EULER HERMES RATING

Guidance Regarding the Consideration of Public Support in Credit Ratings

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EULER HERMES Rating

Ein Unternehmen der Allianz

Introduction

Euler Hermes Rating (EHRG) assesses credit risks on the basis of its "Basic Principles for Assigning Credit Ratings and Other Services" complemented by a variety of specific rating methodologies. These methodologies aim in particular to make the rating process transparent so that clients, investors and interested third parties can understand the relevant rating criteria and their aggregation in the final rating notation.

As explained in the rating methodologies, issuer and project ratings may be influenced by a **public background** of the issuer or the project. Methodologically, EHRG considers public background via an adjustment ("Modification 2") of the stand-alone rating, where **external influences** are incorporated into the final issuer or project rating. In addition to the public background, the modification also allows for potential external influences from associated group entities of the issuer or the project. However, this aspect will not be discussed further in the following, as this guideline solely aims to present and explain EHRG's basic approach to handling a public background in the context of "Modification 2". We use this methodological basis as an orientation and guideline for the rating process. It helps us to assess whether and, if so, by how many notches issuer and project ratings can be upgraded compared to their stand-alone rating or, in exceptional cases, have to be downgraded ("**notching**"). However, the actual notching remains at the discretion of the rating committee in each individual case.

Rating Criteria

The starting point for the assessment of a public background is the question as to whether a possible influence by the public sector can be derived from an existing legal integration ("public ownership") or the public importance of the company or the project (= issuer). More specifically, the **likelihood** and **capability** of temporary interventions by the public sector to avert potential payment incidents or impending insolvency of the issuer or project is assessed on a case by case basis using various criteria.

Likelihood

A central question in the context of our assessment is the **likelihood** of external support by a public body to avert potential payment incidents or impending insolvency of the issuer or project. The likelihood of public support is assessed on the basis of the **integration** between the associated public owner/agency and the company or project, and on the basis of the degree of **importance** of the company or project for the public owner/agency. In these two areas of analysis, various criteria are examined that can typically be an indication of the likelihood of external support. This is a purely qualitative assessment of the various criteria.

The following criteria are usually used to assess the degree of **integration** and **importance**:

Public Integration:

- Public ownership structure
- Degree of legal integration and interdependencies
- Liquidity support and capital measures

Assessment criteria for the public ownership structure are, for example, the legal status, the shareholder structure and position, voting and control rights as well as privatisation risks. For the evaluation of the degree of integration and interdependencies, the autonomy of corporate policies, dependencies in fundamental business decisions as well as integration and consolidation risks are evaluated. Assessment criteria for liquidity support and capital measures are usually public guarantees, preferred access to public financial funds to improve the capital and liquidity position as well as any other public assistance to mitigate financial risks.

Public Importance:

- Importance of the public mandate
- Economic importance and dependence

Assessment criteria for the importance of the public mandate are, for example, a political or legislative mandate, highly regulated markets and competition rules as well as high reputational risks or the provision of critical public services. The economic importance and possible dependencies are assessed on the basis of the scope of the economic, political and social impact, the role as an employer, possible transfer payments to public bodies and the degree of systemic importance as a whole.

The various assessment criteria are analysed and evaluated independently of each other. Based on the outcome, the **likelihood of public support** is derived from the aggregation of the individual scores of each criterion, which are usually equally weighted. Depending on the result, one of the following five probability levels is finally assigned to the likelihood of public support:

Almost certain (91%-100%)	Very high (71%-90%)	High (51%-70%)	Moderate (21%-50%)	Low (0%-20%)

Capability

In general, the associated public owners, such as governments, federal states/regions or municipalities, have a higher credit quality themselves and thus, in principle, also the **capability** to enhance the creditworthiness of the associated companies or projects through **external influence**. External influence in this context usually means an extraordinary measure to secure liquidity or capital (e.g. equity-replacing loans or guarantees) by the public agency. The more likely we assess such an external intervention in the event of a crisis to avert (imminent) insolvency or over-indebtedness, the more we align the stand-alone rating of a company or project with the credit rating of the associated public owner/agency. Besides, a higher degree of legal integration (e.g. statutory bodies, corporations or institutions under public law) typically leads to a rather close alignment with the rating of the public owner/agency. In a few cases, this can even lead to a complete alignment of the stand-alone rating with the rating of the public owner. This also means, however, that the rating of the associated public owner/agency usually represents the upper limit ("ceiling") for the upgrading potential. Sovereign and municipal ratings are regularly published and communicated publicly. When determining the upper rating limit, Euler Hermes Rating also relies on supplementary analyses of macroeconomic, fiscal and monetary key figures or guidelines for limiting government or municipal debt.

Notching

The objective of "notching" is to condense the results from the two analysis areas "**public integration**" and "**public importance**" into a range for a possible upgrading of the company's or project's stand-alone rating (Modification 2). As a result, an upgrading range can be derived which, together with benchmark comparisons of similarly structured companies or projects, serves the rating committee as an indicative assessment and basis for discussion.

As a starting point, the spread between the stand-alone rating of the company or project and the (usually higher) sovereign/municipal rating of the associated public owner must first be determined in numeric steