reevaluate all relevant subfactors (and component assessments).

Table 8

Competitive Advantage Assessment

Qualifier	What it means	Guidance
Strong	• The company has a major competitive advantage due to one or a combination of factors that supports revenue and profit growth, combined with lower-than-average volatility of profits. • There are strong prospects that the company can sustain this advantage over the long term. • This should enable the company to withstand economic downturns and competitive and technological threats better than its competitors can. • Any weaknesses in one or more subfactors are more than offset by strengths in other subfactors that produce sustainable and profitable revenue growth.	• The company's business strategy is highly consistent with, and adaptable to, industry trends and conditions and supports its leadership in the marketplace. • It consistently develops and markets well-differentiated products or services, aligns products with market demand, and enhances the attractiveness or uniqueness of its value proposition through bundling. • Its superior track record of product development, service quality, and customer satisfaction and retention support its ability to maintain or improve its market share. • Its products or services command a clear price premium relative to its competitors' thanks to its brand equity, technological leadership, or quality of service; it is able to sustain this advantage with innovation and effective marketing. • It benefits from barriers to entry from regulation, market characteristics, or intrinsic benefits (such as patents, technology, or customer relationships) that effectively reduce the threat of new competition. • It has demonstrated a commitment and ability to effectively reinvest in its asset base, as evidenced by a continuous pipeline of new products and/or improvement in key capabilities, such as employee retention, customer care, distribution, and supplier relations. These tangible and intangible assets support long term prospects of sustainable and profitable growth.
Adequate	• The company has some competitive advantages, but not so large as to create a superior business model or durable benefit compared to its peers'. • It has some but not all drivers of competitiveness. Certain factors support the business' long-term viability and should result in average profitability and average profit volatility during recessions or periods of increased competition. However, these drivers are partially offset by the company's disadvantages or lack of sustainability of other factors.	• The company's strategy is well adapted to marketplace conditions, but it is not necessarily a leader in setting industry trends. • It exhibits neither superior nor subpar abilities with respect to product or service differentiation and positioning. • Its products command no price premium or advantage relative to competing brands as a result of its brand equity or its technological positioning. • It may enjoy some barriers to entry that provide some defense against competitors but don't overpower them. It faces some risk of product/service displacement or substitution longer term. • Its metrics of product or service quality and customer satisfaction or retention are in line with its industry's average. The company could lose customers to competitors if it makes operational missteps. • Its asset profile does not exhibit particularly superior or inferior characteristics compared to other industry participants. These assets generate consistent revenue and profit growth although long-term prospects are subject to some uncertainty.

Weak	• The company has few, if any, competitive advantages and a number of competitive disadvantages. • Because the company lacks many competitive advantages, its long-term prospects are uncertain, and its profit volatility is likely to be higher than average for its industry. • The company is less likely than its competitors to withstand economic, competitive, or technological threats. • Alternatively, the company has weaknesses in one or more subfactors that could keep its profitability below average and its profit volatility above average during economic downturns or periods of increased competition.	• The company's strategy is inconsistent with, or not well adapted to, marketplace trends and conditions. • There is evidence of little innovation, slowness in developing and marketing new products, an inability to raise prices, and/or ineffective bundling. • Its products generally enjoy no price premium relative to competing brands and it often has to sell its products at a lower price than its peers can command. • It has suffered or is at risk of suffering customer defections due to falling quality and because customers perceive its products or services to be less valuable than those of its competitors. • Its revenues and market shares are vulnerable to aggressive pricing by existing or new competitors or to technological displacement risks over the near to medium term. • Its metrics of product or service quality and customer satisfaction or retention are weaker than the industry average. • Its reinvestment in its business is lower than its peers', its ability to retain operational talent is limited, its distribution network is inefficient, and its revenue could stagnate or decline as result.

Table 9

Scale, Scope, And Diversity

Qualifier	What it means	Guidance
Strong	• The company's overall scale, scope, and diversity supports stable revenues and profits by rendering it essentially invulnerable to all but the most disruptive combinations of adverse factors, events, or trends. • Its significant advantages in scale, scope, and diversity enable it to withstand economic, regional, competitive, and technological threats better than its competitors can.	• The company's range of products or services is among the most comprehensive in its sector. It derives its revenue and profits from a broader set of products or services than the industry average. • Its products and services enjoy industry-leading market shares relative to other participants in its industry. • It does not rely on a particular customer or small group of customers. If it does, the customer(s) is/are of high credit quality, their demand is highly sustainable, or the company and its customer(s) have significant interdependence. • It does not depend on any particular supplier or related group of suppliers that it could not easily replace. If it does, the supplier(s) is/are of high credit quality, or the company and its supplier(s) have significant interdependence. • It enjoys broader geographic diversity than its peers and doesn't overly depend on a single regional or local market. If it does, the market is local, often for regulatory reasons. The company's production or service centers are diversified across several locations. • It holds a strategic investment that provides positive business diversification.
Adequate	• The company's overall scale, scope, and diversity is comparable to its peers'. • Its ability to withstand economic, competitive, or technological threats is comparable to the ability of others within its sector.	• The company has a broad range of products or services compared with its competitors and doesn't depend on a particular product or service for the majority of its revenues and profits. • Its market share is average compared with that of its competitors. • Its dependence on or concentration of key customers is no higher than the industry average, and the loss of a top customer would be unlikely to pose a high risk to its business stability. • It isn't overly dependent on any supplier or regional group of suppliers that it couldn't easily replace. • It doesn't depend excessively on a single local or regional market, and its geographic footprint of production and revenue compares with that of other industry participants.
Weak	• The company's lack of scale, scope, and diversity compromises the stability and sustainability of its revenues and profits. • The company's vulnerability to, or reliance on, various elements of scale, scope, and diversity leaves it less likely than its competitors to withstand economic, competitive, or technological threats.	• The company's product or service lineup is somewhat limited compared to those of its sector peers. The company derives its profits from a narrow group of products or services, and has not achieved significant market share compared with its peers. • Demand for its products or services is lower than for its competitors', and this trend isn't improving. • It relies heavily on a particular customer or small group of customers, and the characteristics of the customer base do not mitigate this risk. • It depends on a particular supplier or group of suppliers, which it would not be able to easily replace without incurring high switching costs. • It depends disproportionately on a single local or regional economy for selling its goods or services, and the company's industry is global. • Key production assets are concentrated by location, and the company has limited ability to quickly replace them without incurring high costs relative to its profits.

Table 10

Operating Efficiency Assessment

Qualifier	What it means	Guidance
Strong	• The company maximizes revenues and profits via intelligent use of assets and by minimizing costs and increasing efficiency. • The company's cost structure should enable it to withstand economic downturns better than its peers.	• The company has a lower cost structure than its peers resulting in higher profits or margins even if capacity utilization or demand are well below ideal levels and during down economic and industry cycles. • It has demonstrated its ability to efficiently manage fixed and variable costs in cyclical downturns, and has a history of successful and often ongoing cost reductions programs. • Its capacity utilization is close to optimal at the peak of the industry cycle and outperforms the industry average over the cycle. • It has demonstrated that it can pass along increases in input costs and we expect this will continue. • It has a very high ability to adjust production and labor costs in response to changes in demand without repercussions for product quality, or has demonstrated the ability to operate very profitably in a more costly or less flexible labor environment. • Its suppliers have demonstrated an ability to meet swings in demand without causing bottlenecks or quality issues, and can absorb all but the most severe supply chain disruptions. • It has superior working capital management, as evidenced by a consistently better-than-average "cash conversion cycle" and other working capital metrics, supporting higher cash flow and lower funding costs. • Its investments in technology are likely to increase revenue growth and/or improve its cost structure and operating efficiency.
Adequate	• A combination of cost structure and efficiency should support sustainable profits with average profit volatility relative to the company's peers. Its cost structure is similar to its peers'.	• The company has demonstrated the ability to manage some fixed and most variable costs except during periods of extremely weak demand, and has some history of cutting costs in good and bad times. • Its cost structure permits some profitability even if capacity utilization or customer demand is well below ideal levels. The company can at least break even during most of the industry/demand cycle. • Its cost structure is in line with its peers'. For example, its selling, general, and administrative (SG&A) expense as a percent of revenue is similar to its peers' and is likely to be stable. • It has demonstrated an ability to adjust labor costs in most scenarios without hurting product output and quality, or can operate profitability in a more costly or less flexible labor environment; it has some success passing on input cost increases, although perhaps only partially or with time lag. • Its suppliers have met typical swings in demand without causing widespread bottlenecks or quality issues, and the company has some capacity to withstand limited supply chain disruptions. • It has good working capital management, evidenced by its cash conversion cycle and working capital metrics that are on par with its peers'. • Its investments in technology are likely to help it at least maintain its cost structure and current level of operating efficiency.

Weak	• The company's operating efficiency leaves it with lower profitability than its peers' due to lower asset utilization and/or a higher, less flexible cost structure.	• The company's cost structure permits better-than-marginal profitability only if capacity utilization is at the top of the cycle or during periods of strong demand. The company needs solid and sustained industry conditions to generate fair profitability. • It has limited success or capability of managing fixed costs and even most typically variable costs are fixed in the next two to three years. • It has a limited track record of successful cost reductions, such as reducing labor costs in the face of swings in demand, or it has limited ability to pass along increases in input costs. • Its costs are higher than its peers'. For example, the company's SG&A expense as a percent of revenue is above that of its peers, and likely to remain so. • Its suppliers may face bottlenecks or quality issues in the event of modest swings in demand, or have limited technological capabilities. There is evidence that a limited supply chain disruption would make it difficult for suppliers to meet their commitments to the company. • Its working capital management is weak, as evidenced by working capital metrics that are significantly worse than those of its peers, resulting in lower cash flow and higher funding costs. • It lacks investments in technology, which could hurt is revenue growth and/or result in a higher cost structure and less efficient operations relative to its peers'.

3. Determining the preliminary competitive position assessment: Competitive position group profile and category weightings

67. After assessing competitive advantage; scale, scope, and diversity; and operating efficiency, we determine a company's preliminary competitive position assessment by ascribing a specific weight to each component. The weightings depend on the company's Competitive Position Group Profile (CPGP).

68. There are six possible CPGPs: 1) services and product focus, 2) product focus/scale driven, 3) capital or asset focus, 4) commodity focus/cost driven, 5) commodity focus/scale driven, and 6) national industry and utilities (see table 11 for definitions and characteristics).

Table 11

Competitive Position Group Profile (CPGP)

	Definition and characteristics	Examples
Services and product focus	Brands, product quality or technology, and service reputation are typically key differentiating factors for competing in the industry. Capital intensity is typically low to moderate, although supporting the brand often requires ongoing reinvestment in the asset base.	Typically, these are companies in consumer-facing light manufacturing or service industries. Examples include branded drug manufacturers, software companies, and packaged food.
Product focus/scale driven	Product and geographic diversity, as well as scale and market position are key differentiating factors. Sophisticated technology and stringent quality controls heighten risk of product concentration. Product preferences or sales relationships are more important than branding or pricing. Cost structure is relatively unimportant.	The sector most applicable is medical device/equipment manufacturers, particularly at the higher end of the technology scale. These companies largely sell through intermediaries, as opposed to directly to the consumer.
Capital or asset focus	Sizable capital investments are generally required to sustain market position in the industry. Brand identification is of limited importance, although product and service quality often remain differentiating factors.	Heavy manufacturing industries typically fall into this category. Examples include telecom infrastructure manufacturers and semiconductor makers.

Commodity focus/cost driven	Cost position and efficiency of production assets are more important than size, scope, and diversification. Brand identification is of limited importance	Typically, these are companies that manufacture products from natural resources that are used as raw materials by other industries. Examples include forest and paper products companies that harvest timber or produce pulp, packaging paper, or wood products.
Commodity focus/scale driven	Pure commodity companies have little product differentiation, and tend to compete on price and availability. Where present, brand recognition or product differences are secondary or of less importance.	Examples range from pure commodity producers and most oil and gas upstream producers, to some producers with modest product or brand differentiation, such as commodity foods.
National industries and utilities	Government policy or control, regulation, and taxation and tariff policies significantly affect the competitive dynamics of the industry (see paragraphs 72-73).	An example is a water-utility company in an emerging market.

69. The nature of competition and key success factors are generally prescribed by industry characteristics, but vary by company. Where service, product quality, or brand equity are important competitive factors, we'll give the competitive advantage component of our overall assessment a higher weighting. Conversely, if the company produces a commodity product, differentiation comes less into play, and we will more heavily weight scale, scope, and diversity as well as operating efficiency (see table 12).

Table 12

Competitive Position Group Profiles (CPGPs) And Category Weightings

--(%)--

Component	Services and product focus	Product focus/scale driven	Capital or asset focus	Commodity focus/cost driven	Commodity focus/scale driven	National industries and utilities
1. Competitive advantage	45	35	30	15	10	60
2. Scale, scope, and diversity	30	50	30	35	55	20
3. Operating efficiency	25	15	40	50	35	20
Total	100	100	100	100	100	100
Weighted-average assessment*	1.0-5.0	1.0-5.0	1.0-5.0	1.0-5.0	1.0-5.0	1.0-5.0

*1 (strong), 2 (strong/adequate), 3 (adequate), 4 (adequate/weak), 5 (weak).

70. We place each of the defined industries (see Appendix B, table 27) into one of the six CPGPs (see above and Appendix B, table 27). This is merely a starting point for the analysis, since we recognize that some industries are less homogenous than others, and that company-specific strategies do affect the basis of competition.

71. In fact, the criteria allow for flexibility in selecting a company's group profile (with its category weightings). Reasons for selecting a profile different than the one suggested in the guidance table could include:

The industry is heterogeneous, meaning that the nature of competition differs from one subsector to the next, and possibly even within subsectors. The KCF article for the industry or the relevant section in "Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)" will identify such circumstances.

A company's strategy could affect the relative importance of its key factors of competition.

72. For example, the standard CPGP for the telecom and cable industry is services and product focus. While this may be an appropriate group profile for carriers and service providers, an infrastructure provider may be better analyzed under the capital or asset focus group profile. Other examples: In the capital goods industry, a construction equipment rental company may be analyzed under the capital or asset focus group profile, owing to the importance of efficiently managing the capital spending cycle in this segment of the industry, whereas a provider of hardware, software, and services for industrial automation might be analyzed under the services and product focus group profile, if we believe it can achieve differentiation in the marketplace based on product performance, technology innovation, and service.

73. In some industries, the effects of government policy, regulation, government control, and taxation and tariff policies can significantly alter the competitive dynamics, depending on the country in which a company operates. That can alter our assessment of a company's competitive advantage; scale, size, and diversity; or operating efficiency. When industries in given

countries have risks that differ materially from those captured in our global industry risk profile and assessment (see "Methodology: Industry Risk (/en_US/web/guest/article/-/view/sourceId/8304862)," section B), we will weight competitive advantage more heavily to capture the effect, positive or negative, on competitive dynamics. The assessment of competitive advantage; scale, size, and diversity; and operating efficiency will reflect advantages or disadvantages based on these national industry risk factors. Table 13 identifies the circumstances under which national industry risk factors are positive or negative.

Table 13

National Industry Risk Factors	
National industry risk factors are positive	• Government policy including regulation, ownership, and taxation is supportive and has a good track record of mitigating risks to the stability of industry margins. • Any government ownership, tariff, and taxation policy supports growth prospects for revenues and profit generation. • There is very little discernible risk of negative policy, regulatory, ownership, or taxation changes that could threaten business stability.
National industry risk factors are negative	• Government policy and regulation has a weak track record of stabilizing margins and reducing industry risks. • Any government ownership, tariff, and taxation policy undermine growth prospects for revenues and profit generation. • There is an increasing risk of negative policy, ownership, and taxation changes that could undermine industry stability.

74. When national industry risk factors are positive for a company, typically they support revenue growth, profit growth, higher EBITDA margins, and/or lower-than-average volatility of profits. Often, these benefits provide barriers to entry that impede or even bar new market entrants, which should be reflected in the competitive advantage assessment. These benefits may also include risk mitigants that enable a company to withstand economic downturns and competitive and technological threats better in its local markets than its global competitors can. The scale, scope, and diversity assessment might also benefit from these policies if the company is able to withstand economic, regional, competitive, and technological threats better than its global competitors can. Likewise, the company's operating efficiency assessment may improve if, as a result, it is better able than its global competitors to withstand economic downturns, taking into account its cost structure.

75. Conversely, when national industry risk factors are negative for a company, typically they detract from revenue growth and profit growth, shrink EBITDA margins, and/or increase the average volatility of profits. The company may also have less protection against economic downturns and competitive and technological threats within its local markets than its global competitors do. We may also adjust the company's scale, scope, and diversity assessment lower if, as a result of these policies, it is less able to withstand economic, regional, competitive, and technological threats than its global competitors can. Likewise, we may adjust its operating efficiency assessment lower if, as a result of these policies, it is less able to withstand economic downturns, taking into account the company's cost structure.

76. An example of when we might use a national industry risk factor would be for a telecommunications network owner that benefits from a monopoly network position, supported by substantial capital barriers to entry, and as a result is subject to regulated pricing for its services. Accordingly, in contrast to a typical telecommunications company, our analysis of the company's competitive position would focus more heavily on the monopoly nature of its operations, as well as the nature and reliability of the operator's regulatory framework in supporting future revenue and earnings. If we viewed the regulatory framework as being supportive of the group's future earnings stability, and we considered its monopoly position to be sustainable, we would assess these national industry risk factors as positive in our assessment of the group's competitive position.

77. The weighted average assessment translates into the preliminary competitive position assessment on a scale of 1 to 6, where one is best. Table 14 describes the matrix we use to translate the weighted average assessment of the three components into the preliminary competitive position assessment.

Table 14

Translation Table For Converting Weighted-Average Assessments Into Preliminary Competitive Position Assessments

Weighted average assessment range	Preliminary competitive position assessment
1.00 - 1.50	1

>1.50 - 2.25	2
>2.25 - 3.00	3
>3.00 - 3.75	4
>3.75 - 4.50	5
>4.50 - 5.00	6

4. Assessing profitability

78. We assess profitability on the same scale of 1 to 6 as the competitive position assessment.

79. The profitability assessment consists of two subcomponents: level of profitability and the volatility of profitability, which we assess separately. We use a matrix to combine these into the final profitability assessment.

a) Level of profitability

80. The level of profitability is assessed in the context of the company's industry. We most commonly measure profitability using return on capital (ROC) and EBITDA margins, but we may also use sector-specific ratios. Importantly, as with the other components of competitive position, we review profitability in the context of the industry in which the company operates, not just in its narrower subsector. (See list of industries and subsectors in Appendix B, table 27.)

81. We assess level of profitability on a three-point scale: above average, average, and below average. We may establish numeric guidance, for instance by stating that an ROC above 12% is considered above average, between 8%-12% is average, and below 8% is below average for the industry, or by differentiating between subsectors in the industry. In the absence of numeric guidance, we compare a company against its peers across the industry. When establishing numeric guidance for assessing profitability within an industry or subsector, we typically consider the distribution of profitability measures across rated issuers in the sector. Depending on the shape of the distribution, we choose logical breakpoints between above average, average, and below average profitability. For instance, for a distribution that resembles a normal curve, we typically assess the top quartile of the relevant profitability indicator to be above average, the two middle quartiles average, and the bottom quartile below average. For a relatively flat distribution curve, we typically assess the top third to be above average, the middle third to be average, and the bottom third to be below average. We also may take averages of historical data or adjust the thresholds between the three ranges to consider factors such as variation over the business cycle and across regions. Finally, we may incorporate our expertise in the sector to adjust for underlying M&A trends or other distortions, as appropriate.

82. We calculate profitability ratios generally based on a five-year average, consisting of two years of historical data, our projections for the current year (incorporating any reported year-to-date results and estimates for the remainder of the year), and the next two financial years. There may be situations where we consider longer or shorter historical results or forecasts, depending on such factors as availability of financials, transformational events (such as mergers or acquisitions [M&A]), cyclical distortion (such as peak or bottom of the cycle metrics that we do not deem fully representative of the company's level of profitability), and we take into account improving or deteriorating trends in profitability ratios in our assessment.

b) Volatility of profitability

83. We base the volatility of profitability on the standard error of the regression (SER) for a company's historical EBITDA, EBITDA margins, or return on capital. The KCF articles and "Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)" detail which measures are most appropriate for a given industry or set of companies. For each of these measures, we divide the standard error by the average of that measure over the time period in order to ensure better comparability across companies.

84. The SER is a statistical measure that is an estimate of the deviation around a 'best fit' linear trend line. We regress the company's EBITDA, EBITDA margins, or return on capital against time. A key advantage of SER over standard deviation or coefficient of variation is that it doesn't view upwardly trending data as inherently more volatile. At the same time, we recognize that SER, like any statistical measure, may understate or overstate expected volatility and thus we will make qualitative adjustments where appropriate (see paragraphs 86-90). Furthermore, we only calculate SER when companies have at least seven years of historical annual data and have not significantly changed their line of business during the timeframe, to ensure that the results are meaningful.

85. As with the level of profitability, we evaluate a company's SER in the context of its industry group. For most industries, we establish a six-point scale with 1 capturing the least volatile companies, i.e., those with the lowest SERs, and 6 identifying companies whose profits are most volatile. We have established industry-specific SER parameters using the most recent seven years of data for companies within each sector. We believe that seven years is generally an adequate number of years to capture a business cycle. (See "Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)" for

industry-specific SER parameters.) For companies whose business segments cross multiple industries, we evaluate the SER in the context of the organization's most dominant industry--if that industry represents at least two-thirds of the organization's EBITDA, sales, or other relevant metric. If the company is a conglomerate and no dominant industry can be identified, we will evaluate its profit volatility in the context of SER guidelines for all nonfinancial companies.

86. In certain circumstances, the SER derived from historical information may understate--or overstate--expected future volatility, and we may adjust the assessment downward or upward. The scope of possible adjustments depends on certain conditions being met as described below.

87. We might adjust the SER-derived volatility assessment to a worse assessment (i.e., to a higher assessment for greater volatility) by up to two categories if the expected level of volatility isn't apparent in historical numbers, and the company either:

Has a weighted country risk assessment of 4 or worse, which may, notwithstanding past performance, result in a less stable business environment going forward;
Operates in a subsector of the industry that may be prone to higher technology or regulation changes, or other potential disruptive risks that have not emerged over the seven year period;
Is of limited size and scope, which will often result in inherently greater vulnerability to external changes; or
Has pursued material M&A or internal growth projects that obscure the company's underlying performance trend line. As an example, a company may have consummated an acquisition during the trough of the cycle, masking what would otherwise be a significant decline in performance.
88. The choice of one or two categories depends on the degree of likelihood that the related risks will materialize and our view of the likely severity of these risks.

89. Conversely, we may adjust the SER-derived volatility assessment to a better assessment (i.e., to a lower assessment reflecting lower volatility) by up to two categories if we observe that the conditions historically leading to greater volatility have receded and are misrepresentative. This will be the case when:

The company grew at a moderately faster, albeit more uneven, pace relative to the industry. Since we measure volatility around a linear trend line, a company growing at a constant percentage of moderate increase (relative to the industry) or an uneven pace (e.g., due to "lumpy" capital spending programs) could receive a relatively unfavorable assessment on an unadjusted basis, which would not be reflective of the company's performance in a steady state. (Alternatively, those companies that grow at a significantly higher-than-average industry rate often do so on unsustainable rates of growth or by taking on high-risk strategies. Companies with these high-risk growth strategies would not receive a better assessment and could be adjusted to a worse assessment;)
The company's geographic, customer, or product diversification has increased in scope as a result of an acquisition or rapid expansion (e.g. large, long-term contracts wins), leading to more stability in future earnings in our view; or
The company's business model is undergoing material change that we expect will benefit earnings stability, such as a new regulatory framework or major technology shift that is expected to provide a significant competitive hedge and margin protection over time.
90. The choice of one or two categories depends on the degree of likelihood that the related risks will materialize and our view of the likely severity of these risks.

91. If the company either does not have at least seven years of annual data or has materially changed its business lines or undertaken abnormally high levels of M&A during this time period, then we do not use its SER to assess the volatility of profitability. In these cases, we use a proxy to establish the volatility assessment. If there is a peer company that has, and is expected to continue having, very similar profitability volatility characteristics, we use the SER of that peer entity as a proxy.

92. If no such matching peer exists, or one cannot be identified with enough confidence, we perform an assessment of expected volatility based on the following rules:

An assessment of 3 if we expect the company's profitability, supported by available historical evidence, will exhibit a volatility pattern in line with, or somewhat less volatile than, the industry average.
An assessment of 2 based on our confidence, supported by available historical evidence, that the company will exhibit lower volatility in profitability metrics than the industry's average. This could be underpinned by some of the factors listed in paragraph 89, whereas those listed in paragraph 87 would typically not apply.
An assessment of 4 or 5 based on our expectation that profitability metrics will exhibit somewhat higher (4), or meaningfully higher (5) volatility than the industry, supported by available historical evidence, or because of the applicability of possible adjustment factors listed in paragraph 87.
Assessments of either 1 or 6 are rarely assigned and can only be achieved based on a combination of data evidence and very high confidence tests. For an assessment of 1, we require strong evidence of minimal volatility in profitability metrics

compared with the industry, supported by at least five years of historical information, combined with a very high degree of confidence that this will continue in the future, including no country risk, subsector risk or size considerations that could otherwise warrant a worse assessment as per paragraph 87. For an assessment of 6 we require strong evidence of very high volatility in profitability metrics compared with the industry, supported by at least five years of historical information and very high confidence that this will continue in the future.

93. Next, we combine the level of profitability assessment with the volatility assessment to determine the final profitability assessment using the matrix in Table 15.

Table 15

Profitability Assessment

	--Volatility of profitability assessment--					
Level of profitability assessment	**1**	**2**	**3**	**4**	**5**	**6**
Above average	1	1	2	3	4	5
Average	1	2	3	4	5	6
Below average	2	3	4	5	6	6

5. Combining the preliminary competitive position assessment with profitability

94. The fourth and final step in arriving at a competitive position assessment is to combine the preliminary competitive position assessment with the profitability assessment. We use the combination matrix in Table 16, which shows how the profitability assessment can confirm, strengthen, or weaken (by up to one category) the overall competitive position assessment.

Table 16

Combining The Preliminary Competitive Position Assessment And Profitability Assessment

	--Preliminary competitive position assessment--					
Profitability assessment	**1**	**2**	**3**	**4**	**5**	**6**
1	1	2	2	3	4	5
2	1	2	3	3	4	5
3	2	2	3	4	4	5
4	2	3	3	4	5	5
5	2	3	4	4	5	6
6	2	3	4	5	5	6

95. We generally expect companies with a strong preliminary competitive position assessment to exhibit strong and less volatile profitability metrics. Conversely, companies with a relatively weaker preliminary competitive position assessment will generally have weaker and/or more volatile profitability metrics. Our analysis of profitability helps substantiate whether management is translating any perceived competitive advantages, diversity benefits, and cost management measures into higher earnings and more stable return on capital and return on sales ratios than the averages for the industry. When profitability differs markedly from what the preliminary/anchor competitive position assessment would otherwise imply, we adjust the competitive position assessment accordingly.

96. Our method of adjustment is biased toward the preliminary competitive position assessment rather than toward the profitability assessment (e.g., a preliminary competitive assessment of 6 and a profitability assessment of 1 will result in a final assessment of 5).

E. Cash Flow/Leverage

97. The pattern of cash flow generation, current and future, in relation to cash obligations is often the best indicator of a company's financial risk. The criteria assess a variety of credit ratios, predominately cash flow-based, which complement each other by focusing on the different levels of a company's cash flow waterfall in relation to its obligations (i.e., before and after working capital investment, before and after capital expenditures, before and after dividends), to develop a thorough perspective. Moreover, the criteria identify the ratios that we think are most relevant to measuring a company's credit risk based on its individual characteristics and its business cycle.

98. For the analysis of companies with intermediate or stronger cash flow/leverage assessments (a measure of the relationship between the company's cash flows and its debt obligations as identified in paragraphs 106 and 124), we primarily evaluate cash flows that reflect the considerable flexibility and discretion over outlays that such companies typically possess. For these

entities, the starting point in the analysis is cash flows before working capital changes plus capital investments in relation to the size of a company's debt obligations in order to assess the relative ability of a company to repay its debt. These "leverage" or "payback" cash flow ratios are a measure of how much flexibility and capacity the company has to pay its obligations.

99. For entities with significant or weaker cash flow/leverage assessments (as identified in paragraphs 105 and 124), the criteria also call for an evaluation of cash flows in relation to the carrying cost or interest burden of a company's debt. This will help us assess a company's relative and absolute ability to service its debt. These "coverage"- or "debt service"-based cash flow ratios are a measure of a company's ability to pay obligations from cash earnings and the cushion the company possesses through stress periods. These ratios, particularly interest coverage ratios, become more important the further a company is down the credit spectrum.

1. Assessing cash flow/leverage

100. Under the criteria, we assess cash flow/leverage as 1, minimal; 2, modest; 3, intermediate; 4, significant; 5, aggressive; or 6, highly leveraged. To arrive at these assessments, the criteria combine the assessments of a variety of credit ratios, predominately cash flow-based, which complement each other by focusing attention on the different levels of a company's cash flow waterfall in relation to its obligations. For each ratio, there is an indicative cash flow/leverage assessment that corresponds to a specified range of values in one of three given benchmark tables (see tables 17, 18, and 19). We derive the final cash flow/leverage assessment for a company by determining the relevant core ratios, anchoring a preliminary cash flow assessment based on the relevant core ratios, determining the relevant supplemental ratio(s), adjusting the preliminary cash flow assessment according to the relevant supplemental ratio(s), and, finally, modifying the adjusted cash flow/leverage assessment for any material volatility.

2. Core and supplemental ratios

a) Core ratios

101. For each company, we calculate two core credit ratios--funds from operations (FFO) to debt and debt to EBITDA--in accordance with S&P Global Ratings' ratios and adjustments criteria (see "Corporate Methodology: Ratios And Adjustments (/en_US/web/guest/article/-/view/sourceId/10906146)"). We compare these payback ratios against benchmarks to derive the preliminary cash flow/leverage assessment for a company. These ratios are also useful in determining the relative ranking of the financial risk of companies.

b) Supplemental ratios

102. The criteria also consider one or more supplemental ratios (in addition to the core ratios) to help develop a fuller understanding of a company's financial risk profile and fine-tune our cash flow/leverage analysis. Supplemental ratios could either confirm or adjust the preliminary cash flow/leverage assessment. The confirmation or adjustment of the preliminary cash flow/leverage assessment will depend on the importance of the supplemental ratios as well as any difference in indicative cash flow/leverage assessment between the core and supplemental ratios as described in section E.3.b.

103. The criteria typically consider five standard supplemental ratios, although the relevant KCF article or "Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)" may introduce additional supplemental ratios or focus attention on one or more of the standard supplemental ratios. The standard supplemental ratios include three payback ratios--cash flow from operations (CFO) to debt, free operating cash flow (FOCF) to debt, and discretionary cash flow (DCF) to debt--and two coverage ratios, FFO plus interest paid to cash interest paid and EBITDA to interest.

104. The criteria provide guidelines as to the relative importance of certain ratios if a company exhibits characteristics such as high leverage, working capital intensity, capital intensity, or high growth.

105. If the preliminary cash flow/leverage assessment is significant or weaker (see section E.3), then two coverage ratios, FFO plus cash interest paid to cash interest paid and EBITDA to interest, will be given greater importance as supplemental ratios. For the definition of these metrics please see "Corporate Methodology: Ratios And Adjustments (/en_US/web/guest/article/-/view/sourceId/10906146)".

106. If the preliminary cash flow/leverage assessment is intermediate or stronger, the criteria first apply the three standard supplemental ratios of CFO to debt, FOCF to debt, and DCF to debt. When FOCF to debt and DCF to debt indicate a cash flow/leverage assessment that is lower than the other payback-ratio-derived cash flow/leverage assessments, it signals that the company has either larger than average capital spending or other non-operating cash distributions (including dividends). If these differences persist and are consistent with a negative trend in overall ratio levels, which we believe is not temporary, then these supplemental leverage ratios will take on more importance in the analysis.

107. If the supplemental ratios indicate a cash flow/leverage assessment that is different than the preliminary cash flow/leverage assessment, it could suggest an unusual debt service or fixed charge burden, working capital or capital expenditure profile, or unusual financial activity or policies. In such cases, we assess the sustainability or persistence of these differences. For example, if either working capital or capital expenditures are unusually low, leading to better indicated assessments, we examine the sustainability of such lower spending in the context of its impact on the company's longer term competitive position. If there is a deteriorating trend in the company's asset base, we give these supplemental ratios less weight. If either working capital or capital expenditures are unusually high, leading to weaker indicated assessments, we examine the persistence and need for such higher spending. If elevated spending levels are required to maintain a company's competitive position, for example to maintain the company's asset base, we give more weight to these supplemental ratios.

108. For capital-intensive companies, EBITDA and FFO may overstate financial strength, whereas FOCF may be a more accurate reflection of their cash flow in relation to their financial obligations. The criteria generally consider a capital-intensive company as having ongoing capital spending to sales of greater than 10%, or depreciation to sales of greater than 8%. For these companies, the criteria place more weight on the supplementary ratio of FOCF to debt. Where we place more analytic weight on FOCF to debt, we also seek to estimate the amount of maintenance or full cycle capital required (see Appendix C) under normal conditions (we estimate maintenance or full-cycle capital expenditure required because this is not a reported number). The FOCF figure may be adjusted by adding back estimated discretionary capital expenditures. The adjusted FOCF to debt based on maintenance or full cycle capital expenditures often helps determine how much importance to place on this ratio. If both the FOCF to debt and the adjusted (for estimated discretionary capital spending) FOCF to debt derived assessments are different from the preliminary cash/flow leverage assessment, then these supplemental leverage ratios take on more importance in the analysis.

109. For working-capital-intensive companies, EBITDA and FFO may also overstate financial strength, and CFO may be a more accurate measure of the company's cash flow in relation to its financial risk profile. Under the criteria, if a company has a working capital-to-sales ratio that exceeds 25% or if there are significant seasonal swings in working capital, we generally consider it to be working-capital-intensive. For these companies, the criteria place more emphasis on the supplementary ratio of CFO to debt. Examples of companies that have working-capital-intensive characteristics can be found in the capital goods, metals and mining downstream, or the retail and restaurants industries. The need for working capital in those industries reduces financial flexibility and, therefore, these supplemental leverage ratios take on more importance in the analysis.

110. For all companies, when FOCF to debt or DCF to debt is negative or indicates materially lower cash flow/leverage assessments, the criteria call for an examination of management's capital spending and cash distribution strategies. For high-growth companies, typically the focus is on FFO to debt instead of FOCF to debt because the latter ratio can vary greatly depending on the growth investment the company is undergoing. The criteria generally consider a high-growth company one that exhibits real revenue growth in excess of 8% per year. Real revenue growth excludes price or foreign exchange related growth, under these criteria. In cases where FOCF or DCF is low, there is a greater emphasis on monitoring the sustainability of margins and return on capital and the overall financing mix to assess the likely trend of future debt ratios. In addition, debt service ratio analysis will be important in such situations. For companies with more moderate growth, the focus is typically on FOCF to debt unless the capital spending is short term or is not funded with debt.

111. For companies that have ongoing and well entrenched banking relationships we can reflect these relationships in our cash flow/leverage analysis through the use of the interest coverage ratios as supplemental ratios. These companies generally have historical links and a strong ongoing relationship with their main banks, as well as shareholdings by the main banks, and management influence and interaction between the main banks and the company. Based on their bank relationships, these companies often have lower interest servicing costs than peers, even if the macro economy worsens. In such cases, we generally use the interest coverage ratios as supplemental ratios. This type of banking relationship occurs in Japan, for example, where companies that have the type of bank relationship described in this paragraph tend to have a high socioeconomic influence within their country by way of their revenue size, total debt quantum, number of employees, and the relative importance of the industry.

c) Time horizon and ratio calculation

112. A company's credit ratios may vary, often materially, over time due to economic, competitive, technological, or investment cycles, the life stage of the company, and corporate or strategic actions. Thus, we evaluate credit ratios on a time series basis with a clear forward-looking bias. The length of the time series is dependent on the relative credit risk of the company and other qualitative factors and the weighting of the time series varies according to transformational events. A transformational event is any event that could cause a material change in a company's financial profile, whether caused by changes to the company's capital base, capital structure, earnings, cash flow profile, or financial policies. Transformational

events can include mergers, acquisitions, divestitures, management changes, structural changes to the industry or competitive environment, and/or product development and capital programs. This section provides guidance on the timeframe and weightings the criteria apply to calculate the indicative ratios.

113. The criteria generally consider the company's credit ratios for the previous one to two years, current-year forecast, and the two subsequent forecasted financial years. There may be situations where longer--or even shorter--historical results or forecasts are appropriate, depending on such factors as availability of financials, transformational events, or relevance. For example, a utility company with a long-term capital spending program may lend itself to a longer-term forecast, whereas for a company experiencing a near-term liquidity squeeze even a two-year forecast will have limited value. Alternatively, for most commodities-based companies we emphasize credit ratios based on our forward-looking view of market conditions, which may differ materially from the historical period.

114. Historical patterns in cash flow ratios are informative, particularly in understanding past volatility, capital spending, growth, accounting policies, financial policies, and business trends. Our analysis starts with a review of these historical patterns in order to assess future expected credit quality. Historical patterns can also provide an indication of potential future volatility in ratios, including that which results from seasonality or cyclicality. A history of volatility could result in a more conservative assessment of future cash flow generation if we believe cash flow will continue to be volatile.

115. The forecast ratios are based on an expected base-case scenario developed by S&P Global Ratings, incorporating current and near-term economic conditions, industry assumptions, and financial policies. The prospective cyclical and longer-term volatility associated with the industry in which the issuer operates is addressed in the industry risk criteria (see section B) and the longer-term directional influence or event risk of financial policies is addressed in our financial policy criteria (see section H).

116. The criteria generally place greater emphasis on forecasted years than historical years in the time series of credit ratios when calculating the indicative credit ratio. For companies where we have five years of ratios as described in section E.3, generally we calculate the indicative ratio by weighting the previous two years, the current year, and the forecasted two years as 10%, 15%, 25%, 25%, and 25%, respectively.

117. This weighting changes, however, to place even greater emphasis on the current and forecast years when:

The issuer meets the characteristics described in paragraph 113, and either shorter- or longer-term forecasts are applicable. The weights applied will generally be quite forward weighted, particularly if a company is undergoing a transformational event and there is moderate or better cash flow certainty.
The issuer is forecast to generate negative cash flow available for debt repayment, which we believe could lead to deteriorating credit metrics. Forecast negative cash flows could be generated from operating activities as well as capital expenditures, share buybacks, dividends, or acquisitions, as we forecast these uses of cash based on the company's track record, market conditions, or financial policy. The weights applied will generally be 30%, 40%, and 30% for the current and two subsequent years, respectively.
The issuer is in an industry that is prospectively volatile or that has a high degree of cash flow uncertainty. Industries that are prospectively volatile are industries whose competitive risk and growth assessments are either high risk (5) or very high risk (6) or whose overall industry risk assessments are either high risk (5) or very high risk (6). The weights applied will generally be 50% for the current year and 50% for the first subsequent forecast year.
118. When the indicative ratio(s) is borderline (i.e., less than 10% different from the threshold in relative terms) between two assessment thresholds (as described in section E.3 and tables 17, 18, and 19) and the forecast points to a switch in the ratio between categories during the rating timeframe, we will weigh the forecast even more heavily in order to prospectively capture the trend.

119. For companies undergoing a transformational event, the weighting of the time series could vary significantly.

120. For companies undergoing a transformational event and with significant or weaker cash flow/leverage assessments, we place greater weight on near-term risk factors. That's because overemphasis on longer-term (inherently less predictable) issues could lead to some distortion when assessing the risk level of a speculative-grade company. We generally analyze a company using the arithmetic mean of the credit ratios expected according to our forecasts for the current year (or pro forma current year) and the subsequent financial year. A common example of this is when a private equity firm acquires a company using additional debt leverage, which makes historical financial ratios meaningless. In this scenario, we weight or focus the majority of our analysis on the next one or two years of projected credit measures.

3. Determining the cash flow/leverage assessment

a) Identifying the benchmark table

121. Tables 17, 18, and 19 provide benchmark ranges for various cash flow ratios we associate with different cash flow/leverage assessments for standard volatility, medial volatility, and low volatility industries. The tables of benchmark ratios differ for a given ratio and cash flow/leverage assessment along two dimensions: the starting point for the ratio range and the width of the ratio range.

122. If an industry exhibits low volatility, the threshold levels for the applicable ratios to achieve a given cash flow/leverage assessment are less stringent than those in the medial or standard volatility tables, although the range of the ratios is narrower. Conversely, if an industry exhibits medial or standard levels of volatility, the threshold for the applicable ratios to achieve a given cash flow/leverage assessment are elevated, albeit with a wider range of values.

123. The relevant benchmark table for a given company is based on our Corporate Industry and Country Risk Assessment, or the CICRA (see section A, table 1), as described in the bullet points below, unless otherwise indicated in a sector's KCF criteria or in "Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)."

The low volatility table (table 19) will generally apply when a company's CICRA is '1' but can infrequently also apply to a company with a CICRA of '2' if the company exhibits or is expected to exhibit low levels of volatility.
The medial volatility table (table 18) will generally apply for a company with a CICRA of '2' but can infrequently also apply to a company with a CICRA of '1' if the company exhibits or is expected to exhibit medial levels of volatility.
The standard volatility table (table 17) serves as the relevant benchmark table for all CICRA scores other than '1', but we will always use it for companies with a CICRA of '1' or '2' whose competitive position is assessed as '5' or '6'.

Table 17

Cash Flow/Leverage Analysis Ratios--Standard Volatility

	--Core ratios--		--Supplementary coverage ratios--		--Supplementary payback ratios--		
	FFO/debt (%)	Debt/EBITDA (x)	FFO/cash interest(x)	EBITDA/interest (x)	CFO/debt (%)	FOCF/debt (%)	DCF/debt (%)
Minimal	60+	Less than 1.5	More than 13	More than 15	More than 50	40+	25+
Modest	45-60	1.5-2	9-13	10-15	35-50	25-40	15-25
Intermediate	30-45	2-3	6-9	6-10	25-35	15-25	10-15
Significant	20-30	3-4	4-6	3-6	15-25	10-15	5-10
Aggressive	12-20	4-5	2-4	2-3	10-15	5-10	2-5
Highly leveraged	Less than 12	Greater than 5	Less than 2	Less than 2	Less than 10	Less than 5	Less than 2

Table 18

Cash Flow/Leverage Analysis Ratios--Medial Volatility

	--Core ratios--		--Supplementary coverage ratios--		--Supplementary payback ratios--		
	FFO/debt (%)	Debt/EBITDA (x)	FFO/cash interest (x)	EBITDA/interest (x)	CFO/debt (%)	FOCF/debt (%)	DCF/debt (%)
Minimal	50+	less than 1.75	10.5+	14+	40+	30+	18+
Modest	35-50	1.75-2.5	7.5-10.5	9-14	27.5-40	17.5-30	11-18
Intermediate	23-35	2.5-3.5	5-7.5	5-9	18.5-27.5	9.5-17.5	6.5-11
Significant	13-23	3.5-4.5	3-5	2.75-5	10.5-18.5	5-9.5	2.5-6.5
Aggressive	9-13	4.5-5.5	1.75-3	1.75-2.75	7-10.5	0-5	(11)-2.5
Highly leveraged	Less than 9	Greater than 5.5	Less than 1.75	Less than 1.75	Less than 7	Less than 0	Less than (11)

Table 19

Cash Flow/Leverage Analysis Ratios--Low Volatility

	--Core ratios--		--Supplementary coverage ratios--		--Supplementary payback ratios--		
	FFO/debt (%)	Debt/EBITDA (x)	FFO/cash interest (x)	EBITDA/interest (x)	CFO/debt (%)	FOCF/debt (%)	DCF/debt (%)
Minimal	35+	Less than 2	More than 8	More than 13	More than 30	20+	11+
Modest	23-35	2-3	5-8	7-13	20-30	10-20	7-11
Intermediate	13-23	3-4	3-5	4-7	12-20	4-10	3-7
Significant	9-13	4-5	2-3	2.5-4	8-12	0-4	0-3

Aggressive	6-9	5-6	1.5-2	1.5-2.5	5-8	(10)-0	(20)-0
Highly leveraged	Less than 6	Greater than 6	Less than 1.5	Less than 1.5	Less than 5	Less than (10)	Less than (20)

b) Aggregating the credit ratio assessments

124. To determine the final cash flow/leverage assessment, we make these calculations:

1) First, calculate a time series of standard core and supplemental credit ratios, select the relevant benchmark table, and determine the appropriate time weighting of the credit ratios.

Calculate the two standard core credit ratios and the five standard supplemental credit ratios over a five-year time horizon. Consult the relevant industry KCF article (if applicable) or "Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)," which may identify additional supplemental ratio(s). The relevant benchmark table for a given company is based on our assessment of the company's associated industry and country risk volatility, or the CICRA.
Calculate the appropriate weighted average cash flow/leverage ratios. If the company is undergoing a transformational event, then the core and supplemental ratios will typically be calculated based on S&P Global Ratings' projections for the current and next one or two financial years.
2) Second, we use the core ratios to determine the preliminary cash flow assessment.

Compare the core ratios (FFO to debt and debt to EBITDA) to the ratio ranges in the relevant benchmark table.
If the core ratios result in different cash flow/leverage assessments, we will select the relevant core ratio based on which provides the best indicator of a company's future leverage.
3) Third, we review the supplemental ratio(s).

Determine the importance of standard or KCF supplemental ratios based on company-specific characteristics, namely, leverage, capital intensity, working capital intensity, growth rate, or industry.
4) Fourth, we calculate the adjusted cash flow/leverage assessment.

If the cash flow/leverage assessment(s) indicated by the important supplemental ratio(s) differs from the preliminary cash flow/leverage assessment, we might adjust the preliminary cash flow/leverage assessment by one category in the direction of the cash flow/leverage assessment indicated by the supplemental ratio(s) to derive the adjusted cash flow/leverage assessment. We will make this adjustment if, in our view, the supplemental ratio provides the best indicator of a company's future leverage.
If there is more than one important supplemental ratio and they result in different directional deviations from the preliminary cash flow/leverage assessment, we will select one as the relevant supplemental ratio based on which, in our opinion, provides the best indicator of a company's future leverage. We will then make the adjustment outlined above if the selected supplemental ratio differs from the preliminary cash flow/leverage assessment and the selected supplemental ratio provides the best overall indicator of a company's future leverage.
5) Lastly, we determine the final cash flow/leverage assessment based on the volatility adjustment.

We classify companies as stable for these cash flow criteria if cash flow/leverage ratios are expected to worsen by up to one category during periods of stress based on their business risk profile. The final cash flow/leverage assessment for these companies will not be modified from the adjusted cash flow/leverage assessment.
We classify companies as volatile for these cash flow criteria if cash flow/leverage ratios are expected to move one or two categories worse during periods of stress based on their business risk profiles. Typically, this is equivalent to EBITDA declining about 30% from its current level. The final cash flow/leverage assessment for these companies will be modified to one category weaker than the adjusted cash flow/leverage assessment; the adjustment will be eliminated if cash flow/leverage ratios, as evaluated, include a moderate to high level of stress already.
We classify companies as highly volatile for these cash flow criteria if cash flow/leverage ratios are expected to move two or three categories worse during periods of stress, based on their business risk profiles. Typically, this is equivalent to EBITDA declining about 50% from its current level. The final cash flow/leverage assessment for these companies will be modified to two categories weaker than the adjusted cash flow/leverage assessment; the adjustment will be eliminated or reduced to one category if cash flow/leverage ratios, as evaluated, include a moderate to high level of stress already.
125. The volatility adjustment is the mechanism by which we factor a "cushion" of medium-term variance to current financial performance not otherwise captured in either the near-term base-case forecast or the long-term business risk assessment. We make this adjustment based on the following:

The expectation of any potential cash flow/leverage ratio movement is both prospective and dependent on the current business or economic conditions.

Stress scenarios include, but are not limited to, a recessionary economic environment, technology or competitive shifts, loss or renegotiation of major contracts or customers, and key product or input price movements, as typically defined in the company's industry risk profile and competitive position assessment.
The volatility adjustment is not static and is company specific. At the bottom of an economic cycle or during periods of stressed business conditions, already reflected in the general industry risk or specific competitive risk profile, the prospect of weakening ratios is far less than at the peak of an economic cycle or business conditions.
The expectation of prospective ratio changes may be formed by observed historical performance over an economic, business, or product cycle by the company or by peers.
The assessment of which classification to use when evaluating the prospective number of scoring category moves will be guided by how close the current ratios are to the transition point (i.e. "buffer" in the current scoring category) and the corresponding amount of EBITDA movement at each scoring transition.

F. Diversification/Portfolio Effect

126. Under the criteria, diversification/portfolio effect applies to companies that we regard as conglomerates. They are companies that have multiple core business lines that may be operated as separate legal entities. For the purpose of these criteria, a conglomerate would have at least three business lines, each contributing a material source of earnings and cash flow.

127. The criteria aim to measure how diversification or the portfolio effect could improve the anchor of a company with multiple business lines. This approach helps us determine how the credit strength of a corporate entity with a given mix of business lines could improve based on its diversity. The competitive position factor assesses the benefits of diversity within individual lines of business. This factor also assesses how poorly performing businesses within a conglomerate affect the organization's overall business risk profile.

128. Diversification/portfolio effect could modify the anchor depending on how meaningful we think the diversification is, and on the degree of correlation we find in each business line's sensitivity to economic cycles. This assessment will have either a positive or neutral impact on the anchor. We capture any potential factor that weakens a company's diversification, including poor management, in our management and governance assessment.

129. We define a conglomerate as a diversified company that is involved in several industry sectors. Usually the smallest of at least three distinct business segments/lines would contribute at least 10% of either EBITDA or FOCF and the largest would contribute no more than 50% of EBITDA or FOCF, with the long-term aim of increasing shareholder value by generating cash flow. Industrial conglomerates usually hold a controlling stake in their core businesses, have highly identifiable holdings, are deeply involved in the strategy and management of their operating companies, generally do not frequently roll over or reshuffle their holdings by buying and selling companies, and therefore have high long-term exposure to the operating risks of their subsidiaries.

130. In rating a conglomerate, we first assess management's commitment to maintain the diversified portfolio over a longer-term horizon. These criteria apply only if the company falls within our definition of a conglomerate.

1. Assessing diversification/portfolio effect

131. A conglomerate's diversification/portfolio effect is assessed as 1, significant diversification; 2, moderate diversification; or 3, neutral. An assessment of moderate diversification or significant diversification potentially raises the issuer's anchor. To achieve an assessment of significant diversification, an issuer should have uncorrelated diversified businesses whose breadth is among the most comprehensive of all conglomerates'. This assessment indicates that we expect the conglomerate's earnings volatility to be much lower through an economic cycle than an undiversified company's. To achieve an assessment of moderate diversification, an issuer typically has a range of uncorrelated diversified businesses that provide meaningful benefits of diversification with the expectation of lower earnings volatility through an economic cycle than an undiversified company's.

132. We expect that a conglomerate will also benefit from diversification if its core assets consistently produce positive cash flows over our rating horizon. This supports our assertion that the company diversifies to take advantage of allocating capital among its business lines. To this end, our analysis focuses on a conglomerate's track record of successfully deploying positive discretionary cash flow into new business lines or expanding capital-hungry business lines. We assess companies that we do not expect to achieve these benefits as neutral.

2. Components of correlation and how it is incorporated into our analysis

133. We determine the assessment for this factor based on the number of business lines in separate industries (as described in table 27) and the degree of correlation between these business lines as described in table 20. There is no rating uplift for an issuer with a small number of business lines that are highly correlated. By contrast, a larger number of business lines that are not closely correlated provide the maximum rating uplift.

Table 20

Assessing Diversification/Portfolio Effect

	--Number of business lines--		
Degree of correlation of business lines	**3**	**4**	**5 or more**
High	Neutral	Neutral	Neutral
Medium	Neutral	Moderately diversified	Moderately diversified
Low	Moderately diversified	Significantly diversified	Significantly diversified

134. The degree of correlation of business lines is high if the business lines operate within the same industry, as defined by the industry designations in Appendix B, table 27. The degree of correlation of business lines is medium if the business lines operate within different industries, but operate within the same geographic region (for further guidance on defining geographic regions, see Appendix A, table 26). An issuer has a low degree of correlation across its business lines if these business lines are both a) in different industries and b) either operate in different regions or operate in multiple regions.

135. If we believe that a conglomerate's various industry exposures fail to provide a partial hedge against the consolidated entity's volatility because they are highly correlated through an economic cycle, then we assess the diversification/portfolio effect as neutral.

G. Capital Structure

136. S&P Global Ratings uses its capital structure criteria to assess risks in a company's capital structure that may not show up in our standard analysis of cash flow/leverage. These risks may exist as a result of maturity date or currency mismatches between a company's sources of financing and its assets or cash flows. These can be compounded by outside risks, such as volatile interest rates or currency exchange rates.

1. Assessing capital structure

137. Capital structure is a modifier category, which adjusts the initial anchor for a company after any modification due to diversification/portfolio effect. We assess a number of subfactors to determine the capital structure assessment, which can then raise or lower the initial anchor by one or more notches--or have no effect in some cases. We assess capital structure as 1, very positive; 2, positive; 3, neutral; 4, negative; or 5, very negative. In the large majority of cases, we believe that a firm's capital structure will be assessed as neutral. To assess a company's capital structure, we analyze four subfactors:

Currency risk associated with debt,
Debt maturity profile (or schedule),
Interest rate risk associated with debt, and
Investments.

138. Any of these subfactors can influence a firm's capital structure assessment, although some carry greater weight than others, based on a tiered approach:

Tier one risk subfactors: Currency risk of debt and debt maturity profile, and
Tier two risk subfactor: Interest rate risk of debt.

139. The initial capital structure assessment is based on the first three subfactors (see table 21). We may then adjust the preliminary assessment based on our assessment of the fourth subfactor, investments.

Table 21

Preliminary Capital Structure Assessment

Preliminary capital structure assessment	**Subfactor assessments**
Neutral	No tier one subfactor is negative.
Negative	One tier one subfactor is negative, and the tier two subfactor is neutral.
Very negative	Both tier one subfactors are negative, or one tier one subfactor is negative and the tier two subfactor is negative.

140. Tier one subfactors carry the greatest risks, in our view, and, thus, could have a significant impact on the capital structure assessment. This is because, in our opinion, these factors have a greater likelihood of affecting credit metrics and potentially causing liquidity and refinancing risk. The tier two subfactor is important in and of itself, but typically less so than the tier one subfactors. In our view, in the majority of cases, the tier two subfactor in isolation has a lower likelihood of leading to liquidity and default risk than do tier one subfactors.

141. The fourth subfactor, investments, as defined in paragraph 153, quantifies the impact of a company's investments on its overall financial risk profile. Although not directly related to a firm's capital structure decisions, certain investments could provide a degree of asset protection and potential financial flexibility if they are monetized. Thus, the fourth subfactor could modify the preliminary capital structure assessment (see table 22). If the subfactor is assessed as neutral, then the preliminary capital structure assessment will stand. If investments is assessed as positive or very positive, we adjust the preliminary capital structure assessment upward (as per table 22) to arrive at the final assessment.

Table 22

Final Capital Structure Assessment

	--Investments subfactor assessment--		
Preliminary capital structure assessment	**Neutral**	**Positive**	**Very positive**
Neutral	Neutral	Positive	Very positive
Negative	Negative	Neutral	Positive
Very negative	Very negative	Negative	Negative

2. Capital structure analysis: Assessing the subfactors

a) Subfactor 1: Currency risk of debt

142. Currency risk arises when a company borrows without hedging in a currency other than the currency in which it generates revenues. Such an unhedged position makes the company potentially vulnerable to fluctuations in the exchange rate between the two currencies, in the absence of mitigating factors. We determine the materiality of any mismatch by identifying situations where adverse exchange-rate movements could weaken cash flow and/or leverage ratios. We do not include currency mismatches under the following scenarios:

The country where a company generates its cash flows has its currency pegged to the currency in which the company has borrowed, or vice versa (or the currency of cash flows has a strong track record and government policy of stability with the currency of borrowings), examples being the Hong Kong dollar which is pegged to the U.S. dollar, and the Chinese renminbi which is managed in a narrow band to the U.S. dollar (and China's foreign currency reserves are mainly in U.S. dollars). Moreover, we expect such a scenario to continue for the foreseeable future;
A company has the proven ability, through regulation or contract, to pass through changes in debt servicing costs to its customers; or
A company has a natural hedge, such as where it may sell its product in a foreign currency and has matched its debt in that same currency.
143. We also recognize that even if an entity generates insufficient same-currency cash flow to meet foreign currency-denominated debt obligations, it could have substantial other currency cash flows it can convert to meet these obligations. Therefore, the relative amount of foreign denominated debt as a proportion of total debt is an important factor in our analysis. If foreign denominated debt, excluding fully hedged debt principal, is 15% or less of total debt, we assess the company as neutral on currency risk of debt. If foreign-denominated debt, excluding fully hedged debt principal, is greater than 15% of total debt, and debt to EBITDA is greater than 3.0x, we evaluate currency risks through further analysis.

144. If an entity's foreign-denominated debt in a particular currency represents more than 15% of total debt, and if its debt to EBITDA ratio is greater than 3.0x, we identify whether a currency-specific interest coverage ratio indicates potential currency risk. The coverage ratio divides forecasted operating cash flow in each currency by interest payments over the coming 12 months for that same currency. It is often easier to ascertain the geographic breakdown of EBITDA as opposed to operating cash flow. So in situations where we don't have sufficient cash flow information, we may calculate an EBITDA to interest expense coverage ratio in the relevant currencies. If neither cash flow nor EBITDA information is disclosed, we estimate the relevant exposures based on available information.

145. In such an instance, our assessment of this subfactor is negative if we believe any appropriate interest coverage ratio will fall below 1.2x over the next 12 months.

b) Subfactor 2: Debt maturity profile

146. A firm's debt maturity profile shows when its debt needs to be repaid, or refinanced if possible, and helps determine the firm's refinancing risk. Lengthier and more evenly spread out debt maturity schedules reduce refinancing risk, compared with front-ended and compressed ones, since the former give an entity more time to manage business- or financial market-related setbacks.

147. In evaluating debt maturity profiles, we measure the weighted average maturity (WAM) of bank debt and debt securities (including hybrid debt) within a capital structure, and make simplifying assumptions that debt maturing beyond year five matures in year six. WAM = (Maturity1/Total Debt)*tenor1 + (Maturity2/Total Debt)* tenor2 +... (Thereafter/Total Debt)* tenor6

148. In evaluating refinancing risk, we consider risks in addition to those captured under the 12-month to 24-month time-horizons factored in our liquidity criteria (see "Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers (/en_US/web/guest/article/-/view/sourceId/8956570)"). While we recognize that investment-grade companies may have more certain future business prospects and greater access to capital than speculative-grade companies, all else being equal, we view a company with a shorter maturity schedule as having greater refinancing risk compared to a company with a longer one. In all cases, we assess a company's debt maturity profile in conjunction with its liquidity and potential funding availability. Thus, a short-dated maturity schedule alone is not a negative if we believe the company can maintain enough liquidity to pay off debt that comes due in the near term.

149. Our assessment of this subfactor is negative if the WAM is two years or less, and the amount of these near-term maturities is material in relation to the issuer's liquidity so that under our base-case forecast, we believe the company's liquidity assessment will become less than adequate or weak over the next two years due to these maturities. In certain cases, we may assess a debt maturity profile as negative regardless of whether or not the company passes the aforementioned test. We expect such instances to be rare, and will include scenarios where we believed a concentration of debt maturities within a five-year time horizon poses meaningful refinancing risk, either due to the size of the maturities in relation to the company's liquidity sources, the company's leverage profile, its operating trends, lender relationships, and/or credit market standings.

c) Subfactor 3: Interest rate risk of debt

150. The interest rate risk of debt subfactor analyzes the company's mix of fixed-rate and floating-rate debt. Generally, a higher proportion of fixed-rate debt leads to greater predictability and stability of interest expense and therefore cash flows. The exception would be companies whose operating cash flows are to some degree correlated with interest rate movements--for example, a regulated utility whose revenues are indexed to inflation--given the typical correlation between nominal interest rates and inflation.

151. The mix of fixed versus floating-rate debt is usually not a significant risk factor for companies with intermediate or better financial profiles, strong profitability, and high interest coverage. In addition, the interest rate environment at a given point in time will play a role in determining the impact of interest rate movements. Our assessment of this subcategory will be negative if a 25% upward shift (e.g., from 2.0% to 2.5%) or a 100 basis-point upward shift (e.g., 2% to 3%) in the base interest rate of the floating rate debt will result in a breach of interest coverage covenants or interest coverage rating thresholds identified in the cash flow/leverage criteria (see section E.3).

152. Many loan agreements for speculative-grade companies contain a clause requiring a percentage of floating-rate debt to be hedged for a period of two to three years to mitigate this risk. However, in many cases the loan matures after the hedge expires, creating a mismatched hedge. We consider only loans with hedges that match the life of the loan to be--effectively--fixed-rate debt.

d) Subfactor 4: Investments

153. For the purposes of the criteria, investments refer to investments in unconsolidated equity affiliates, other assets where the realizable value isn't currently reflected in the cash flows generated from those assets (e.g. underutilized real-estate property), we do not expect any additional investment or support to be provided to the affiliate, and the investment is not included within S&P Global Ratings' consolidation scope and so is not incorporated in the company's business and financial risk profile analysis. If equity affiliate companies are consolidated, then the financial benefits and costs of these investments will be captured in our cash flow and leverage analysis. Similarly, where the company's ownership stake does not qualify for consolidation under accounting rules, we may choose to consolidate on a pro rata basis if we believe that the equity affiliates' operating and financing strategy is influenced by the rated entity. If equity investments are strategic and provide the company with a competitive advantage, or benefit a company's scale, scope, and diversity, these factors will be captured in our competitive position criteria and will not be used to assess the subfactor investments as positive. Within the capital structure

criteria, we aim to assess nonstrategic financial investments that could provide a degree of asset protection and financial flexibility in the event they are monetized. These investments must be noncore and separable, meaning that a potential divestiture, in our view, has no impact on the company's existing operations.

154. In many instances, the cash flows generated by an equity affiliate, or the proportional share of the associate company's net income, might not accurately reflect the asset's value. This could occur if the equity affiliate is in high growth mode and is currently generating minimal cash flow or net losses. This could also be true of a physical asset, such as real estate. From a valuation standpoint, we recognize the subjective nature of this analysis and the potential for information gaps. As a result, in the absence of a market valuation or a market valuation of comparable companies in the case of minority interests in private entities, we will not ascribe value to these assets.

155. We assess this subfactor as positive or very positive if three key characteristics are met. First, an estimated value can be ascribed to these investments based on the presence of an existing market value for the firm or comparable firms in the same industry. Second, there is strong evidence that the investment can be monetized over an intermediate timeframe--in the case of an equity investment, our opinion of the marketability of the investment would be enhanced by the presence of an existing market value for the firm or comparable firms, as well as our view of market liquidity. Third, monetization of the investment, assuming proceeds would be used to repay debt, would be material enough to positively move existing cash flow and leverage ratios by at least one category and our view on the company's financial policy, specifically related to financial discipline, supports the assessment that the potential proceeds would be used to pay down debt. This subfactor is assessed as positive if debt repayment from the investment sale has the potential to improve cash flow and leverage ratios by one category. We assess investments as very positive if proceeds upon sale of the investment have the potential to improve cash flow and leverage ratios by two or more categories. If the three characteristics are not met, this subfactor will be assessed as neutral and the preliminary capital structure assessment will stand.

156. We will not assess the investments subfactor as positive or very positive when the anchor is 'b+' or lower unless the three conditions described in paragraph 155 are met, and:

For issuers with less than adequate or weak liquidity, the company has provided a credible near-term plan to sell the investment.
For issuers with adequate or better liquidity, we believe that the company, if needed, could sell the investment in a relatively short timeframe.

H. Financial Policy

157. Financial policy refines the view of a company's risks beyond the conclusions arising from the standard assumptions in the cash flow/leverage assessment (see section E). Those assumptions do not always reflect or entirely capture the short-to-medium term event risks or the longer-term risks stemming from a company's financial policy. To the extent movements in one of these factors cannot be confidently predicted within our forward-looking evaluation, we capture that risk within our evaluation of financial policy. The cash flow/leverage assessment will typically factor in operating and cash flows metrics we observed during the past two years and the trends we expect to see for the coming two years based on operating assumptions and predictable financial policy elements, such as ordinary dividend payments or recurring acquisition spending. However, over that period and, generally, over a longer time horizon, the firm's financial policies can change its financial risk profile based on management's or, if applicable, the company's controlling shareholder's (see Appendix E, paragraphs 254-257) appetite for incremental risk or, conversely, plans to reduce leverage. We assess financial policy as 1) positive, 2) neutral, 3) negative, or as being owned by a financial sponsor. We further identify financial sponsor-owned companies as "FS-4", "FS-5", "FS-6", or "FS-6 (minus)" (see section H.2).

1. Assessing financial policy

158. First, we determine if a company is owned by a financial sponsor. Given the intrinsic characteristics and aggressive nature of financial sponsor's strategies (i.e. short- to intermediate-term holding periods and the use of debt or debt-like instruments to maximize shareholder returns), we assign a financial risk profile assessment to a firm controlled by a financial sponsor that reflects the likely impact on leverage due to these strategies and we do not separately analyze management's financial discipline or financial policy framework.

159. If a company is not controlled by a financial sponsor, we evaluate management's financial discipline and financial policy framework. Management's financial discipline measures its tolerance for incremental financial risk or, conversely, its willingness to maintain the same degree of financial risk or to lower it compared with recent cash flow/leverage metrics and our projected ratios for the next two years. The company's financial policy framework assesses the comprehensiveness, transparency, and sustainability of the entity's financial policies. We do not assess these factors for financial sponsor controlled firms.

160. The financial discipline assessments can have a positive or negative influence on an enterprise's overall financial policy assessment, or can have no net effect. Conversely, the financial policy framework assessment cannot positively influence the overall financial policy assessment. It can constrain the overall financial policy assessment to no greater than neutral.

161. The separate assessments of a company's financial policy framework and financial discipline determine the financial policy adjustment.

162. We assess management's financial discipline as 1, positive; 2, neutral; or 3, negative. We determine the assessment by evaluating the predictability of an entity's expansion plans and shareholder return strategies. We take into account, generally, management's tolerance for material and unexpected negative changes in credit ratios or, instead, its plans to rapidly decrease leverage and keep credit ratios within stated boundaries.

163. A company's financial policy framework assessment is: 1, supportive or 2, non-supportive. We make the determination by assessing the comprehensiveness of a company's financial policy framework and whether financial targets are clearly communicated to a large number of stakeholders, and are well defined, achievable, and sustainable.

Table 23

Financial Policy Assessments

Assessment	What it means	Guidance
Positive	Indicates that we expect management’s financial policy decisions to have a positive impact on credit ratios over the time horizon, beyond what can be reasonably built in our forecasts on the basis of normalized operating and cash flow assumptions. An example would be when a credible management team commits to dispose of assets or raise equity over the short to medium term in order to reduce leverage. A company with a 1 financial risk profile will not be assigned a positive assessment.	If financial discipline is positive, and the financial policy framework is supportive
Neutral	Indicates that, in our opinion, future credit ratios won’t differ materially over the time horizon beyond what we have projected, based on our assessment of management’s financial policy, recent track record, and operating forecasts for the company. A neutral financial policy assessment effectively reflects a low probability of “event risk,” in our view.	If financial discipline is positive, and the financial policy framework is non-supportive. Or when financial discipline is neutral, regardless of the financial policy framework assessment.
Negative	Indicates our view of a lower degree of predictability in credit ratios, beyond what can be reasonably built in our forecasts, as a result of management’s financial discipline (or lack of it). It points to high event risk that management’s financial policy decisions may depress credit metrics over the time horizon, compared with what we have already built in our forecasts based on normalized operating and cash flow assumptions.	If financial discipline is negative, regardless of the financial policy framework assessment
Financial Sponsor*	We define a financial sponsor as an entity that follows an aggressive financial strategy in using debt and debt-like instruments to maximize shareholder returns. Typically, these sponsors dispose of assets within a short to intermediate time frame. Accordingly, the financial risk profile we assign to companies that are controlled by financial sponsors ordinarily reflects our presumption of some deterioration in credit quality in the medium term. Financial sponsors include private equity firms, but not infrastructure and asset-management funds, which maintain longer investment horizons.	We define financial sponsor-owned companies as nonfinancial corporate entities in which one or more financial sponsors own at least 40% of the entity's common equity, or retain the majority of the voting rights and control through preference shares, and where we consider that the sponsors exercise control of the company either solely or jointly.

*Assessed as FS-4, FS-5, FS-6, or FS-6 (minus).

2. Financial sponsor-controlled companies

164. We define a financial sponsor as an entity that follows an aggressive financial strategy in using debt and debt-like instruments to maximize shareholder returns. Typically, these sponsors dispose of assets within a short-to-intermediate time frame. Financial sponsors include private equity firms, but not infrastructure and asset-management funds, which maintain longer investment horizons.

165. We define financial sponsor-owned companies as nonfinancial corporate entities in which one or more financial sponsors own at least 40% of the entity's common equity, or retain the majority of the voting rights and control through preference shares, and where we consider that the sponsors exercise control of the company either solely or jointly. "Control" refers to the sponsors' ability to dictate an entity's strategy and cash flow. The strategic goals of the sponsors must be aligned for us to consider the sponsors as having joint control.

166. We differentiate between financial sponsors and other types of controlling shareholders and companies that do not have controlling shareholders based on our belief that short-term ownership--such as exists in private equity sponsor-owned companies--generally entails financial policies aimed at achieving rapid returns for shareholders typically through aggressive debt leverage.

167. Financial sponsors often dictate policies regarding risk-taking, financial management, and corporate governance for the companies that they control. There is a common pattern of these investors extracting cash in ways that increase the companies' financial risk by utilizing debt or debt like instruments. Accordingly, the financial risk profile we assign to companies that are controlled by financial sponsors ordinarily reflect our presumption of some deterioration in credit quality or steadily high leverage in the medium term.

168. We assess the influence of financial sponsor ownership as "FS-4", "FS-5", "FS-6", and "FS-6 (minus)" depending on how aggressive we assume the sponsor will be and assign a financial risk profile accordingly (see table 24).

169. Generally, financial sponsor-owned issuers will receive an assessment of "FS-6" or "FS-6 (minus)", leading to a financial risk profile assessment of '6', under the criteria. A "FS-6" assessment indicates that, in our opinion, forecasted credit ratios in the medium term are likely be to be consistent with a '6' financial risk profile, based on our assessment of the financial sponsor's financial policy and track record. A "FS-6 (minus)" will likely be applied to companies that we forecast to have near-term credit ratios consistent with a '6' financial risk profile, but we believe the financial sponsor to be very aggressive and that leverage could increase materially even further from our forecasted levels.

170. In a small minority of cases, a financial sponsor-owned entity could receive an assessment of "FS-5". This assessment will apply only when we project that the company's leverage will be consistent with a '5' (aggressive) financial risk profile (see tables 17, 18, and 19), we perceive that the risk of releveraging is low based on the company's financial policy and our view of the owner's financial risk appetite, and liquidity is at least adequate.

171. In even rarer cases, we could assess the financial policy of a financial sponsor-owned entity as "FS-4". This assessment will apply only when all of the following conditions are met: other shareholders own a material (generally, at least 20%) stake, we expect the sponsor to relinquish control over the intermediate term, we project that leverage is currently consistent with a '4' (significant) financial risk profile (see tables 17, 18, and 19), the company has said it will maintain leverage at or below this level, and liquidity is at least adequate.

Table 24

Financial Risk Profile Implications For Sponsor-Owned Issuers

Assessment	What it Means	Guidance
FS-4	Financial risk profile set at '4'	Issuer must meet all of the following conditions: • Other shareholders must own a material (no less than 20%) stake; • We anticipate that the sponsor will relinquish control over the medium term; • For issuers subject to Table 17 (standard volatility), debt to EBITDA is less than 4x, and we estimate that it will remain less than 4x. For issuers that are subject to Table 18 (medial volatility), debt to EBITDA is below 4.5x and we forecast it to remain below that level. Or for issuers subject to Table 19 (low volatility), debt to EBITDA is less than 5x and our estimation is it will remain below that level; • The company has indicated a financial policy stipulating a level of leverage consistent with a significant or better financial risk profile (that is, debt to EBITDA of less than 4x when applying standard volatility tables, 4.5x when applying medial volatility tables, or less than 5x when applying low volatility tables) and • We assess liquidity to be at least adequate, with adequate covenant headroom.
FS-5	Financial risk profile set at '5'	Issuer must meet all of the following conditions: • For issuers subject to the standard volatility table, debt to EBITDA is less than 5x, and we estimate that it will remain less than 5x. For issuers that are subject to the medial volatility table, debt to EBITDA is below 5.5x and we forecast it to remain below that level. Or for issuers subject to the low volatility table, debt to EBITDA is less than 6x and our estimation is it will remain below that level; • We believe the risk of releveraging beyond 5x (standard volatility issuer), 5.5x (medial volatility issuer), or 6x (low volatility issuer) is low; and • We assess liquidity to be at least adequate, with adequate covenant headroom.
FS-6	Financial risk profile set at '6'	Standard & Poor's debt to EBITDA is greater than 5x (when applying the standard volatility table), greater than 5.5x (when applying the medial volatility table), or greater than 6x (when applying the low volatility table). However, we believe leverage is unlikely to increase meaningfully beyond these levels.
FS-6 (minus)	Financial risk profile set at '6', and anchor reduced by one notch (unless this results in a final rating below 'B-')	In determining the anchor the financial risk profile is a '6', but we believe the track record of the financial sponsor indicates that leverage could increase materially from already high levels.

3. Companies not controlled by a financial sponsor

172. For companies not controlled by a financial sponsor we evaluate management's financial discipline and financial policy framework to determine the influence on an entity's financial risk profile beyond what is implied by recent credit ratios and our cash flow and leverage forecasts. This influence can be positive, neutral, or negative.

173. We do not distinguish between management and a controlling shareholder that is not a financial sponsor when assessing these subfactors, as the controlling shareholder usually has the final say on financial policy.

a) Financial discipline

174. The financial discipline assessment is based on management's leverage tolerance and the likelihood of event risk. The criteria evaluate management's potential appetite to incur unforeseen, higher financial risk over a prolonged period and the associated impact on credit measures. We also assess management's capacity and commitment to rapidly decrease debt leverage to levels consistent with its credit ratio targets.

175. This assessment therefore seeks to determine whether unforeseen actions by management to increase, maintain, or reduce financial risk are likely to occur during the next two to three years, with either a negative or positive effect, or none at all, on our baseline forecasts for the period.

176. This assessment is based on the leverage tolerance of a company's management, as reflected in its plans or history of acquisitions, shareholder remuneration, and organic growth strategies (see Appendix E, paragraphs 258 to 263).

177. We assess financial discipline as positive, neutral, or negative, based on its potential impact on our forward-looking assessment of a firm's cash flow/leverage, as detailed in table 25. For example, a neutral assessment for leverage tolerance reflects our expectation that management's financial policy will unlikely lead to significant deviation from current and forecasted credit ratios. A negative assessment acknowledges a significant degree of event risk of increased leverage relative to our base-case forecast, resulting from the company's acquisition policy, its shareholder remuneration policy, or its organic growth strategy. A positive assessment indicates that the company is likely to take actions to reduce leverage, but we cannot confidently incorporate these actions into our baseline forward-looking assessment of cash flow/leverage.

178. A positive assessment indicates that management is committed and has the capacity to reduce debt leverage through the rapid implementation of credit enhancing measures, such as asset disposals, rights issues, or reductions in shareholder returns. In addition, management's track record over the past five years shows that it has taken actions to rapidly reduce unforeseen increases in debt leverage and that there have not been any prolonged periods when credit ratios were weaker than our expectations for the rating. Management, even if new, also has a track record of successful execution. Conversely, a negative assessment indicates management's financial policy allows for significant increase in leverage compared with both current levels and our forward-looking forecast under normal operating/financial conditions or does not have observable time limits or stated boundaries. Management has a track record of allowing for significant and prolonged peaks in leverage and there is no commitment or track record of management using mitigating measures to rapidly return to credit ratios consistent with our expectations.

179. As evidence of management's leverage tolerance, we evaluate its track record and plans regarding acquisitions, shareholder remuneration, and organic growth strategies (see Appendix E, paragraphs 258 to 263). Acquisitions could increase the risk that leverage will be higher than our base-case forecast if we view management's strategy as opportunistic or if its financial policy (if it exists) provides significant headroom for debt-financed acquisitions. Shareholder remuneration could also increase the risk of leverage being higher than our base-case forecast if management's shareholder reward policies are not particularly well defined or have no clear limits, management has a tolerance for shareholder returns exceeding operating cash flow, or has a track record of sustained cash returns despite weakening operating performance or credit ratios. Organic growth strategies can also result in leverage higher than our base-case forecast if these plans have no clear focus or investment philosophy, capital spending is fairly unpredictable, or there is a track record of overspending or unexpected or rapid shifts in plans for new markets or products.

180. We also take into account management's track record and level of commitment to its stated financial policies, to the extent a company has a stated policy. Historical evidence and any deviations from stated policies are key elements in analyzing a company's leverage tolerance. Where material and unexpected deviation in leverage may occur (for example, on the back of operating weakness or acquisitions), we also assess management's plan to restore credit ratios to levels consistent with previous expectations through rapid and proactive non-organic measures. Management's track record to execute its deleveraging plan, its level of commitment, and the scope and timeframe of debt mitigating measures will be key differentiators in assessing a company's financial policy discipline.

Table 25

Assessing Financial Discipline

Descriptor	What it means	Guidance
Positive	Management is likely to take actions that result in leverage that is lower than our base-case forecast, but can't be confidently included in our base-case assumptions. Event risk is low.	Management is committed and has capacity to reduce debt leverage and increase financial headroom through the rapid implementation of credit enhancing measures, in line with its stated financial policy, if any. This relates primarily to management's careful and moderate policy with regard to acquisitions and shareholder remuneration as well as to its organic growth strategy. The assessments are supported by historical evidence over the past five years of not showing any prolonged weakening in the company's credit ratios, or relative to our base-case credit metrics' assumptions. Management, even if new, has a track record of successful execution.
Neutral	Leverage is not expected to deviate materially from our base-case forecast. Event risk is moderate.	Management's financial discipline with regard to acquisitions, shareholder remuneration, as well as its organic growth strategy does not result in significantly different leverage as defined in its stated financial policy framework.

Negative	Leverage could become materially higher than our base-case forecast. Event risk is high.	Management's financial policy framework does not explicitly rule out a significant increase in leverage compared to our base-case assumptions, possibly reflecting a greater event risk with regard to its M&A and shareholder remuneration policy as well as to its organic growth strategy. These points are supported by historical evidence over the past five years of allowing for significant and prolonged peaks in leverage, which remained unmitigated by credit supporting measures by management.

b) Financial policy framework

181. The company's financial policy framework assesses the comprehensiveness, transparency, and sustainability of the entity's financial policies (see Appendix E, paragraphs 264-268). This will help determine whether there is a satisfactory degree of visibility into the issuer's future financial risk profile. Companies that have developed and sustained a comprehensive set of financial policies are more likely to build long-term, sustainable credit quality than those that do not.

182. We will assess a company's financial policy framework as supportive or non-supportive based on evidence that supports the characteristics listed below. In order for an entity to receive a supportive assessment for financial policy framework, there must be sufficient evidence of management's financial policies to back that assessment.

183. A company assessed as supportive will generally exhibit the following characteristics:

Management has a comprehensive set of financial policies covering key areas of financial risk, including debt leverage and liability management. Financial targets are well defined and quantifiable.
Management's financial policies are clearly articulated in public forums (such as public listing disclosures and investor presentations) or are disclosed to a limited number of key stakeholders such as main creditors or to the credit rating agencies. The company's adherence to these policies is satisfactory.
Management's articulated financial policies are considered achievable and sustainable. This assessment takes into consideration historical adherence to articulated policies, existing financial risk profile, capacity to sustain capital structure through nonorganic means, demands of key stakeholders, and the stability of financial policy parameters over time.
184. A company receives a non-supportive assessment if it does not meet all the conditions for a supportive assessment. We expect a non-supportive assessment to be uncommon.

I. Liquidity

185. Our assessment of liquidity focuses on monetary flows--the sources and uses of cash--that are the key indicators of a company's liquidity cushion. The analysis assesses the potential for a company to breach covenant tests related to declines in EBITDA, as well as its ability to absorb high-impact, low-probability events, the nature of the company's bank relationships, its standing in credit markets, and how prudent (or not) we believe its financial risk management to be (see "Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers (/en_US/web/guest/article/-/view/sourceId/8956570)").

J. Management And Governance

186. The analysis of management and governance addresses how management's strategic competence, organizational effectiveness, risk management, and governance practices shape the issuer's competitiveness in the marketplace, the strength of its financial risk management, and the robustness of its governance. Stronger management of important strategic and financial risks may enhance creditworthiness (see "Methodology: Management And Governance Credit Factors For Corporate Entities (/en_US/web/guest/article/-/view/sourceId/7629699)").

K. Comparable Ratings Analysis

187. The comparable ratings analysis is our last step in determining a SACP on a company. This analysis can lead us to raise or lower our anchor, after adjusting for the modifiers, on a company by one notch based on our overall assessment of its credit characteristics for all subfactors considered in arriving at the SACP. This involves taking a holistic review of a company's stand-alone credit risk profile, in which we evaluate an issuer's credit characteristics in aggregate. A positive assessment leads to a one-notch upgrade, a negative assessment leads to a one-notch downgrade, and a neutral assessment indicates no change to the anchor.

188. The application of comparable ratings analysis reflects the need to "fine-tune" ratings outcomes, even after the use of each of the other modifiers. A positive or negative assessment is therefore likely to be common rather than exceptional.

189. We consider our assessments of each of the underlying subfactors to be points within a possible range. Consequently, each of these assessments that ultimately generate the SACP can be at the upper or lower end, or at the mid-point, of such a range:

A company receives a positive assessment if we believe, in aggregate, its relative ranking across the subfactors typically to be at the higher end of the range;
A company receives a negative assessment if we believe, in aggregate, its relative ranking across the subfactors typically to be at the lower end of the range;
A company receives a neutral assessment if we believe, in aggregate, its relative ranking across the subfactors typically to be in line with the middle of the range.
190. The most direct application of the comparable ratings analysis is in the following circumstances:

Business risk assessment. If we expect a company to sustain a position at the higher or lower end of the ranges for the business risk category assessment, the company could receive a positive or negative assessment, respectively.
Financial risk assessment and financial metrics. If a company's actual and forecasted metrics are just above (or just below) the financial risk profile range, as indicated in its cash flow/leverage assessment, we could assign a positive or negative assessment.
191. We also consider additional factors not already covered, or existing factors not fully captured, in arriving at the SACP. Such factors will generally reflect less frequently observed credit characteristics, may be unique, or may reflect unpredictability or uncertain risk attributes, both positive and negative.

192. Some examples that we typically expect could lead to a positive or negative assessment using comparable ratings analysis include:

Short operating track record. For newly formed companies or companies that have experienced transformational events, such as a significant acquisition, a lack of an established track record of operating and financial performance could lead to a negative assessment until such a track record is established.
Entities in transition. A company in the midst of changes that we anticipate will strengthen or weaken its creditworthiness and that are not already fully captured elsewhere in the criteria could receive a positive or negative assessment. Such a transition could occur following major divestitures or acquisitions, or during a significant overhaul of its strategy, business, or financial structure.
Industry or macroeconomic trends. When industry or macroeconomic trends indicate a strengthening or weakening of the company's financial condition that is not already fully captured elsewhere in the criteria, the company could receive a positive or negative assessment, respectively.
Unusual funding structures. A company with exceptional financial resources that the criteria do not capture in the traditional ratio or liquidity analysis, or in capital structure analysis, could receive a positive assessment.
Contingent risk exposures. How well (or not) a company identifies, manages, and reserves for contingent risk exposures that can arise if guarantees are called, derivative contract break clauses are activated, or substantial lawsuits are lost could lead to a negative assessment.

APPENDIXES

A. Country Risk

Table 26

Countries And Regions
Region
Western Europe
Southern Europe
Western + Southern Europe
East Europe
Central Europe
Eastern Europe and Central Asia
Middle East
Africa
North America
Central America
Latin America
The Caribbean
Asia-Pacific
Central Asia
East Asia
Australia NZ

Country	Region
South Africa	Africa
Egypt	Africa
Nigeria	Africa
Algeria	Africa
Morocco	Africa
Angola	Africa
Tunisia	Africa
Ethiopia	Africa
Ghana	Africa
Kenya	Africa
Tanzania	Africa
Uganda	Africa
Botswana	Africa
Congo, Democratic Republic of	Africa
Gabon	Africa
Senegal	Africa
Mozambique	Africa
Burkina Faso	Africa
Zambia	Africa
Congo, Republic of	Africa
Zimbabwe	Africa
Eritrea	Africa
Indonesia	Asia-Pacific
Taiwan	Asia-Pacific
Thailand	Asia-Pacific
Malaysia	Asia-Pacific
Philippines	Asia-Pacific
Vietnam	Asia-Pacific
Bangladesh	Asia-Pacific
Sri Lanka	Asia-Pacific
Cambodia	Asia-Pacific
Laos	Asia-Pacific
Papua New Guinea	Asia-Pacific
Mongolia	Asia-Pacific
Australia	Australia NZ
New Zealand	Australia NZ
Guatemala	Central America
Costa Rica	Central America
Panama	Central America
Honduras	Central America
India	Central Asia
Pakistan	Central Asia
Kazakhstan	Central Asia
Bhutan	Central Asia
Poland	Central Europe
Czech Republic	Central Europe
Romania	Central Europe
Hungary	Central Europe
Slovakia	Central Europe
Bulgaria	Central Europe
Croatia	Central Europe
Serbia	Central Europe
Lithuania	Central Europe
Latvia	Central Europe
Bosnia and Herzegovina	Central Europe
Estonia	Central Europe

Albania	Central Europe
Macedonia	Central Europe
China	East Asia
Japan	East Asia
South Korea	East Asia
Hong Kong	East Asia
Singapore	East Asia
Macau	East Asia
Greece	Eastern Europe
Slovenia	Eastern Europe
Cyprus	Eastern Europe
Russia	Eastern Europe and Central Asia
Ukraine	Eastern Europe and Central Asia
Belarus	Eastern Europe and Central Asia
Azerbaijan	Eastern Europe and Central Asia
Georgia	Eastern Europe and Central Asia
Brazil	Latin America
Mexico	Latin America
Argentina	Latin America
Colombia	Latin America
Venezuela	Latin America
Peru	Latin America
Chile	Latin America
Ecuador	Latin America
Bolivia	Latin America
Uruguay	Latin America
El Salvador	Latin America
Paraguay	Latin America
Trinidad and Tobago	Latin America
Suriname	Latin America
Belize	Latin America
Turkey	Middle East
Saudi Arabia	Middle East
United Arab Emirates	Middle East
Israel	Middle East
Qatar	Middle East
Kuwait	Middle East
Iraq	Middle East
Oman	Middle East
Lebanon	Middle East
Jordan	Middle East
Bahrain	Middle East
United States	North America
Canada	North America
Italy	Southern Europe
Spain	Southern Europe
Portugal	Southern Europe
Dominican Republic	The Caribbean
Jamaica	The Caribbean
Bahamas	The Caribbean
Barbados	The Caribbean
Curacao	The Caribbean
Cayman Islands	The Caribbean
Grenada	The Caribbean
Turks and Caicos	The Caribbean
Germany	Western Europe
United Kingdom	Western Europe

France	Western Europe
Netherlands	Western Europe
Belgium	Western Europe
Sweden	Western Europe
Switzerland	Western Europe
Austria	Western Europe
Norway	Western Europe
Denmark	Western Europe
Finland	Western Europe
Ireland	Western Europe
Luxembourg	Western Europe
Iceland	Western Europe
Malta	Western Europe

B. Competitive Position

Table 27

List Of Industries, Subsectors, And Standard Competitive Position Group Profiles

Industry	Subsector	Competitive position group profile
Transportation cyclical	Airlines	Capital or asset focus
	Marine	Capital or asset focus
	Trucking	Capital or asset focus
Auto OEM	Automobile and truck manufacturers	Capital or asset focus
Metals and mining downstream	Aluminum	Commodity focus/cost driven
	Steel	Commodity focus/cost driven
Metals and mining upstream	Coal and consumable fuels	Commodity focus/cost driven
	Diversified metals and mining	Commodity focus/cost driven
	Gold	Commodity focus/cost driven
	Precious metals and minerals	Commodity focus/cost driven
Homebuilders and developers	Homebuilding	Capital or asset focus
Oil and gas refining and marketing	Oil and gas refining and marketing	Commodity focus/scale driven
Forest and paper products	Forest products	Commodity focus/cost driven
	Paper products	Commodity focus/cost driven
Building Materials	Construction materials	Capital or asset focus
Oil and gas integrated, exploration and production	Integrated oil and gas	Commodity focus/scale driven
	Oil and gas exploration and production	Commodity focus/scale driven
Agribusiness and commodity foods	Agricultural products	Commodity focus/scale driven
Real estate investment trusts (REITs)	Diversified REITs	Real-estate specific*
	Health care REITS	Real-estate specific*
	Industrial REITs	Real-estate specific*
	Office REITs	Real-estate specific*
	Residential REITs	Real-estate specific*
	Retail REITs	Real-estate specific*
	Specialized REITs	Not applicable**
	Self-storage REITs	Real-estate specific*
	Net lease REITs	Real-estate specific*
	Real estate operating companies	Real-estate specific*
Leisure and sports	Casinos and gaming	Services and product focus
	Hotels, resorts, and cruise lines	Services and product focus
	Leisure facilities	Services and product focus
Commodity chemicals	Commodity chemicals	Commodity focus/cost driven
	Diversified chemicals	Commodity focus/cost driven
	Fertilizers and agricultural chemicals	Commodity focus/cost driven
Auto suppliers	Auto parts and equipment	Capital or asset focus
	Tires and rubber	Capital or asset focus

	Vehicle-related suppliers	Capital or asset focus
Aerospace and defense	Aerospace and defense	Services and product focus
Technology hardware and semiconductors	Communications equipment	Capital or asset focus
	Computer hardware	Capital or asset focus
	Computer storage and peripherals	Capital or asset focus
	Consumer electronics	Capital or asset focus
	Electronic equipment and instruments	Capital or asset focus
	Electronic components	Capital or asset focus
	Electronic manufacturing services	Capital or asset focus
	Technology distributors	Capital or asset focus
	Office electronics	Capital or asset focus
	Semiconductor equipment	Capital or asset focus
	Semiconductors	Capital or asset focus
Specialty Chemicals	Industrial gases	Capital or asset focus
	Specialty chemicals	Capital or asset focus
Capital Goods	Electrical components and equipment	Capital or asset focus
	Heavy equipment and machinery	Capital or asset focus
	Industrial componentry and consumables	Capital or asset focus
	Construction equipment rental	Capital or asset focus
	Industrial distributors	Services and product focus
Engineering and construction	Construction and engineering	Services and product focus
Railroads and package express	Railroads	Capital or asset focus
	Package express	Services and product focus
	Logistics	Services and product focus
Business and consumer services	Consumer services	Services and product focus
	Distributors	Services and product focus
	Facilities services	Services and product focus
	General support services	Services and product focus
	Professional services	Services and product focus
Midstream energy	Oil and gas storage and transportation	Commodity focus/scale driven
Technology software and services	Internet software and services	Services and product focus
	IT consulting and other services	Services and product focus
	Data processing and outsourced services	Services and product focus
	Application software	Services and product focus
	Systems software	Services and product focus
	Consumer software	Services and product focus
Consumer durables	Home furnishings	Services and product focus
	Household appliances	Services and product focus
	Housewares and specialties	Services and product focus
	Leisure products	Services and product focus
	Photographic products	Services and product focus
	Small appliances	Services and product focus
Containers and packaging	Metal and glass containers	Capital or asset focus
	Paper packaging	Capital or asset focus
Media and entertainment	Ad agencies and marketing services companies	Services and product focus
	Ad-supported online content platforms	Services and product focus
	Broadcast networks	Services and product focus
	Cable TV and OTT networks	Services and product focus
	Newspapers/magazines	Services and product focus
	Data publishing	Services and product focus
	E-Commerce (services)	Services and product focus
	Educational publishing	Services and product focus
	Film and TV programming production	Capital or asset focus
	Miscellaneous media and entertainment	Services and product focus
	Motion picture exhibitors	Services and product focus
	Music publishing and recording	Services and product focus
	Outdoor advertising	Services and product focus

	Printing	Commodity focus/scale driven
	Radio stations	Services and product focus
	Local TV stations	Services and product focus
Oil and gas drilling, equipment and services	Onshore contract drilling	Commodity focus/scale driven
	Offshore contract drilling	Capital or Asset Focus
	Oil and gas equipment and services (oilfield services)	Commodity focus/scale driven
Retail and restaurants	Catalog retail	Services and product focus
	Internet retail	Services and product focus
	Department stores	Services and product focus
	General merchandise stores	Services and product focus
	Apparel retail	Services and product focus
	Computer and electronics retail	Services and product focus
	Home improvement retail	Services and product focus
	Specialty stores	Services and product focus
	Automotive retail	Services and product focus
	Home furnishing retail	Services and product focus
Health care services	Health care services	Commodity focus/scale driven
Transportation infrastructure	Airport services	National industries and utilities
	Highways	National industries and utilities
	Railtracks	National industries and utilities
	Marine ports and services	National industries and utilities
Environmental services	Environmental and facilities services	Services and product focus
Regulated utilities	Electric utilities	National industries and utilities
	Gas utilities	National industries and utilities
	Multi-utilities	National industries and utilities
	Water utilities	National industries and utilities
Unregulated power and gas	Independent power producers and energy traders	Capital or asset focus
	Merchant power	Capital or asset focus
Pharmaceuticals	Branded pharmaceuticals	Services and product focus
	Generic pharmaceuticals	Commodity focus/scale driven
Health care equipment	High-tech health care equipment	Product focus/scale driven
	Low-tech health care equipment	Commodity focus/scale driven
Branded nondurables	Brewers	Services and product focus
	Distillers and vintners	Services and product focus
	Soft drinks	Services and product focus
	Packaged foods and meats	Services and product focus
	Tobacco	Services and product focus
	Household products	Services and product focus
	Apparel, footwear, accessories, and luxury goods	Services and product focus
	Personal products	Services and product focus
Telecommunications and cable	Cable and satellite	Services and product focus
	Alternative carriers	Services and product focus
	Integrated telecommunication services	Services and product focus
	Wireless towers	Capital or asset focus
	Data center operators	Capital or asset focus
	Fiber-optic carriers	Capital or asset focus
	Wireless telecommunication services	Services and product focus

*See "Key Credit Factors For The Real Estate Industry." **For specialized REITs, there is no standard CPGP, as the CPGP will vary based on the underlying industry exposure (e.g., a forest and paper products REIT).

1. Analyzing subfactors for competitive advantage

193. Competitive advantage is the first component of our competitive position analysis. Companies that possess a sustainable competitive advantage are able to capitalize on key industry factors or mitigate associated risks more effectively. When a company operates in more than one business, we analyze each segment separately to form an overall view of its competitive

advantage. In assessing competitive advantage, we evaluate the following subfactors:

Strategy;
Differentiation/uniqueness, product positioning/bundling;
Brand reputation and marketing;
Product/service quality;
Barriers to entry, switching costs;
Technological advantage and capabilities, technological displacement; and
Asset profile.

a) Strategy

194. A company's business strategy will enhance or undermine its market entrenchment and business stability. Compelling business strategies can create a durable competitive advantage and thus a relatively stronger competitive position. We form an opinion as to the source and sustainability (if any) of the company's competitive advantage relative to its peers'. The company may have a differentiation advantage (i.e., brand, technology, regulatory) or a cost advantage (i.e., lower cost producer/servicer at the same quality level), or a combination.

195. Our assessment of a company's strategy is informed by a company's historical performance and how realistic we view its forward-looking business objectives to be. These may include targets for market shares, the percentage of revenues derived from new products, price versus the competition's, sales or profit growth, and required investment levels. We evaluate these objectives in the context of industry dynamics and the attractiveness of the markets in which the company participates.

b) Differentiation/uniqueness, product positioning/bundling

196. The attributes of product or service differentiation vary by sector, and may include product or services features, performance, durability, reliability, delivery, and comprehensiveness, among other measures. The intensity of competition may be lower where buyers perceive the product or service to be highly differentiated or to have few substitutes. Conversely, products and services that lack differentiation, or offer little value-added in the eyes of customers, are generally commodity-type products that primarily compete on price. Competition intensity will often be highest where limited or moderate investment (R&D, capital expenditures, or advertising) or low employee skill levels (for service businesses) are required to compete. Independent market surveys, media commentaries, market share trends, and evidence of leading or lagging when it comes to raising or lowering prices can indicate varying degrees of product differentiation.

197. Product positioning influences how companies are able to extend or protect market shares by offering popular products or services. A company's abilities to replace aging products with new ones, or to launch product extensions, are important elements of product positioning. In addition, the ability to sell multiple products or services to the same customer, known as bundling or cross-selling, (for instance, offering an aftermarket servicing contract together with the sale of a new appliance) can create a competitive advantage by increasing customers' switching costs and fostering loyalty.

c) Brand reputation and marketing

198. Brand equity measures the price premium a company receives based on its brand relative to the generic equivalent. High brand equity typically translates into customer loyalty, built partially via marketing campaigns. One measure of advertising effectiveness can be revenue growth compared with the increase in advertising expenses.

199. We also analyze re-investment and advertising strategies to anticipate potential strengthening or weakening of a company's brand. A company's track record of boosting market share and delivering attractive margins could indicate its ability to build and maintain brand reputation.

d) Product/service level quality

200. The strength and consistency of a value proposition is an important factor contributing to a sustainable competitive advantage. Value proposition encompasses the key features of a product or a service that convince customers that their purchase has the right balance between price and quality. Customers generally perceive a product or a service to be good if their expectations are consistently met. Quality, both actual and perceived, can help a company attract and retain customers. Conversely, poor product and service quality may lead to product recalls, higher-than-normal product warnings, or service interruptions, which may reduce demand. Measures of customer satisfaction and retention, such as attrition rates and contract renewal rates, can help trace trends in product/service quality.

201. Maintaining the value proposition requires consistency and adaptability around product design, marketing, and quality-related operating controls. This is pertinent where product differentiation matters, as is the case in most noncommodity industries, and especially so where environmental or human health (concerns for the chemical, food, and pharmaceutical industries) adds a liability dimension to the quality and value proposition. Similarly, regulated utilities (which often do not set their own prices) typically focus on delivering uninterrupted service, often to meet the standards set by their regulator.

e) Barriers to entry, switching costs

202. Barriers to entry can reduce or eliminate the threat of new market entrants. Where they are effective, these barriers can lead to more predictable revenues and profits, by limiting pricing pressures and customer losses, lowering marketing costs, and improving operating efficiency. While barriers to entry may enable premium pricing, a dominant player may rationally choose pricing restraint to further discourage new entrants.

203. Barriers to entry can be one or more of: a natural or regulatory monopoly; supportive regulation; high transportation costs; an embedded customer base that would incur high switching costs; a proprietary product or service; capital or technological intensiveness.

204. A natural monopoly may result from unusually high requirements for capital and operating expenditures that make it uneconomic for a market to support more than a single, dominant provider. The ultimate barrier to entry is found among regulated utilities, which provide an essential service in their 'de juris' monopolies and receive a guaranteed rate of return on their investments. A supportive regulatory regime can include rules and regulations with high hurdles that discourage competitors, or mandate so many obligations for a new entrant as to make market entry financially unviable.

205. In certain industrial sectors, proprietary access to a limited supply of key raw materials or skilled labor, or zoning laws that effectively preclude a new entrant, can provide a strong barrier to entry. Factors such as relationships, long-term contracts or maintenance agreements, or exclusive distribution agreements can result in a high degree of customer stickiness. A proprietary product or service that's protected by a copyright or patent can pose a significant hurdle to new competitors.

f) Technological advantage and capabilities, technological displacement

206. A company may benefit from a proprietary technology that enables it to offer either a superior product or a commodity-type product at a materially lower cost. Proven research and development (R&D) capabilities can deliver a differentiated, superior product or service, as in the pharmaceutical or high tech sectors. However, optimal R&D strategies or the importance or effectiveness of patent protection differ by industry, stage of product development, and product lifecycle.

207. Technological displacement can be a threat in many industries; new technologies or extensions of current ones can effectively displace a significant portion of a company's products or services.

g) Asset profile

208. A company's asset profile is a reflection of its reinvestment, which creates tangible or intangible assets, or both. Companies in similar sectors and industries usually have similar reinvestment options and, thus, their asset profiles tend to be comparable. The reinvestment in "heavy" industries, such as oil and gas, metals and mining, and automotive, tends to produce more tangible assets, whereas the reinvestment in certain "light" industries, such as services, media and entertainment, and retail, tends to produce more intangible assets.

209. We evaluate how a company's asset profile supports or undermines its competitive advantage by reviewing its manufacturing or service creation capabilities and investment requirements, its distribution capabilities, and its track record and commitment to reinvesting in its asset base. This may include a review of the company's ability to attract and retain a talented workforce; its degree of vertical integration and how that may help or hinder its ability to secure supply sources, control the value-added part of its production chain, or adjust to technological developments; or its ability develop a broad and strong distribution network.

2. Analyzing subfactors for scale, scope, and diversity

210. In assessing the relative strength of this component, we evaluate four subfactors:

Diversity of product or service range;
Geographic diversity;
Volumes, size of markets and revenues, and market shares; and
Maturity of products or services.

211. In a given industry, entities with a broader mix of business activities are typically lower risk, and entities with a narrower mix are higher risk. High concentration of business volumes by product, customer, or geography, or a concentration in the production footprint or supplier base, can lead to less stable and predictable revenues and profits. Comparatively broader diversity helps a company withstand economic, competitive, or technological threats better than its peers.

212. There is no minimum size criterion, although size often provides a measure of diversification. Size and scope of operations is important relative to those of industry peers, though not in absolute terms. While relatively smaller companies can enjoy a high degree of diversification, they will likely be, almost by definition, more concentrated in terms of product, number of customers, or geography than their larger peers in the same industry.

213. Successful and continuing diversification supports a stronger competitive position. Conversely, poor diversification weakens overall competitive position. For example, a company will weaken its overall business position if it enters new product lines and countries where it has limited expertise and lacks critical mass to be a real competitor to the incumbent market leaders. The weakness is greater when the new products or markets are riskier than the traditional core business.

214. Where applicable, we also include under scale, scope, and diversity an assessment of the potential benefits derived from unconsolidated (or partially consolidated) investments in strategic assets. The relative significance of such an investment and whether it is in an industry that exhibits high or, conversely, low correlation with the issuer's businesses would be considered in determining its potential benefits to scale, scope, and diversity. This excludes nonstrategic, financial investments, the analysis of which does not fall under the competitive position criteria but, instead, under the capital structure criteria.

a) Diversity of product or service range

215. The concentration of business volumes or revenues in a particular or comparatively small set of products or services can lead to less stable revenues and profits. Even if this concentration is in an attractive product or service, it may be a weakness. Likewise, the concentration of business volumes with a particular customer or a small group of customers, or the reliance on one or a few suppliers, can expose the company to a potentially greater risk of losing and having to replace related revenues and profits. On the other hand, successful diversification across products, customers, and/or suppliers can lead to more stable and predictable revenues and profits, which supports a stronger assessment of scale, scope, and diversity.

216. The relative contribution of different products or services to a company's revenues or profits helps us gauge its diversity. We also evaluate the correlation of demand between product or services lines. High correlation in demand between seemingly different product or service lines will accentuate volume declines during a weak part of the business cycle.

217. In most sectors, the share of revenue a company receives from its largest five to 10 customers or counterparties reveals how diversified its customer base is. However, other considerations such as the stability and credit quality of that customer base, and the company's ability to retain significant customers, can be mitigating or accentuating factors in our overall evaluation. Likewise, supplier dependency can often be measured based on a supplier's share of a company's operating or capital costs. However, other factors, such as the degree of interdependence between the company and its supplier(s), the substitutability of key supply sources, and the company's presumed ability to secure alternative supply without incurring substantial switching costs, are important considerations. Low switching costs (i.e. limited impact on input price, quality, or delivery times as a result of having to adapt to a new supply chain partner) can mitigate a high level of concentration.

b) Geographic diversity

218. We assess geographic diversity both from the standpoint of the breadth of the company's served or addressable markets, and from the standpoint of how geographically concentrated its facilities are.

219. The concentration of business volumes and revenues within a particular region can lead to greater exposure to economic factors affecting demand for a company's goods or services in that region. Even if the company's volumes and revenues are concentrated in an attractive region, it may still be vulnerable to a significant drop in demand for its goods and services. Conversely, a company that serves multiple regions may benefit from different demand conditions in each, possibly resulting in greater revenue stability and more consistent profitability than a more focused peer's. That said, we consider geographic diversification in the context of the industry and the size of the local or regional economy. For instance, companies operating in local industries (such as food retailers) may benefit from a well-entrenched local position.

220. Generally, though, geographically concentrated production or service operations can expose a company to the risk of disruption, and damage revenues and profitability. Even when country risks don't appear significant, a company's vulnerability to exogenous factors (for example, natural disasters, labor or political unrest) increases with geographic concentration.

c) Volumes, size of markets and revenues, market share

221. Absolute sales or unit volumes and market share do not, by themselves, support a strong assessment of scale, scope, and diversity. Yet superior market share is a positive, since it may indicate a broad range of operations, products, or services.

222. We view volume stability (relative to peers') as a positive especially when: a company has demonstrated it during an economic downturn; if it has been achieved without relying on greater price concessions than competitors have made; and when it is likely to be sustained in the future. However, volume stability combined with shrinking market share could be evidence of a company's diminishing prospects for future profitability. We assess the predictability of business volumes and the likely degree of future volume stability by analyzing the company's performance relative to peers' on several industry factors: cyclicality; ability to adapt to technological and regulatory threats; the profile of the customer base (stickiness); and the potential life cycle of the company's products or services.

223. Depending on the industry sector, we measure a company's relative size and market share based on unit sales; the absolute amount of revenues; and the percentage of revenues captured from total industry revenues. We also adjust for industry and company specific qualitative considerations. For example, if an industry is particularly fragmented and has a number of similarly sized participants, none may have a particular advantage or disadvantage with respect to market share.

d) Maturity of products or services

224. The degree of maturity and the relative position on the lifecycle curve of the company's product or service portfolio affect the stability and sustainability of its revenues and margins. It is important to identify the stage of development of a company's products or services in order to measure the life cycle risks that may be associated with key products or services.

225. Mature products or services (e.g. consumer products or broadcast programming) are not necessarily a negative, in our view, if they still contribute reliable profits. If demand is declining for a company's product or service, we examine its track record on introducing new products with staying power. Similarly, a company's track record with product launches is particularly relevant.

3. Analyzing subfactors for operating efficiency

226. In assessing the relative strength of this component, we consider four subfactors:

Cost structure,
Manufacturing processes,
Working capital management, and
Technology.

227. To the extent a company has high operating efficiency, it should be able to generate better profit margins than peers that compete in the same markets, whatever the prevailing market conditions. The ability to minimize manufacturing and other operational costs and thus maximize margins and cash flow--for example, through manufacturing excellence, cost control, and diligent working capital management--will provide the funds for research and development, marketing, and customer service.

a) Cost structure

228. Companies that are well positioned from a cost standpoint will typically enjoy higher capacity utilization and be more profitable over the course of the business cycle. Cost structure and cost control are keys to generating strong profits and cash flow, particularly for companies that produce commodities, operate in mature industries, or face pricing pressures. It is important to consider whether a company or any of its competitors has a sustainable cost advantage, which can be based on access to cheaper energy, favorable manufacturing locations, or lower and more flexible labor costs, for example.

229. Where information is available, we examine a company's fixed versus variable cost mix as an indication of operating leverage, a measure of how revenue growth translates into growth in operating income. A company with significant operating leverage may witness dramatic declines in operating profit if unit volumes fall, as during cyclical downturns. Conversely, in an upturn, once revenues pass the breakeven point, a substantial percentage of incremental revenues typically becomes profit.

b) Manufacturing process

230. Capital intensity characterizes many heavy manufacturing sectors that require minimum volumes to produce acceptable profits, cash flow, and return on assets. We view capacity utilization through the business cycle (combined with the cost base) as a good indication of manufacturers' ability to maintain profits in varying economic scenarios. Our capacity utilization assessment is based on a company's production capacity across its manufacturing footprint. In addition, we consider the direction of a company's capacity utilization in light of our unit sales expectations, as opposed to analyzing it plant-by-plant.

231. Labor relations remain an important focus in our analysis of operating efficiency for manufacturers. Often, a company's labor cost structure is driven by its history of contractual negotiations and the countries in which it operates. We examine the rigidity or flexibility of a company's labor costs and the extent to which it relies on labor rather than automation. We analyze labor cost structure by assessing the extent of union representation, wage and benefit costs as a share of cost of goods sold (when available), and by assessing the balance of capital equipment vs. labor input in the manufacturing process. We also incorporate trends in a company's efforts to transfer labor costs from high-cost to low-cost regions.

c) Working capital management

232. Working capital management--of current or short-term assets and liabilities--is a key factor in our evaluation of operating efficiency. In general, companies with solid working capital management skills exhibit shorter cash conversion cycles (defined as days' investment in inventory and receivables less days' investment in accounts payable) than their lower-skilled peers. Short cash-conversion cycles could, for instance, demonstrate that a company has a stronger position in the supply chain (for example, requiring suppliers or dealers to hold more of its inventory). This allows a company to direct more capital than its peers can to other areas of investment.

d) Technology

233. Technology can play an important role in achieving superior operating efficiency through effective yield management (by improving input/output ratios), supply chain automation, and cost optimization.

234. Achieving high yield management is particularly important in industries with limited inventory and high fixed costs, such as transportation, lodging, media, and retail. The most efficient airlines can achieve higher revenue per available seat mile than their peers, while the most efficient lodging companies can achieve a higher revenue per available room than their peers. Both industries rely heavily on technology to effectively allocate inventory (seats and rooms) to maximize sales and profitability.

235. Effective supply chain automation systems enable companies to reduce investments in inventory and better forecast future orders based on current trends. By enabling electronic data interchange between supplier and retailer, such systems help speed orders and reorders for goods by quickly pinpointing which merchandise is selling well and needs restocking. They also identify slow moving inventory that needs to be marked down, making space available for fresh merchandise.

236. Effective use of technology can also help hold down costs by improving productivity via automation and workflow management. This can reduce selling, general, and administrative costs, which usually represent a substantial portion of expenditures for industries with high fixed costs, thus boosting earnings.

[Tables 28-30 have been deleted.]

C. Cash Flow/Leverage Analysis

1. The merits and drawbacks of each cash flow measure

a) EBITDA

237. EBITDA is a widely used, and therefore a highly comparable, indicator of cash flow, although it has significant limitations. Because EBITDA derives from the income statement entries, it can be distorted by the same accounting issues that limit the use of earnings as a basis of cash flow. In addition, interest can be a substantial cash outflow for speculative-grade companies and therefore EBITDA can materially overstate cash flow in some cases. Nevertheless, it serves as a useful and common starting point for cash flow analysis and is useful in ranking the financial strength of different companies.

b) Funds from operations (FFO)

238. FFO is a hybrid cash flow measure that estimates a company's inherent ability to generate recurring cash flow from its operations independent of working capital fluctuations. FFO estimates the cash flow available to the company before working capital, capital spending, and discretionary items such as dividends, acquisitions, etc.

239. Because cash flow from operations tends to be more volatile than FFO, FFO is often used to smooth period-over-period variation in working capital. We consider it a better proxy of recurring cash flow generation because management can more easily manipulate working capital depending on its liquidity or accounting needs. However, we do not generally rely on FFO as a guiding cash flow measure in situations where assessing working capital changes is important to judge a company's cash flow generating ability and general creditworthiness. For example, for working-capital-intensive industries such as retailing, operating cash flow may be a better indicator than FFO of the firm's actual cash generation.

240. FFO is a good measure of cash flow for well-established companies whose long-term viability is relatively certain (i.e., for highly rated companies). For such companies, there can be greater analytical reliance on FFO and its relation to the total debt burden. FFO remains very helpful in the relative ranking of companies. In addition, more established, healthier companies usually have a wider array of financing possibilities to cover potential short-term liquidity needs and to refinance upcoming maturities. For marginal credit situations, the focus shifts more to free operating cash flow--after deducting the various fixed uses such as working capital investment and capital expenditures--as this measure is more directly related to current debt service capability.

c) Cash flow from operations (CFO)

241. The measurement and analysis of CFO forms an important part of our ratings assessment, in particular for companies that operate in working-capital-intensive industries or industries in which working capital flows can be volatile. CFO is distinct from FFO as it is a pure measure of cash flow calculated after accounting for the impact on earnings of changes in operating assets and liabilities. CFO is cash flow that is available to finance items such as capital expenditures, repay borrowing, and pay for dividends and share buybacks.

242. In many industries, companies shift their focus to cash flow generation in a downturn. As a result, even though they typically generate less cash from ordinary business activities because of low capacity utilization and relatively low fixed-cost absorption, they may generate cash by reducing inventories and receivables. Therefore, although FFO is likely to be lower in a downturn, the impact on CFO may not be as great. In times of strong growth the opposite will be true, and consistently lower CFO compared to FFO without a corresponding increase in revenue and profitability can indicate an untenable situation.

243. Working capital is a key element of a company's cash flow generation. While there tends to be a need to build up working capital and therefore to consume cash in a growth or expansion phase, changes in working capital can also act as a buffer in case of a downturn. Many companies will sell off inventories and invest a lower amount in raw materials because of weaker business activities, both of which reduce the amount of capital and cash that is tied up in working capital. Therefore, working capital fluctuations can occur both in periods of revenue growth and contraction and analyzing a company's near-term working capital needs is crucial for estimating future cash flow developments.

244. Often, businesses that are capital intensive are not working-capital-intensive: most of the capital commitment is upfront in equipment and machinery, while asset-light businesses may have to invest proportionally more in inventories and receivables. That also affects margins, because capital-intensive businesses tend to have proportionally lower operating expenses (and therefore higher EBITDA margins), while working-capital-intensive businesses usually report lower EBITDA margins. The resulting cash flow volatility can be significant: because all investment is made upfront in a capital-intensive business, there is usually more room to absorb subsequent EBITDA volatility because margins are higher. For example, a capital-intensive company may remain reasonably profitable even if its EBITDA margin declines from 30% to 20%. By contrast, a working-capital-intensive business with a lower EBITDA margin (due to higher operating expenses) of 8% can post a negative EBITDA margin if EBITDA volatility is large.

d) Free operating cash flow (FOCF)

245. By deducting capital expenditures from CFO, we arrive at FOCF, which can be used as a proxy for a company's cash generated from core operations. We may exclude discretionary capital expenditures for capacity growth from the FOCF calculation, but in practice it is often difficult to discriminate between spending for expansion and replacement. And, while companies have some flexibility to manage their capital budgets to weather down cycles, such flexibility is generally temporary and unsustainable in light of intrinsic requirements of the business. For example, companies can be compelled to increase their investment programs because of strong demand growth or technological changes. Regulated entities (for example, telecommunications companies) might also face significant investment requirements related to their concession contracts (the understanding between a company and the host government that specifies the rules under which the company can operate locally).

246. Positive FOCF is a sign of strength and helpful in distinguishing between two companies with the same FFO. In addition, FOCF is helpful in differentiating between the cash flows generated by more and less capital-intensive companies and industries.

247. In highly capital-intensive industries (where maintenance capital expenditure requirements tend to be high) or in other situations in which companies have little flexibility to postpone capital expenditures, measures such as FFO to debt and debt to EBITDA may provide less valuable insight into relative creditworthiness because they fail to capture potentially meaningful capital expenditures. In such cases, a ratio such as FOCF to debt provides greater analytical insight.

248. A company serving a low-growth or declining market may exhibit relatively strong FOCF because of diminishing fixed and working capital needs. Growth companies, in contrast, exhibit thin or even negative FOCF because of the investment needed to support growth. For the low-growth company, credit analysis weighs the positive, strong current cash flow against the danger that this high level of cash flow might not be sustainable. For the high-growth company, the opposite is true: weighing the negatives of a current cash deficit against prospects of enhanced cash flow once current investments begin yielding cash benefits. In the latter case, if we view the growth investment as temporary and not likely to lead to increased leverage over the long-term, we'll place greater analytical importance on FFO to debt rather than on FOCF to debt. In any event, we also consider the impact of a company's growth environment in our business risk analysis, specifically in a company's industry risk analysis (see section B).

e) Discretionary cash flow (DCF)

249. For corporate issuers primarily rated in the investment-grade universe, DCF to debt can be an important barometer of future cash flow adequacy as it more fully reflects a company's financial policy, including decisions regarding dividend payouts and share buybacks. In addition, potential M&A can represent a very significant use of cash and is an important component in cash flow analysis.

250. The level of dividends depends on a company's financial strategy. Companies with aggressive dividend payout targets might be reluctant to reduce dividends even under some liquidity pressure. In addition, investment-grade companies are less likely to reduce dividend payments following some reversals--although dividends ultimately are discretionary. DCF is the truest reflection of excess cash flow, but it is also the most affected by management decisions and, therefore, does not necessarily reflect the potential cash flow available.

D. Diversification/Portfolio Effect

1. Academic research

251. Academic research recently concluded that, during the global financial crisis of 2007-2009, conglomerates had the advantage over single sector-focused firms because they had better access to the credit markets as a result of their debt co-insurance and used the internal capital markets more efficiently (i.e., their core businesses had stronger cash flows). Debt co-insurance is the view that the joining-together of two or more firms whose earnings streams are less-than-perfectly correlated reduces the risk of default of the merged firms (i.e., the co-insurance effect) and thereby increases the "debt capacity" or "borrowing ability" of the combined enterprise. These financing alternatives became more valuable during the crisis. (Source: "Does Diversification Create Value In The Presence Of External Financing Constraints? Evidence From The 2007-2009 Financial Crisis," Venkat Kuppuswamy and Belen Villalonga, Harvard Business School, Aug. 19, 2011.)

252. In addition, fully diversified, focused companies saw more narrow credit default swap spreads from 2004-2010 vs. less diversified firms. This highlighted that lenders were differentiating for risk and providing these companies with easier and cheaper access to capital. (Source: "The Power of Diversified Companies During Crises," The Boston Consulting Group and Leipzig Graduate School of Management, January 2012.)

253. Many rated conglomerates are either country- or region-specific; only a small percentage are truly global. The difference is important when assessing the country and macroeconomic risk factors. Historical measures for each region, based on volatility and correlation, reflect regional trends that are likely to change over time.

E. Financial Policy

1. Controlling shareholders

254. Controlling shareholder(s)--if they exist--exert significant influence over a company's financial risk profile, given their ability to use their direct or indirect control of the company's financial policies for their own benefit. Although the criteria do not associate the presence of controlling shareholder(s) to any predefined negative or positive impact, we assess the potential medium- to long-term implications for a company's credit standing of these strategies. Long-term ownership--such as exists in many family-run businesses--is often accompanied by financial discipline and reluctance to incur aggressive leverage. Conversely, short-term ownership--such as exists in private equity sponsor-owned companies--generally entails financial policies aimed at achieving rapid returns for shareholders typically through aggressive debt leverage.

255. The criteria define controlling shareholder(s) as:

A private shareholder (an individual or a family) with majority ownership or control of the board of directors;
A group of shareholders holding joint control over the company's board of directors through a shareholder agreement. The shareholder agreement may be comprehensive in scope or limited only to certain financial aspects; and

A private equity firm or a group of private equity firms holding at least 40% in a company or with majority control of its board of directors.

256. A company is not considered to have a controlling shareholder if it is publicly listed with more than 50% of voting interest listed or when there is no evidence of a particular shareholder or group of shareholders exerting 'de facto' control over a company.

257. Companies that have as their controlling shareholder governments or government-related entities, infrastructure and asset-management funds, and diversified holding companies and conglomerates are assessed in separate criteria.

2. Financial discipline

a) Leverage influence from acquisitions

258. Companies may employ more or less acquisitive growth strategies based on industry dynamics, regulatory changes, market opportunities, and other factors. We consider management teams with disciplined, transparent acquisition strategies that are consistent with their financial policy framework as providing a high degree of visibility into the projected evolution of cash flow and credit measures. Our assessment takes into account management's track record in terms of acquisition strategy and the related impact on the company's financial risk profile. Historical evidence of limited management tolerance for significant debt-funded acquisitions provides meaningful support for the view that projected credit ratios would not significantly weaken as a result of the company's acquisition policy. Conversely, management teams that pursue opportunistic acquisition strategies, without well-defined parameters, increase the risks that the company's financial risk profile may deteriorate well beyond our forecasts.

259. Acquisition funding policies and management's track record in this respect also provide meaningful insight in terms of credit ratio stability. In the criteria, we take into account management's willingness and capacity to mobilize all funding resources to restore credit quality, such as issuing equity or disposing of assets, to mitigate the impact of sizable acquisitions on credit ratios. The financial policy framework and related historical evidence are key considerations in our assessment.

b) Leverage influence from shareholder remuneration policies

260. A company's approach to rewarding shareholders demonstrates how it balances the interests of its various stakeholders over time. Companies that are consistent and transparent in their shareholder remuneration policies, and exhibit a willingness to adjust shareholder returns to mitigate adverse operating conditions, provide greater support to their long-term credit quality than other companies. Conversely, companies that prioritize cash returns to shareholders in periods of deteriorating economic, operating, or share price performance can significantly undermine long-term credit quality and exacerbate the credit impact of adverse business conditions. In assessing a company's shareholder remuneration policies, the criteria focus on the predictability of shareholder remuneration plans, including how a company builds shareholder expectations, its track record in executing shareholder return policies over time, and how shareholder returns compare with industry peers'.

261. Shareholder remuneration policies that lack transparency or deviate meaningfully from those of industry peers introduce a higher degree of event risk and volatility and will be assessed as less predictable under the criteria. Dividend and capital return policies that function primarily as a means to distribute surplus capital to shareholders based on transparent and stable payout ratios--after satisfying all capital requirements and leverage objectives of the company, and that support stable to improving leverage ratios--are considered the most supportive of long term credit quality.

c) Leverage influence from plans regarding investment decisions or organic growth strategies

262. The process by which a company identifies, funds, and executes organic growth, such as expansion into new products and/or new markets, can have a significant impact on its long-term credit quality. Companies that have a disciplined, coherent, and manageable organic growth strategy, and have a track record of successful execution are better positioned to continue to attract third-party capital and maintain long-term credit quality. By contrast, companies that allocate significant amounts of capital to numerous, unrelated, large and/or complex projects and often incur material overspending against the original budget can significantly increase their credit risk.

263. The criteria assess whether management's organic growth strategies are transparent, comprehensive, and measurable. We seek to evaluate the company's mid- to long-term growth objectives--including strategic rationales and associated execution risks--as well as the criteria it uses to allocate capital. Effective capital allocation is likely to include guidelines for capital deployment, including minimum return hurdles, competitor activity analysis, and demand forecasting. The company's track record will provide key data for this assessment, including how well it executes large and/or complex projects against initial budgets, cost overruns, and timelines.

3. Financial policy framework

a) Comprehensiveness of financial policy framework

264. Financial policies that are clearly defined, unambiguous, and provide a tight framework around management behavior are the most reliable in determining an issuer's future financial risk profile. We assess as consistent with a supportive assessment, policies that are clear, measurable, and well understood by all key stakeholders. Accordingly, the financial policy framework must include well-defined parameters regarding how the issuer will manage its cash flow protection strategies and debt leverage profile. This includes at least one key or a combination of financial ratio constraints (such as maximum debt to EBITDA threshold) and the latter must be relevant with respect to the issuer's industry and/or capital structure characteristics.

265. By contrast, the absence of established financial policies, policies that are vague or not quantifiable, or historical evidence of significant and unexpected variation in management's long-term financial targets could contribute to an overall assessment of a non-supportive financial policy framework.

b) Transparency of financial policies

266. We assess as supportive financial policy objectives that are transparent and well understood by all key stakeholders and we view them as likely to influence an issuer's financial risk profile over time. Alternatively, financial policies, if they exist, that are not communicated to key stakeholders and/or where there is limited historical evidence to support the company's commitment to these policies, are non-supportive, in our view. We consider the variety of ways in which a company communicates its financial policy objectives, including public disclosures, investor presentation materials, and public commentary.

267. In some cases, however, a company may articulate its financial policy objectives to a limited number of key stakeholders, such as its main creditors or to credit rating agencies. In these situations, a company may still receive a supportive classification if we assess that there is a sufficient track record (more than three years) to demonstrate a commitment to its financial policy objectives.

c) Achievability and sustainability of financial policies

268. To assess the achievability and sustainability of a company's financial policies, we consider a variety of factors, including the entity's current and historical financial risk profile; the demands of its key stakeholders (including dividend and capital return expectations of equity holders); and the stability of the company's financial policies that we have observed over time. If there is evidence that the company is willing to alter its financial policy framework because of adverse business conditions or growth opportunities (including M&A), this could support an overall assessment of non-supportive.

4. Financial policy adjustments--examples

269. Example 1: A moderately leveraged company has just been sold to a new financial sponsor. The financial sponsor has not leveraged the company yet and there is no stated financial policy at the outset. We expect debt leverage to increase upon refinancing, but we are not able to factor it precisely in our forecasts yet.

Likely outcome: FS-6 financial policy assessment, implying that we expect the new owner to implement an aggressive financial policy in the absence of any other evidence.

270. Example 2: A company has two owners--a family owns 75%, a strategic owner holds the remaining 25%. Although the company has provided S&P Global Ratings with some guidance on long-term financial objectives, the overall financial policy framework is not sufficiently structured nor disclosed to a sufficient number of stakeholders to qualify for a supportive assessment. Recent history, however, does not provide any evidence of unexpected, aggressive financial transactions and we believe event risk is moderate.

Likely outcome: Neutral financial policy impact, including an assessment of neutral for financial discipline. Although the company's financial framework does not support long-term visibility, historical evidence and stability of management suggest that event risk is not significant. The unsupportive financial framework assessment, however, prevents the company from qualifying for an overall positive financial policy assessment, should the conditions for positive financial discipline be met.

271. Example 3: A company (not owned by financial sponsors) has stated leverage targets equivalent to a significant financial risk profile assessment. The company continues to make debt-financed acquisitions yet remains within its leverage targets, albeit at the weaker end of these. Our forecasts are essentially built on expectations that excess cash flow will be fully used to fund M&A or, possibly pay share repurchases, but that management will overall remain within its leverage targets.

Likely outcome: Neutral financial policy impact. Although management is fairly aggressive, the company consistently stays within its financial policy targets. We think our forecasts provide a realistic view of the evolution of the company's credit metrics over the next two years. No event risk adjustment is needed.

272. Example 4: A company (not owned by a financial sponsor) has just made a sizable acquisition (consistent with its long-term business strategy) that has brought its credit ratios out of line. Management expressed its commitment to rapidly improve credit ratios back to its long-term ratio targets--representing an acceptable range for the SACP--through asset disposals or a rights issue. We see their disposal plan (or rights issue) as realistic but precise value and timing are uncertain. At the same time, management has a supportive financial policy framework, a positive track record of five years, and assets are viewed as fairly easily tradable.

Likely outcome: Positive financial policy impact. Although forecast credit ratios will remain temporarily depressed, as we cannot fully factor in asset disposals (or rights issue) due to uncertainty on timing/value, or without leaking confidential information, the company's credit risk should benefit from management's positive track record and a supportive financial policy framework. The anchor will be better by one notch if management and governance is at least satisfactory and liquidity is at least adequate.

273. Example 5: A company (not owned by a financial sponsor) has very solid financial ratios, providing it with meaningful flexibility for M&A when compared with management's long-term stated financial policy. Also, its stock price performance is somewhat below that of its closest industry peers. Although we have no recent evidence of any aggressive financial policy steps, we fundamentally believe that, over the long-term term, the company will end up using its financial flexibility for the right M&A opportunity, or alternatively return cash to shareholders.

Likely outcome: Negative financial policy impact. Long-term event risk derived from M&A cannot be built into forecasts nor shareholder returns (share buybacks or one-off dividends) be built into forecasts to attempt aligning projected ratios with stated long-term financial policy levels. This is because our forecasts are based on realistic and reasonably predictable assumptions for the medium term. The anchor will be adjusted down, by one notch or more, because of the negative financial policy assessment.

F. Corporate Criteria Glossary

Anchor: The combination of an issuer's business risk profile assessment and its financial risk profile assessment determine the anchor. Additional rating factors can then modify the anchor to determine the final rating or SACP.

Asset profile: A descriptive way to look at the types and quality of assets that comprise a company (examples can include tangible versus intangible assets, those assets that require large and continuing maintenance, upkeep, or reinvestment, etc.).

Business risk profile: This measure comprises the risk and return potential for a company in the market in which it participates, the country risks within those markets, the competitive climate, and the competitive advantages and disadvantages the company has. The criteria combine the assessments for Corporate Industry and Country Risk Assessment (CICRA), and competitive position to determine a company's business risk profile assessment.

Capital-intensive company: A company exhibiting large ongoing capital spending to sales, or a large amount of depreciation to sales. Examples of capital-intensive sectors include oil production and refining, telecommunications, and transportation sectors such as railways and airlines.

Cash available for debt repayment: Forecast cash available for debt repayment is defined as the net change in cash for the period before debt borrowings and debt repayments. This includes forecast discretionary cash flow adjusted for our expectations of any share issuance and M&A. Discretionary cash flow is defined in our Ratios And Adjustments criteria and guidance.

Competitive position: Our assessment of a company's: 1) competitive advantage; 2) operating efficiency; 3) scale, scope, and diversity; and 4) profitability.

Competitive advantage--The strategic positioning and attractiveness to customers of the company's products or services, and the fragility or sustainability of its business model.
Operating efficiency--The quality and flexibility of the company's asset base and its cost management and structure.
Scale, scope, and diversity--The concentration or diversification of business activities.
Profitability--Our assessment of both the company's level of profitability and volatility of profitability.
Competitive Position Group Profile (CPGP): Used to determine the weights to be assigned to the three components of competitive position other than profitability. While industries are assigned to one of the six profiles, individual companies and industry subsectors can be classified into another CPGP because of unique characteristics. Similarly, national industry risk

factors can affect the weighing. The six CPGPs are:

Services and product focus,
Product focus/scale driven,
Capital or asset focus,
Commodity focus/cost driven,
Commodity focus/scale driven, and
National industry and utilities.
Conglomerate: Companies that have at least three distinct business segments, each contributing between 10%-50% of EBITDA or FOCF. Such companies may benefit from the diversification/portfolio effect.

Controlling shareholders: Equity owners who are able to affect decisions of varying effect on operations, leverage, and shareholder reward without necessarily being a majority of shareholders.

Corporate Industry and Country Risk Assessment (CICRA): The result of the combination of an issuer's country risk assessment and industry risk assessment.

Debt co-insurance: The view that the joining-together of two or more firms whose earnings streams are less-than-perfectly correlated reduces the risk of default of the merged firms (i.e., the co-insurance effect) and thereby increases the "debt capacity" or "borrowing ability" of the combined enterprise. These financing alternatives became more valuable during the global financial crisis of 2007-2009.

Financial headroom: Measure of deviation tolerated in financial metrics without moving outside or above a pre-designated band or limit typically found in loan covenants (as in a debt to EBITDA multiple that places a constraint on leverage). Significant headroom would allow for larger deviations.

Financial risk profile: The outcome of decisions that management makes in the context of its business risk profile and its financial risk tolerances. This includes decisions about the manner in which management seeks funding for the company and how it constructs its balance sheet. It also reflects the relationship of the cash flows the organization can achieve, given its business risk profile, to its financial obligations. The criteria use cash flow/leverage analysis to determine a corporate issuer's financial risk profile assessment.

Financial sponsor: An entity that follows an aggressive financial strategy in using debt and debt-like instruments to maximize shareholder returns. Typically, these sponsors dispose of assets within a short to intermediate time frame. Financial sponsors include private equity firms, but not infrastructure and asset-management funds, which maintain longer investment horizons.

Profitability ratio: Commonly measured using return on capital and EBITDA margins but can be measured using sector-specific ratios. Generally calculated based on a five-year average, consisting of two years of historical data, and our projections for the current year and the next two financial years.

Shareholder remuneration policies: Management's stated shareholder reward plans (such as a buyback or dividend amount, or targeted payout ratios).

Stand-alone credit profile (SACP): S&P Global Ratings' opinion of an issue's or issuer's creditworthiness, in the absence of extraordinary intervention or support from its parent, affiliate, or related government or from a third-party entity such as an insurer.

Transfer and convertibility assessment: S&P Global Ratings' view of the likelihood of a sovereign restricting nonsovereign access to foreign exchange needed to satisfy the nonsovereign's debt service obligations.

Unconsolidated equity affiliates: Companies in which an issuer has an investment, but which are not consolidated in an issuer's financial statements. Therefore, the earnings and cash flows of the investees are not included in our primary metrics unless dividends are received from the investees.

Upstream/midstream/downstream: Referring to exploration and production, transport and storage, and refining and distributing, respectively, of natural resources and commodities (such as metals, oil, gas, etc.).

Volatility of profitability/SER: We base the volatility of profitability on the standard error of the regression (SER) for a company's historical EBITDA. The SER is a statistical measure that is an estimate of the deviation around a 'best fit' trend line. We combine it with the profitability ratio to determine the final profitability assessment. We only calculate SER when companies have at least seven years of historical annual data, to ensure that the results are meaningful.

Working-capital-intensive companies: Generally a company with large levels of working capital in relation to its sales in order to meet seasonal swings in working capital. Examples of working-capital-intensive sectors include retail, auto manufacturing, and capital goods.

G. Sector-Specific Criteria

1) Financial market infrastructure companies

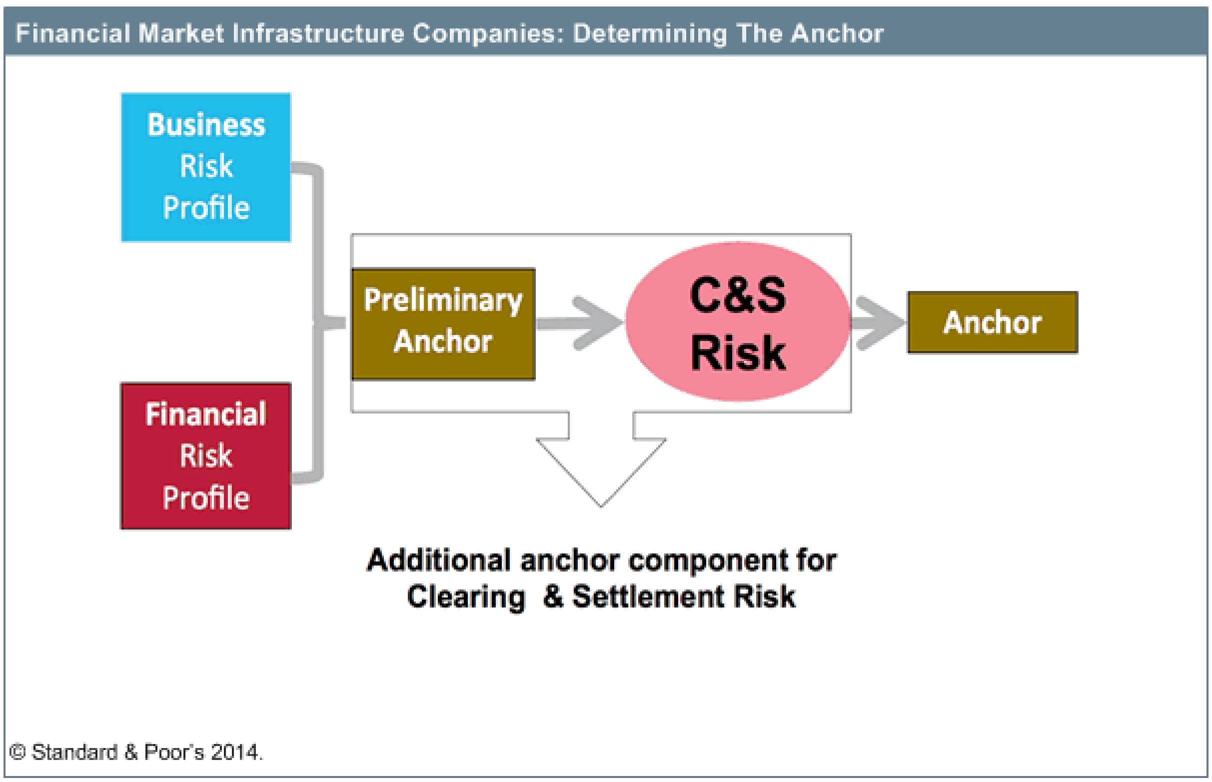
Financial market infrastructure companies (FMIs) are principally exchanges, clearinghouses, central security depositories (CSDs), and payment networks that process and clear credit or debit card transactions and cash payments.

a) Clearing and settlement risk

For FMIs, including exchanges, clearinghouses, CSDs, and payment networks, the analysis combines the FMI's business risk profile assessment and its financial risk profile assessment to determine the preliminary anchor. We then incorporate our view of clearing and settlement (C&S) risk to determine the anchor. The C&S risk assessment, as a component of the anchor, is the key difference between the FMI rating framework and the corporate methodology. This is because a clearinghouse's most important function is to reduce credit risk among its members by acting as guarantor or CCP to trades executed in its market. In our opinion, the risk of a member default is the single largest risk that a clearinghouse faces. Similarly, a CSD acts to reduce settlement risk among its members by completing trades on a delivery-versus-payment (DVP) basis and by following other well-established risk management procedures.

Our C&S risk assessment considers the diversity and creditworthiness of membership and an institution's risk management policies and procedures per international standards. The outcome of our C&S risk assessment could raise (by one notch), lower (by one to eight notches), or leave unchanged the preliminary anchor to determine the anchor.

Chart 2



b) Capital structure

For the most part, we follow the corporate methodology for assessing capital structure, which focuses on two Tier 1 risk subfactors (currency risk associated with debt and the debt maturity profile) and one Tier 2 subfactor (interest rate risk associated with debt).

In a limited number of cases, our assessment of capital structure for an FMI differs from the corporate methodology when the FMI is prudentially regulated by the national banking regulators and conducts some (limited) banking operations, such as deposit-taking and/or granting of credit facilities, linked to its core FMI business (e.g., European-based international CSDs).

For these FMI companies, we calculate the risk-adjusted capital (RAC) ratio. (For details, see "Risk-Adjusted Capital Framework Methodology (/en_US/web/guest/article/-/view/sourceId/10170016).")

For those few FMI companies for which we calculate a RAC ratio and assign potential modifiers, as per table 28, we apply the same five-point scale from very positive (1) to very negative (5), employing similar gradation of RAC ratios as in "Banks: Rating Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceId/6921376)."

There are two important exceptions. If an FMI has an anchor of 'aa-' or higher, it is not eligible to receive any notches of uplift. This is because we expect FMI companies exhibiting strong business and financial risk profiles to have strong capitalization. Likewise, if an FMI has an anchor within the 'a' category, it may receive a maximum uplift of one notch.

Table 28

Capital Structure--RAC Ratio

	Descriptor	RAC ratio %	Notches
1	Very positive	>15	2
2	Positive	10-15	1
3	Neutral	7.0-9.9	0
4	Negative	5.0-6.9	(1)
5	Very negative	<5	(2) or more

In our view, there is no optimal structure of the financial safeguard package or default waterfall. Some clearinghouses may rely more on individual member margin requirements, while others may rely more on the mutualized guarantee fund. For this reason, the overall protection afforded by the financial safeguard package (i.e., the sum of the parts) is more important than the individual components of the financial safeguard package. For example, very strong guarantee fund contributions can offset weakness in the margin calculation.

2) Financial services finance companies

Financial services finance companies (FSFCs) are finance companies for which the greatest risks relate more to their ability to generate cash flow than to the amount of capital they may need to withstand credit losses. These include consumer finance companies, originators and servicers, auto fleet services companies, real estate services, and money transaction processors, among others.

a) Competitive position

In assessing the competitive position group profile (CPGP) for FSFCs, we review the following factors:

Competitive advantage;
Scale, scope, and diversity;
Operating efficiency;
Profitability; and
Regulatory and legislative risks.

We assess a company's exposure to regulatory or legislative risks as either (1) adequate, (2) weak, or (3) vulnerable. If the regulatory and legislative risk assessment is (3) vulnerable, a company's competitive position is capped at (6) vulnerable. If the regulatory and legislative risk is assessment is (2) weak, the competitive position assessment is capped at (5) weak. If the regulatory and legislative risk assessment is (1) adequate, there are no caps on the competitive position assessment.

Regulatory and legislative risks. Regulatory and legislative risks are prominent factors for FSFCs. When assessing regulatory and legislative risks, we consider the credit implications on the FSFC and don't opine on the larger policy issue. From this perspective, regulators may introduce new legislation or change existing policy that could have significant financial consequences related to both the revenue and costs for individual FSFCs or FSFC subsectors. For example, regulators could impose new regulatory reporting standards, which would increase costs, or regulators could impose limits on the maximum rates at which an individual FSFC or FSFC subsector can lend, which would reduce revenue. Our assessment balances how regulation may constrain profitability while at the same time enhancing profit stability.

Depending on the operating environment, new rules could incrementally constrain the profitability of business activities--for example, by limiting the interest rates permissible to be charged to clients or by limiting the range of clients that a finance company could help finance. Regulatory or legislative changes could also result in higher compliance costs.

We do not view regulatory and legislative risks as a potential positive to competitive advantage. We recognize that regulation could help stabilize volatility for FSFCs, but that would be reflected in the financial risk profile if it were to occur. Given their typically negative impact on competitive ability, regulatory and legislative risks cannot be assessed above adequate. An FSFC with an adequate assessment is not exposed to regulatory policies--existing or prospective--that meaningfully constrain profitability. When regulation reduces competition, we do reflect these benefits directly in the specific company's competitive advantage, as opposed to the overall sector.

An FSFC with a weak regulatory and legislative risk assessment is typically characterized by two or more of the following, or one of the following that is particularly significant:

Subject to regulatory scrutiny, sometimes in a loosely regulated industry, and profitability could be constrained if new policies were implemented
Exposed to regulatory and legislative changes, but in some cases, diversification by product or geography partially mitigates these risks
Has a track record of government policy and regulation that constrain profitability or alter the standards for business conduct
An FSFC with a vulnerable regulatory and legislative risk assessment typically has two or more of the following, or one of the following that is particularly significant:

Subject to ongoing regulatory scrutiny, and profitability will likely be constrained if new policies were implemented
Exposed to regulatory and legislative changes, with limited diversification by product or geography
Has a track record of government policy and regulation that significantly constrain profitability or alter the standards for business conduct

b) Capital structure

We consider a company's dependence on revolving, and generally short-term, asset-specific funding as an additional Tier 1 risk subfactor in our analysis of capital structure for FSFCs.

We assess asset-specific funding as either: (1) neutral, (2) negative, or (3) very negative. We then replace table 21 ("Preliminary Capital Structure Assessment") with table 29 here to determine the preliminary capital structure assessment.

When debt, such as warehouse facilities, or other asset-specific funding is used to finance assets and we net the debt with the assets, we assess the asset-specific Tier 1 subfactor as negative.

Typically, asset-specific funding includes secured and unsecured warehouse lending facilities, repurchase agreements, asset-backed security (ABS) securitizations, and residential mortgage-backed security (RMBS) securitizations.

Table 29

Assessing Capital Structure

Preliminary capital structure assessment	Subfactor assessment
Neutral	No Tier 1 subfactor is negative.
Negative	One Tier 1 subfactor is negative, and the Tier 2 subfactor is neutral.
Very negative	Two or more Tier 1 subfactors are negative; or one Tier 1 subfactor is negative and the Tier 2 subfactor is negative; or asset-specific funding is very negative.

We consider asset-specific funding a key driver of creditworthiness when a company is dependent on this form of funding to facilitate origination volume, primarily because the company could be susceptible to disruptions in adverse economic environments. Specifically, how an FSFC funds its business and the confidence sensitivity of its assets directly affect its ability to maintain business volumes and meet obligations in the event that asset-specific funding options become unavailable at different points in the business cycle. However, finance companies with large confidence-sensitive funding exposures are more susceptible to changes in asset credit quality and tangible capital, and we rate these entities under our NBFI criteria.

We assess asset-specific funding by considering stability during times of stress, the diversity of counterparties, the type of collateral being pledged, and the maturity of asset-specific funding sources.

An FSFC with a neutral asset-specific funding assessment generally has a limited amount of, or no reliance on, asset-specific funding sources for ongoing business operations.

An FSFC with a negative asset-specific funding assessment is typically characterized by one or more of the following:

The company is reliant on asset-specific funding sources for ongoing business operations.
A large proportion of maturities are less than one year, or there is a maturity concentration in the same quarter.
The company is reliant on a concentrated group of financial counterparties.
An FSFC with a very negative asset-specific funding assessment is characterized by both of the following:

A company exhibits all of the characteristics of a negative asset-specific funding assessment as per the previous paragraph. One or more facilities are subject to substantial margin call exposure.

FREQUENTLY ASKED QUESTIONS

A. Volatility of cash flows

If a company exhibits volatile cash flow metrics, does S&P Global Ratings capture this in the cash flow volatility adjustment or in the financial policy assessment?

We capture this in either analytic factor, as appropriate. As per paragraph 125, the volatility adjustment is the mechanism by which we factor a "cushion" of medium-term variance to current financial performance not otherwise captured in either the near-term base-case forecast or the long-term business risk assessment. We make this adjustment based on the following:

The expectation of any potential cash flow/leverage ratio movement is both prospective and dependent on the current business or economic conditions.
Stress scenarios include, but are not limited to, a recession, technology or competitive shifts, loss or renegotiation of major contracts or customers, and key product or input price movements, as typically defined in the company's industry risk profile and competitive position assessment.
The volatility adjustment is not static and is company-specific. At the bottom of an economic cycle or during periods of stressed business conditions, already reflected in the general industry risk or specific competitive risk profile, the prospect of weakening ratios is far less than at the peak of an economic cycle or business conditions.
The expectation of prospective ratio changes may be formed by observed historical performance over an economic, business, or product cycle by the company or by peers.
The assessment of which classification to use when evaluating the prospective number of scoring category moves will be guided by how close the current ratios are to the transition point (i.e. "buffer" in the current scoring category) and the corresponding amount of EBITDA movement at each scoring transition.
As per paragraph 157, financial policy refines our view of a company's risks beyond the conclusions arising from the standard assumptions in the cash flow/leverage assessment. Those assumptions do not always reflect or entirely capture the short-to-medium term event risks or the longer-term risks stemming from a company's financial policy. To the extent movements in one of these factors cannot be confidently predicted within our forward-looking evaluation of cash flow/leverage, we capture that risk in our evaluation of financial policy.

What constitutes a period of stress when assessing whether a company has a volatile or highly volatile level of cash flow/leverage?

As guidance, our global default studies demonstrate significant correlation of defaults with weak points in business cycles and banking crises. The 1991 peak default rate occurred after a mild recession in the U.S., a severe but short recession in the U.K., and the Nordic banking crisis. Other developed-market speculative-grade default peaks were the U.S., at 10.6% in 2001 (the U.S. recession) and 11.4% in 2009 (the global banking crisis and recession); and Europe, at 12.3% in 2002 (due in part to the bursting of the technology/Internet bubble and failures of a large number of telecom start-ups). (Sources: "2012 Annual Global Corporate Default Study (/en_US/web/guest/article/-/view/sourceId/7829258)," published March 18, 2013, and "Understanding Standard & Poor's Rating Definitions (/en_US/web/guest/article/-/view/sourceId/5435305).")

Additional guidance can be found in "Methodology: Industry Risk (/en_US/web/guest/article/-/view/sourceId/8304862)," Appendix 1 where we considered sensitivity to economic cycles, as measured by the historical cyclical peak-to-trough decline in profitability and revenues for major recessions ('BBB' and 'BB' stress) mapped to specific industry sectors.

B. Profitability

If a company operates in a region or in a country where local inflation is high, and you believe that this affects the comparability of its profitability measures with industry peers', how do you incorporate this in your assessment?

When analyzing level of profitability, we use, where available, the numeric guidance developed by considering the distribution of profitability measures within an industry or subsector. These thresholds apply globally irrespective of the underlying level of inflation, although we also consider trends in the profitability ratio to determine the level of profitability assessment. However, high inflation environments are often associated with exposure to countries with a high country risk, in which case as per paragraph 87 we may adjust the volatility of profitability assessment to account for this exposure. Finally, to the extent not captured elsewhere in the analysis, we may incorporate this factor as part of the comparable ratings analysis.

REVISIONS AND UPDATES

This article was originally published on Nov. 19, 2013. These criteria became effective on the date of publication.

Changes introduced after original publication:

Following our periodic review completed on Oct. 16, 2015, we deleted paragraphs 9 and 10, which were related to the initial publication of our criteria and no longer relevant. We also made some adjustments to language. These adjustments have no impact on our ratings or the effective date of the criteria.
Following our periodic review completed on Oct. 14, 2016, we updated criteria references, the contact list, and the definitions of financial sponsor-owned companies and financial sponsors to be consistent with those in the article "The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities (/en_US/web/guest/article/-/view/sourceId/8569927)," published April 29, 2014.
On Feb. 8, 2017, we republished the article to correct an error in the regional grouping for the countries of Bhutan, Grenada, and Eritrea introduced after the periodic criteria review closed on Oct. 14, 2016.
Following our periodic review completed on Oct. 11, 2017, we updated criteria references.
On April 23, 2018, we updated the definition of a financial sponsor-owned company in table 23. We also updated the contact information.
On Dec. 7, 2018, we republished this criteria article to make nonmaterial changes. We updated table 26, which supplements paragraph 46, by removing the GDP weightings of each country making up each defined region. The GDP weightings were removed because they were outdated and because a static table does not reflect the fact that GDP data change dynamically. Consistent with the criteria (see paragraph 46), we calculate regional risk assessments as the average of the unadjusted country risk assessments, weighted by the GDP of each country in a defined region. These GDP weights were published in the criteria at the time of initial publication for reference only. Since the GDP data change, we use current GDP data each time we recalculate the regional risk assessments. We also updated the contact information and a criteria reference.
On April 1, 2019, we changed the definition of discretionary cash flow in the Corporate Criteria Glossary section because it was superseded by "Corporate Methodology: Ratios And Adjustments (/en_US/web/guest/article/-/view/sourceId/10906146)," published on April 1, 2019 (Ratios and Adjustments). We also aligned the FFO to cash interest coverage ratio in paragraphs 103 and 105 with Ratios and Adjustments. We also made a nonmaterial change to paragraph 81 and the Frequently Asked Questions to provide additional transparency on how we assess profitability. Finally, we updated criteria references.
On July 1, 2019, we republished this criteria article to make nonmaterial changes. We removed tables 28, 29, and 30 that contained industry-specific SER parameters. These parameters are not key rating factors and may change over time. We will update these tables and republish them in "Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)." We also amended the reference to these tables in paragraph 85 and updated the related research.
On Dec. 4, 2019, we republished this article to make nonmaterial changes. Specifically, we deleted a sentence in paragraph seven that contained an example that is not criteria text, we clarified language in paragraph 124, we updated the title of table 26, and we updated criteria references.
On April 30, 2020, we republished this criteria article to make nonmaterial changes: 1) We clarified language in paragraphs 7, 64, 71, 83, 103, 123, and 124 to reflect the fact that some previous content from archived KCFs has subsequently been included in "Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716)"; 2) in paragraph 123, we reformatted and clarified our language as to the use of the standard and medial volatility tables; 3) we added Appendix G, "Sector-Specific Criteria", through which we have consolidated sector-specific criteria for financial market infrastructure companies (FMIs) and financial service finance companies (FSFCs) (the criteria in Appendix G previously appeared in separate Key Credit Factors articles for FMIs and for FSFCs, both of which have since been archived); 4) in table 27 of Appendix B, we updated the list of subsectors under the media and entertainment industry--specifically, we eliminated trade show, directories, and internet search engines as subsectors, since they are not materially represented in our current rated universe, and we combined several similar subsectors within media and entertainment to simplify the sector-specific guidance; and 5) we updated the "Related Publications" section to include criteria articles referenced by Appendix G.
Sectors that fall in the scope of these criteria since the original publication include:

Agricultural cooperatives following publication of "Key Credit Factors For Agricultural Cooperatives (/en_US/web/guest/article/-/view/sourceId/9074133)" on March 17, 2015;
Entities engaged in commodities trading activities that generate less than 70% of expected earnings from commodities trading following publication of "Commodities Trading Industry Methodology (/en_US/web/guest/article/-/view/sourceId/9925346)," published Jan. 19, 2017;
Master limited partnerships and general partnerships of master limited partnerships trading following publication of "Methodology: Master Limited Partnerships And General Partnerships (/en_US/web/guest/article/-/view/sourceId/8740073)"

on Sept. 22, 2014; and

Transportation equipment leasing and car rental companies following publication of "Key Credit Factors For The Operating Leasing Industry (/en_US/web/guest/article/-/view/sourceId/9849429)," published on Dec. 14, 2016.

RELATED PUBLICATIONS

Superseded Criteria

Companies Owned By Financial Sponsors: Rating Methodology (/en_US/web/guest/article/-/view/sourceId/7848619), March 21, 2013
Methodology: Business Risk/Financial Risk Matrix Expanded (/en_US/web/guest/article/-/view/sourceId/7549527), Sept. 18, 2012
How Stock Prices Can Affect An Issuer's Credit Rating (/en_US/web/guest/article/-/view/sourceId/5030180), Sept. 26, 2008
2008 Corporate Criteria: Analytical Methodology (/en_US/web/guest/article/-/view/sourceId/5446217), April 15, 2008
Credit FAQ: Knowing The Investors In A Company's Debt And Equity (/en_US/web/guest/article/-/view/sourceId/3619668), April 4, 2006

Related Criteria

Group Rating Methodology (/en_US/web/guest/article/-/view/sourceId/10999747), July 1, 2019
Corporate Methodology: Ratios And Adjustments (/en_US/web/guest/article/-/view/sourceId/10906146), April 1, 2019
Reflecting Subordination Risk In Corporate Issue Ratings (/en_US/web/guest/article/-/view/sourceId/10486915), March 28, 2018
Risk-Adjusted Capital Framework Methodology (/en_US/web/guest/article/-/view/sourceId/10170016), July 20, 2017
Recovery Rating Criteria For Speculative-Grade Corporate Issuers (/en_US/web/guest/article/-/view/sourceId/9831306), Dec. 7, 2016
Rating Government-Related Entities: Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceId/9032821), March 25, 2015
Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers (/en_US/web/guest/article/-/view/sourceId/8956570), Dec. 16, 2014
The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities (/en_US/web/guest/article/-/view/sourceId/8569927), April 29, 2014
Country Risk Assessment Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceId/8313032), Nov. 19, 2013
Methodology: Industry Risk (/en_US/web/guest/article/-/view/sourceId/8304862), Nov. 19, 2013
Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceId/8343660), Nov. 19, 2013
Methodology: Management And Governance Credit Factors For Corporate Entities (/en_US/web/guest/article/-/view/sourceId/7629699), Nov. 13, 2012
Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings (/en_US/web/guest/article/-/view/sourceId/7554329), Oct. 1, 2012
Banks: Rating Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceId/6921376), Nov. 9, 2011
Principles Of Credit Ratings (/en_US/web/guest/article/-/view/sourceId/6485398), Feb. 16, 2011
Stand-Alone Credit Profiles: One Component Of A Rating (/en_US/web/guest/article/-/view/sourceId/6219375), Oct. 1, 2010

Related Guidance

Guidance: Corporate Methodology (/en_US/web/guest/article/-/view/sourceId/11046716), July 1, 2019
Guidance: Corporate Methodology: Ratios And Adjustments (/en_US/web/guest/article/-/view/sourceId/10906146), April 1, 2019

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.

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Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence Of Legally Binding Parent Support

Executive Summary

Moody's approach to rating non-guaranteed subsidiaries starts with the determination of stand-alone ratings for both the parent and the subsidiary. We then determine the likelihood that the parent will provide financial support to the subsidiary during periods of distress. The likelihood of support has two components — ***willingness and ability*** to support. Willingness to support incorporates considerations of reputation and confidence sensitivity, strategy, operational integration as well as marginal return on required prospective investment and the role of financial regulators. Ability to support is based on the parent's own rating, the correlation between the parent's and subsidiary's financial condition, and the relative magnitude and timing of all such expected investments. Moody's may notch the parent's own stand-alone rating down to reflect the expected financial support likely to be provided to a weak subsidiary, or up to reflect the expected financial support likely to be received from a strong subsidiary.

Several defaults over the past two years relating to unexpected decisions by parent companies not to support their subsidiaries illustrate not only the weaknesses of non-legally enforceable support such as comfort letters and verbal statements, but also that a subsidiary may be "strategic" and yet not be supported by its parent, in the absence of a persuasive return on incremental investment to justify the parent's continuing support. These defaults illustrate the difficulty of giving ratings benefit for the perceived strategic importance of a subsidiary to its parent in the absence of legally binding support, particularly for non-financial corporations.

When rating financially weak subsidiaries with high risk, limited histories, and need for periodic parental funding where there is no guarantee or legally binding support mechanism from the parent, Moody's will in all likelihood rate the subsidiary at or close to its intrinsic stand-alone rating. We are particularly attuned to cases where a parent has the motivation and ability and to insulate its own financial position without material adverse consequences to its own operations by discontinuing financial support to the subsidiary.

When rating better-established lower-risk subsidiaries whose operations are critical to those of the parent and for which incremental investment would meet parental return objectives, Moody's will start with the intrinsic stand-alone rating and, after a review of several factors — such as the subsidiary's financial track record and the parent/subsidiary support relationship, may opt to lift or "notch" the rating higher.

When rating financial institutions, certain additional factors may also be considered. Financial institutions generally have a high degree of confidence sensitivity. The more connections there are between a financial institution parent and its subsidiary (such as shared customers, a shared name, or significant operational links) the harder it may be for the parent to abandon its subsidiary without suffering a loss of confidence and significant material adverse consequences of its own. This provides a parent financial institution with a strong incentive to support even a weak subsidiary. In addition, financial institutions are often highly regulated, and as such a parent may choose to support a subsidiary to avoid suffering adverse regulatory consequences. Because of these additional factors, Moody's believes that in many cases financial institutions will be more likely to support weaker affiliates or subsidiaries than non-financial corporations. Thus ratings lift may often be greater for financial institutions.

Introduction

When rating the debt of subsidiaries, Moody's framework for determining how much weight to assign the support mechanism provided by a parent or affiliate differentiates between the support provided by way of guarantees and support provided by maintenance agreements. We segregate these as follows[1]:

1. Guarantees

Guarantees are legally enforceable agreements that are intended to survive the insolvency of the issuer and oblige the guarantor to provide for payment if the issuer does not make payment. Provided the guarantee is valid, unconditional and irrevocable, and provided that it requires prompt payment to the creditor in full before pursuit of remedies, it provides full credit substitution. Where such guarantees exist, the subsidiary's debt is given the same rating as that of the guaranteeing parent.

2. Maintenance Agreements

Maintenance agreements, on the other hand, are agreements whereby the supporting entity undertakes to provide support of a specific kind — which is typically limited — for the supported entity. These agreements usually do not require the supporting entity to provide full and timely payment if the issuer does not. In most cases, but not all, maintenance agreements do not provide the debt holder with enforceable remedies. Issues of legal enforceability and timeliness of payment vary according to the terms of each specific agreement and the governing jurisdiction.

Although some maintenance agreements may provide credit enhancement, they do not provide full credit substitution. The degree of support that they provide can vary very significantly. Examples of stronger forms of maintenance agreements, which often include quantifiable measures of support, include minimum net worth agreements, operating agreements, and debt service reserve make-up provisions. Weaker forms, which generally do not contain quantifiable measures of support, include keep-wells, comfort letters and moral obligations. The weakest forms of support are represented by *verbal* statements of intent to provide financial support and *verbal* statements regarding the strategic importance of a subsidiary.

1. *Please see Moody's Rating Methodology, "How Moody's Evaluates Support Mechanisms Provided By Parents, Affiliates Or Other Related Entities" (December 1999)*

When rating transactions for subsidiaries with these arrangements, we have generally rated debt supported by a maintenance agreement at the same level as that of the supporting entity if: (1) there is a strong incentive to provide support on a timely basis, (2) the maintenance agreement is structured in a way that makes payment interruption unlikely, and (3) the parent demonstrates a willingness to maintain a creditworthy subsidiary. Doubts about the incentive of the supporting entity, or reservations about the strength of the maintenance agreement, or failure by the parent to keep the subsidiary in good overall financial condition would typically cause rating committees to notch down the debt of the supported entity from that of the supporting entity. The degree of the notching reflects the rating committee's assessment of the risk that support might not be forthcoming when needed.

Several high profile credit defaults over the past two years have illustrated not only the weaknesses of non-legally enforceable support such as comfort letters and verbal statements in protecting creditors, but also that a subsidiary may be "strategic" and yet not be supported by its parent absent a persuasive return on incremental investment to justify the parent's continuing support.

Bottoms Up: The Case For Starting With The Stand-Alone Rating

During 2002, there were four instances in which highly rated parent companies opted to maximize shareholder value by curtailing investment in wholly or partially owned subsidiaries that failed to produce or show any prospects of generating satisfactory returns on investment. As a consequence, the subsidiaries ultimately defaulted on their debt despite, in several cases, public assurances by the parent of continuing support given the ongoing strategic importance of the underlying subsidiary to its parent. While the subsidiaries ultimately defaulted, it should be noted that the cessation of funding weak non-return producing subsidiaries was ultimately a positive credit event at the parent level.

These defaults illustrate the difficulty of giving ratings benefit for the perceived strategic importance of a subsidiary to its parent in the absence of legally binding support. This report examines the circumstances of these four defaults and highlights a framework setting forth our bottoms up approach to address instances in which Moody's rates weak subsidiaries of strong parents absent a legally binding parent support agreement.

These instances of default include:

*Parent**	Subsidiary	DefaultedDebt
BCE Inc.	Teleglobe Inc.	US$3.2 billion
AT&T Corp.	AT&T Canada Inc.	US$3.7 billion
Verizon Communications, Inc.	Genuity Inc.	US$2.0 billion
TXU Corp.	TXU Europe Ltd.	US$2.8 billion

** "Parent" is used broadly, as AT&T Corp. owned 31% of AT&T Canada and Verizon owned 9.5% of Genuity*

Initially the subsidiaries of each of these entities were considered strategic investments by their parent companies, and their operations were portrayed as being closely aligned with the core businesses of their parents. However, in each case, the parent companies opted to discontinue future investments in the subsidiaries. Moody's believes that the deterioration -- and the parents' decisions — occurred for several reasons:

1. The industry sectors targeted for investment (i.e. telecommunications and energy) became highly competitive as a result of: a) industry deregulation and b) high growth expectations. These factors prompted many new entrants into these sectors, which produced eventual oversupply, and consequent large, unexpected deterioration in the future profitability of the sectors.

2. The investments were characteristic of end-of-cycle investment programs with associated speculative elements.

3. The subsidiaries exhibited weak or yet to be achieved profitability as exhibited by low or negative returns on assets.

4. The subsidiaries were cash consumptive with ongoing requirements for large amounts of cash. Free cash flow was projected to be a future event. As a result, continuing amounts of cash from the parent or capital markets was required by the subsidiaries to fund negative operating cash flow, service debt, provide for working capital, and to meet capital investment requirements.

5. Additional funding required by the subsidiaries to become self-sufficient was more than originally expected and highly unpredictable given the uncertainty about the future in the subsidiaries' business sectors. Given the deteriorated industry economics the parent in each case was unable to anticipate how much additional negative free cash flow would have to be funded, and therefore could not justify further investment.

6. Incremental investments in the subsidiaries became uneconomic for the parents, even considering the large investments — often in the multi-billion dollar range — that previously were made. It is probable that the boards of the parent companies in some cases could have been advised by legal counsel and financial advisors to cease funding losses at these subsidiaries.

7. Continued support was likely to have an adverse affect on the rating of the parent or supporting entity.

Table 1 illustrates that each of the four subsidiaries had weak financial positions as reflected by:

- Debt in excess of revenues (with the exception of TXU Europe Ltd.)
- Weak (or negative) returns on assets
- Negative free cash flow

Table 1: Summary Financial Information For Defaulting Subsidiaries

	Teleglobe Inc.	AT&T Canada Inc.	Genuity Inc.	TXU Europe Ltd.
Last 12 months ended	**31-Dec-01**	**30-Sep-02**	**30-Jun-02**	**30-Jun-02**
(in millions)	**USD**	**CAD**	**USD**	**Sterling**
Revenues	1,292	1,523	1,185	9,473
Debt	2,651	4,727	2,634	3,261
Return on Average Assets	-0.1%	-40.9%	-107.5%	.7%
Cash Flow from Operations	-39	-187	-522	-90
Capital Expenditures	1,420	146	343	203
Free Cash Flow	-1,459	-333	-865	-293

Rating Subsidiaries/Affiliates In The Absence Of Legally Binding Parent Support

Moody's assigns subsidiary debt ratings in the absence of legally binding parental support utilizing a two-step process:

1. Assign a stand-alone rating to the subsidiary
   - This process is described in the next section.
2. Determine the likelihood of support based upon an evaluation of:
   - Willingness to support, and
   - Ability to support

Moody's evaluation of the ***willingness*** of a parent to support a subsidiary incorporates considerations of reputation and confidence sensitivity, strategy, operational integration as well as marginal return on required prospective investment and the role of financial regulators. This analysis will encompass the degree of uncertainty in forecasting the subsidiary's business, the financial implications for the parent's own business of supporting versus not supporting the subsidiary including commercial interrelationships between the two, and the financial implications of any adverse reputation consequences for the parent of not supporting. Sunk costs into the subsidiary, both initial investment and ongoing historic cash support, will not be material factors.

Moody's evaluation of the ***ability*** of the parent to support a subsidiary is based on the parent's own stand-alone rating, any correlation of business risks between the parent and the subsidiary, and the relative magnitude and timing of all such expected investments. Highly correlated businesses, often the case with "strategic" subsidiaries, can result in instances when the parent may be suffering from the same adverse economic issues as the subsidiary at the time that when the subsidiary needs support, and thus may have a much reduced ability to assist when most needed.[2]

Utilizing this two step process, the ratings of subsidiaries will be largely based on their own stand-alone creditworthiness, with a potential minor notching to reflect nonbinding parental support.

Within this broad methodology framework, Moody's recognizes two types of subsidiaries involving non-legally binding support, which result in slightly different ratings outcomes:

1. Financially Weak Subsidiaries With High Risk And Limited Histories

The first arrangement involves financially weak subsidiaries that generally have high business risk profiles and limited operating histories. While the parent companies may retain strong financial profiles, the subsidiaries exhibit weak performance metrics with respect to profitability and free cash flow. This situation may also involve cases where the parent has made a substantial financial investment in the subsidiary, but where the subsidiary's ability to generate an economic return on the parent's outlay is not assured.

Examples might include start-up operations or speculative ventures where the probability of success can not be measured readily.

2. *For a further discussion of both economic and legal correlations between a support provider and an underlying obligor, please see "Moody's Approach to Jointly Supported Obligations" (November 1997)*

We recognize that, in the absence of a guarantee or a legally binding support mechanism, the parent has the ability to insulate its own financial position without material adverse consequences to its own operations by discontinuing financial support to the subsidiary should results not turn out as envisioned.

In all likelihood, our approach in these cases will be to rate the subsidiary at or close to its intrinsic stand-alone rating. With this degree of business risk, there is a significant possibility that the economics of the sector and/or of the subsidiary itself might deteriorate, leading the parent to change its mind regarding the “strategic” nature of the subsidiary, regardless of past public pronouncements.

Further, if the subsidiary actually needs ongoing voluntary cash support from the parent, it likely has no stand-alone access to capital and would be close to insolvency except for the parent. In such circumstances, the subsidiary’s stand-alone rating will be very low.

2. Established Subsidiaries With Lower Risk Profiles

The second situation involves operationally and financially established subsidiary issuers with more conservative risk profiles. These subsidiaries demonstrate well-established independent operating and financial histories, with modest future reliance on parent funding.

In contrast to the above referenced start up or relatively risky subsidiary investments, where parents strategically and financially insulate themselves, these cases may involve parents with material ongoing incentives to support their subsidiaries because the subsidiaries are essential to the parents' ongoing operations. While parental financial support is not expected to be needed, Moody’s perceives that it would be provided in unusual circumstances as there would be a compelling marginal return on investment for doing so, potentially including impacts on the parent’s own business. Financial incentives for the parent are compelling in that it would be injurious to the parent not to support these established operations.

Our approach in these cases will be to commence with the intrinsic stand-alone rating and, depending on the facts and circumstances involved, notch the rating higher if the rating committee determines that the parent has significant financial incentives to provide support to the subsidiary. The approach will begin with the subsidiary’s stand-alone rating. Any “ratings lift” based on the parent’s willingness and ability to provide support could be limited to only one or two notches above the stand-alone rating.

While the norm for “ratings lift” may be only one or two notches for non-financial corporations, it could be considerably more for financial corporations because of the role played by regulation and reputation among financial firms.

Assigning The Stand-Alone Rating — The Importance Of Subsidiary Financial Information In Determining Self Sufficiency

The determination of a stand-alone rating starts with an assessment of the subsidiary's stand-alone financial statements. A stand-alone assessment and a rating assignment of a non-guaranteed subsidiary cannot be made without adequate financial information.[3]

The usual factors are considered in assessing the stand-alone rating of the subsidiary, including:

- An evaluation of the operating strategy of the subsidiary issuer, its competitive position within the industry and the forecasted economic health of the industry
- An evaluation of the financial plan including projected cash flows and debt levels
- An assessment of the issuer's ability to meet its debt service requirements considering the amortization schedule and maturity of debt issues
- A liquidity analysis including an assessment of the subsidiary's ability to obtain external funding in an amount sufficient to execute its business plan

In addition, we consider an assessment of the commercial relationship of the subsidiary to its parent on an "arm's length" basis. The commercial relationship with a parent may be valuable to the subsidiary, thereby serving as a positive factor in the stand-alone rating determination. Conversely, consideration will also be given to the risk of any concentration of subsidiary business with the parent and any economic benefits arising from non-arm's length arrangements.

This analysis enables Moody's to determine if the subsidiary needs funding support from the parent. If so, we will examine how much is required and for how long before the subsidiary is able to generate free cash flow.

Risk to both the parent and the subsidiary increases with the duration that the subsidiary is cash consumptive as well as with the amount of required support. A self-sustaining state is assumed to be achieved when the subsidiary can generate free cash flow sufficient to sustain the business and meet its obligations, including debt amortization, without the need for external funding. If the subsidiary is not self-sustaining, its stand-alone credit rating will be weak given its near insolvency absent continuing parent support.

3. ***Appendix 1*** *summarizes the requirements for filing periodic financial reports with the United States Securities and Exchange Commission*

Notching The Rating Higher: Examples Of "Ratings Lift" For Subsidiaries That Are Financially, Strategically And Operationally Intertwined With Strong Parents

Below are two cases that illustrate situations that involve subsidiary or affiliated issuers that are financially, strategically, and operationally intertwined with higher-rated issuers. Both cases involve subsidiaries/affiliates with well-established profitable businesses that are financially independent of the parent, and are essential to the ongoing operations of their respective parents. On a stand-alone basis, both subsidiaries benefit economically from the association with their parent, a factor incorporated into the subsidiaries' ratings.

The ratings for the companies below, **Coca-Cola Enterprises, Inc.** and **Schlumberger Technology Group** have been notched considerably higher than their stand-alone intrinsic ratings based on their material linkage to higher-rated parents and the parents' noteworthy incentives to ensure the subsidiaries' continuing financial viability.

Coca-Cola Enterprises Inc.

Coca-Cola Enterprises Inc. (CCE) – (A2 – sr. unsecured) is 37.8% owned by **The Coca-Cola Company** (KO) - (Aa3 - sr. unsecured) and is the largest soft drink bottler worldwide accounting for some 80% of all KO canned and bottled products in the U.S. and Canada and 25% globally. KO is the largest soft drink producer in the world and distributes its products worldwide through bottlers such as CCE.

This case provides an example of a relationship between companies with mutually dependent core businesses. KO does not guarantee or otherwise explicitly support CCE's debt. However, CCE's ratings are significantly higher than they would be on a stand-alone basis, based on the company's inextricable ties to KO. On a stand-alone basis, CCE's leverage is more consistent with speculative grade than investment grade ratings. However, its ratings enjoy significant lift based on Moody's assessment that KO has a very strong economic incentive, as well as sufficient financial resources, to provide financial and operational support if CCE were to encounter serious problems. Default risk is therefore significantly lower than CCE's aggressive capital structure suggests. Nonetheless, CCE's highly leveraged balance sheet is putting pressure on its current ratings, as well as those of KO, and this pressure is reflected in the negative rating outlooks of both CCE and KO.

Moody's assessment that KO would support CCE if it were to encounter serious problems, including difficulty making timely debt service payments, is based on a number of important strategic, operational, financial and legal ties between the two companies:

- CCE is a cornerstone of KO's overall strategy for manufacturing, marketing and distributing Coca-Cola products worldwide. KO's business model involves differentiated yet closely integrated functions for the concentrate producer/brand owner and its bottlers that create a symbiotic system of mutual dependence. CCE has, with KO's approval, grown significantly over a number of years by acquiring additional territories in the U.S., Canada, and Western Europe so that it now distributes 80% of Coca-Cola products sold in the important North American market and 25% of Coca-Cola products worldwide. KO does not have bottling or distribution capability of its own in CCE's markets. It would therefore be extremely difficult for KO to find one or more bottlers to replace CCE without harming the Coca-Cola franchise in these markets, given the size and efficiency of CCE's bottling and distribution operations.

- The Coca-Cola beverage system and KO as a stand-alone entity can only prosper if its bottlers also prosper. Strategic decisions, including pricing of concentrate and other services provided by KO, take into account the need for the bottlers to generate adequate returns. It is particularly important for there to be broad agreement between KO and CCE on the way in which risks and rewards are allocated given CCE's size within the Coca-Cola system. Strategic alignment between the two companies occurs as a result of interaction at a variety of levels, which include senior level KO representation on CCE's board.
- Financially, KO provides assistance to CCE in a variety of ways such as marketing, advertising and promotion support, site location for cold drink equipment, and growth incentive programs.

  KO has a track record of supporting bottlers that encounter difficulties and of orchestrating a long-term solution to their problems that has allowed all financial commitments to be met on time and in full. On many occasions, KO has either bought back the ailing bottler's territories or brokered the sale of these territories to another bottler. The Control and Profit and Loss Agreement put in place with Coca-Cola Erfrischungsgetraenke, the large German bottler, provides a recent example of how KO seeks to resolve problems that occur in the Coca-Cola system and thereby ensures that a challenged bottler meets its obligations.

  If CCE, the largest Coca-Cola bottler, were to default on a financial obligation or commitment, the cost of capital for all other Coca-Cola bottlers worldwide would increase significantly. KO has a strong economic incentive, as well as the financial wherewithal, to provide sufficient support to CCE to prevent such an occurrence.
- Legally, CCE benefits from exclusive contracts to market, distribute and produce Coca-Cola beverages in authorized containers in specific territories. It is obligated to purchase concentrates and syrups for Coca-Cola trademark beverages from KO. The agreement relating to Coca-Cola trademark beverages in the U.S. is in perpetuity.

Schlumberger Technology Corp.

Schlumberger Technology Corporation (STC) - (A2 sr. unsecured), is a wholly owned U.S. domiciled subsidiary of **Schlumberger Ltd.** (SLB) - (A1 sr. unsecured). STC is an oil field services company and leading U.S. supplier of services and technology to the petroleum industry. Schlumberger Ltd. is a leading provider of similar services on a global basis.

The debt incurred by STC is not guaranteed by SLB. On a standalone basis, STC has a moderate investment grade profile. The ratings lift provided by Schlumberger Ltd. is a result of the financial and strategic importance and operational alignment with the rest of the SLB group.

- Financially, STC is SLB's largest subsidiary and accounts for approximately one-third of the SLB Group's revenue, assets and cash flow. STC's financial policies mirror those of the Schlumberger Group, and STC has not had a history of paying material dividends. Continued profitability of the U.S. operation and its ability to maintain financial independence from the parent are critical to our rating of STC.

- Operationally, STC is a material contributor to the Schlumberger Group's oil field services research, engineering and equipment manufacturing. STC develops a large portion of the technology supporting its products and services, which we consider a valuable intangible asset for the group. R&D successes can benefit the group as a whole. We note that transactions between STC and the Schlumberger Group are done on an arm's length basis. Considerable weight is given to these factors when considering the rating lift.
- Strategically, the U.S. is the largest oil field services market and is a source of significant innovation. As such, we believe that Schlumberger Ltd. needs to maintain a strong presence in this market in order to further its global strategy.

The Weaknesses Of Certain Non-Legally Enforceable Support Mechanisms

As we have discussed, the fact that some parent companies decided to discontinue investment in their subsidiaries after determining that such funding would fail to produce a satisfactory return illustrates the low intrinsic value of non-legally binding support such as comfort letters, keep-well agreements, letters of moral intent, or verbal support. With any of these options, a parent company would likely bear modest financial liability for creditor losses should the subsidiary default, albeit at a possible cost to the parent's reputation in the financial markets.

In the four cases of subsidiary defaults, the parent company elected to discontinue support notwithstanding having: (1) made sizable initial and, in some cases, certain follow-on investments and (2) publicly articulated the "strategic" nature and ongoing support for their subsidiary issuers. In each case, the parent made a decision not to provide further support once it determined that further investments were unlikely to provide an economic return on the incremental funds.

In these four cases, there was no clear indicator of the amount of additional support required for the subsidiary to thrive or of the return on incremental capital that the parent would have received from providing ongoing funds. Decisions by the parents to cease support were based on the following:

- BCE Inc. decided after a review of strategic alternatives that the incremental investment required to support its subsidiary, Teleglobe Inc., to a self-sustaining status in the deteriorating long-haul telecommunications sector was very unclear, and therefore so was the likelihood of earning an adequate return on its marginal investment.
- AT&T Corp. decided not to make further marginal investments in its partly owned subsidiary, AT&T Canada Inc., (ATTC) likely because the facilities-based competitive local exchange carrier (CLEC) business was unable to support existing debt levels. Moreover, regulatory pricing changes in 2002 did not make economic the reselling of the incumbent telcos' own networks by ATTC.
- Verizon Communications, Inc. made a decision to curtail further investment in Genuity Inc., a leading provider of enterprise IP networking services. Verizon opted not to exercise its option to acquire and reintegrate Genuity after reevaluating Genuity's growth prospects in light of the significant slowdown in IT spending and order rates.
- TXU Corp. discontinued financial support for its subsidiary, TXU Europe Ltd., despite publicly stating its willingness to do so, after determining that further funding of TXU Europe would not maximize shareholder value and recognizing that TXU Europe Ltd. was putting the ratings of its other subsidiaries at tremendous risk. TXU Europe's operations were hampered by the effects of increasing competition following deregulation of UK power markets, declining wholesale power prices, and contracts to purchase power at prices above market.

Appendix 1

Public Availability Of Financial Statements

The following summarizes the rules and regulations of the United States Securities and Exchange Commission (the "U.S. SEC") that require issuers of debt securities to file periodic reports with the U.S. SEC.

U.S. SEC Reporting Obligations

In general, the obligation of a corporate debt issuer to file periodic reports (*e.g.*, annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K or Forms 20-F and 6-K for foreign issuers) under the Securities Exchange Act of 1934 (the "Exchange Act") arises when the debt securities are the subject of a registration statement under the Securities Act of 1933 (the "Securities Act") (*e.g.*, a public offering).

Exceptions include:

- Record holders fall below 300 after the first fiscal year in which the registration statement is declared effective.

However, if the debt securities are listed on a national securities exchange, the public filing requirements will continue.

Financial Statements Of Guarantors And Issuers Of Guaranteed Securities

Even if the number of record holders exceeds 300 persons, any wholly-owned operating subsidiary issuer of a debt security guaranteed by a parent is exempt from the reporting requirements of the Exchange Act if:

1. The issuer is 100% owned by the parent guarantor;
2. The guarantee is full and unconditional;
3. No other subsidiary of the parent guarantees the securities; and
4. The parent company's financial statements are filed with the U.S. SEC for the periods specified by Regulation S-X and include, in a footnote, condensed consolidating financial information.

Instead of complying with number 4 above, the parent company's financial statements may include a footnote stating that:

- The parent company has no independent assets or operations
- The guarantee is full and unconditional and;
- Any subsidiaries of the parent, other than the subsidiary issuer, are in generally less than 10% of the assets of the parent and the other subsidiaries on a consolidated basis as of the end of the most recently completed fiscal year.

Under these circumstances, a subsidiary issuer of debt securities that are guaranteed by the parent would not be required to file its financial statements with the U.S. SEC.

Contractual Reporting Obligations

In order to ensure that an issuer's financial statements are publicly disclosed, whether or not required by current U.S. SEC disclosure requirements, some indentures include a covenant requiring the issuer to make its financial statements available to the trustee and file periodic reports with the U.S. SEC so long as debt governed by the indenture remains outstanding, regardless of (a) the number of holders or, (b) the issuer is listed on a national securities exchange or, (c) whether the debt is guaranteed by a parent or, (d) not registered under the Securities Act. It is also important to note that any such covenant in an indenture may be amended or waived with the consent of the requisite percentage of the outstanding debt securities.

Related Research

Rating Methodology

How Moody's Evaluates Support Mechanisms Provided By Parents, Affiliates Or Other Related Entities, December 1999, #51555

Moody's Approach to Jointly Supported Obligations, November 1997, #28153

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

To order reprints of this report (100 copies minimum), please call 1.212.553.1658.
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BANK "A"'S CREDIT AND COLLECTION POLICY

Credit Policy

Credit is extended and managed in accordance with Bank "A"'s credit policy (the "**Credit Policy**").

The Credit Policy sets out the fundamental credit principles, disciplines and standards for business origination and the global management of credit risks within the BANK "A" Group. The BANK "A" Group operates around three client segments: "Corporate and Institutional Clients", "Commercial and Private Banking Clients", and "Retail Clients". All credit facilities extended to clients in segments "Corporate and Institutional Clients" and "Commercial and Private Banking Clients" (the "**Client Segments**") are covered by Business Credit Applications ("**BCAs**").

Scope of Credit Policies

Loan origination in the Client Segments is supported by complementary cross selling of core products including Financial Markets and Transactional Banking products subject to adequate risk assessment.

Key factors in any credit decision include the repayment ability of the borrower based on assessment of its cashflows, the borrower's management plan, the associated business, industry and management risks, and the overall risk/reward profile of the borrower.

Credit Applications Approval and Reviews

The BCA process is founded on, among other things, information about the customers' background, business activities, terms of trade, supplier and buyer information and an assessment of the borrowers' risk profile (including environmental and social risks etc). Additionally, a 'Know Your Customer' approach establishes clear lines of internal accountability, responsibility and reporting for each customer as are considered essential to identify and prevent money laundering.

BCAs are put up by relationship managers together with credit analysts. In each BCA, each proposed credit exposure must demonstrate (1) a clear understanding of the customer, (2) an analysis of the risks associated with the facilities proposed and the contractual counterparties (whether the customer or otherwise), and (3) a review of the risk adjusted return where appropriate.

Risk assessment will include, but need not be limited to, an analysis of:

(a) The business environment and general economic outlook;

(b) Current and future business prospects;

(c) Management strengths and weaknesses;

(d) Financial strength;

(e) The size and structure of proposed facilities and the fit with customer needs;

(f) Account performance;

(g) Compliance with policy requirements and portfolio or underwriting standards;

(h) Absolute revenues and risk adjusted rates of return; and

(i) Environmental and social risks.

The level of credit approval for Corporate and Institutional Clients and Commercial Clients segments is based on nominal exposure, expected loss ("**EL**"), and tenor. The highest level of approval is the Credit Approval Committee (the "**CAC**") and this extends to levels below the CAC including the Chief Risk Officer (the "**CRO**"), Senior Regional Credit Officers, Regional Credit Officers, Senior Credit Officers, Senior Credit Managers and Credit Managers depending on the level of nominal exposure, EL, and tenor.

The CAC requires a quorum of three members, including two representatives from the "Risk" function of the BANK “A” Group. The CAC is chaired by the Deputy Group Chief Risk Officer or Group Chief Credit Officer or Chief Risk Officer, Regions. Decisions of the CAC must be unanimous.

Each step of the credit approval process is segregated to provide independence and a control, check and balance mechanism:

(a) *Client Segments* – accountable for the credit reviews/applications preparation and submission;

(b) *Credit function* – responsible for the approval/decline of credit reviews/applications;

(c) *Credit Risk Control ("**CRC**")* – ensures all appropriate credit documentation (facilities, security agreements etc.) is in place and verifies that the requisite approvals have been obtained for any amendments to standard documentation and non-standard documentation with Control Functions before issuing the SCC ("**Security Compliance Certificate**") for limit loading. CRC also updates the documentation and collateral details in the CMS (Collateral Management System).

CRC is also responsible for the administration of newly approved facilities or any amendments or deletions of existing approved facilities which have been properly approved by credit approvers, including local regulatory and credit compliance requirements. CRC's key functions include limit loading and updating all terms and conditions as per the relevant facilities approved by credit approvers. These functions will be performed upon receipt of the SCC as detailed above.

Each counterparty is subject to at least an annual review whereby the credit grade is determined, a review of the counterparty is undertaken in line with the applicable credit policies, and the business viability of the relationship assessed. The risk review is prepared by the client relationship function within the Client Segments. Each counterparty must be overseen by an account manager within the Client Segments.

Internal Credit Risk Rating

The BANK “A” Group uses a set of internal credit grades (comprising the "**Expanded Credit Master Scale**") for quantifying the 1-year probability of default of any given borrower. In order to determine a credit grade (a "**Credit Grade**") a scorecard is used in accordance with the Credit Grading Policy. Each scorecard comprises quantitative and qualitative factors which have been chosen and calibrated based on their ability to predict default, such that the larger the numerical value of the credit grade the higher the probability of default.

A number of scorecards have been developed for different types of borrower by business segment and size. A scorecard generates a credit grade for each borrower which is associated with a 1-year default probability. Credit Grading Policy documents set out the key principles of credit grading appropriate to all scorecards for determining the most appropriate grade for borrowers.

Credit grading of customers, as a part of credit approval process, is a dynamic process and is updated at least annually and when new material information, which can affect the credit grading, becomes available. Grading is a continuous process, not necessarily an annual event.

A separate grading approach is adopted for accounts once they move into impaired loan status.

Currently the Credit Grading scale for Corporate/Banks/Non Banking Financial Institutions consists of 28 Credit Grades that fall into 3 larger classes of risk.

(a) 1A, 1B, 2A, 2B, 3A, 3B, 4A, 4B, 5A, 5B, 6A, 6B, 7A, 7B, 8A, 8B, 9A, 9B, 10A, 10B, 11A, 11B, 11C – performing loans

(b) 12A, 12B, 12C – performing loans managed by GSAM (defined below)

(c) 13, 14 – impaired/non-performing loans

The BANK “A” Group's Credit Grades are not intended to replicate external credit grades, and ratings assigned by external ratings agencies are not used in determining Credit Grades. Nonetheless, as the factors used to grade a borrower may be similar, a borrower rated poorly by an external rating agencies is typically assigned a weak Credit Grade.

As a guide the table below presents the BANK “A” Group's Credit Grades in relation to that of S&P's credit ratings.

In this Prospectus, references to BANK “A” Corporate Risk Factors mean the Credit Grades as described in this section.

	Guidance S&P's Mapping	
Credit Grade	**Corporates / Non Banking Financial Institutions**	**Banks**
1A	AAA	AAA/AA+
1B	AA+	AA/AA-
2A	AA	AA-/A+
2B	AA-	A+
3A	A+	A
3B	A	A-
4A	A-	A-
4B	BBB+	BBB+
5A	BBB	BBB/BBB-
5B	BBB-	BB+
6A	BB+	BB
6B	BB+	BB
7A	BB	BB-
7B	BB-	B+
8A	BB-	B+/B
8B	BB-/B+	B
9A	B+	B-
9B	B+/B	B-/CCC
10A	B	B-/CCC
10B	B/B-	CCC/C
11A-B	B-	CCC/C
11C	B-/CCC	CCC/C
12A	B-/CCC	CCC/C
12B-C	CCC/C	CCC/C

Early Identification and Work-out and Recovery Procedures

Early identification, reporting and management of accounts that have risks or potential weaknesses of a material nature are prime credit responsibilities of all relationship managers, which must be undertaken on a continuous basis. This continuous process is known as the "**Early Alert Review**" or "**EAR**".

Early identification and reporting of deteriorating credit signs enables the BANK “A” Group to take swift action to protect the BANK “A” Group's interest. Moreover, early discussion with customers enhances the likelihood of developing strategies mutually acceptable to both the customer and the BANK “A” Group. As such, the BANK “A” Group maintains a policy of monthly early alert meetings, where all accounts marked for early alert are reviewed. The process of Early Alert Review is conducted through the Credit Issues Committee, whose members include the in-country heads of Client Segments, Senior Credit Officer and Group Special Assets Management ("**GSAM**"). The committee is chaired by the CEO for the relevant country.

GSAM is an independent division with direct reporting lines into the Group Chief Risk Officer. This autonomy allows for decision making without influence from the originating departments. GSAM manages all Credit Grade 12-14 accounts for client segment groups "Corporate and Institutional Clients" and "Commercial and Private Banking Clients"; it also may shadow a small number of accounts graded above CG 12 where early warning signs of deterioration may be evident (as identified by the Early Alert Review) but downgrade to CG 12 is not yet considered necessary. Upon downgrade of an account below Credit Grade 11C, control for the account is transferred from the line manager to a GSAM account manager. For some CG 12 accounts, there may be co-management between GSAM and the line manager, although decision making lies with GSAM.

Once an account is transferred to GSAM, a strategy is proposed. Depending on the borrower's circumstances, this strategy could include one of or a combination of the following:

(a) Restructure and return to Client Segments once the account is rehabilitated;

(b) Orderly exit which may include sale in the secondary market;

(c) Debt/equity swap;

(d) Realisation of collateral;

(e) Receivership and/or liquidation;

(f) Litigation.

Rehabilitation is always the most desirable outcome when possible.

No assurance can be given that the procedures described above will not change over time.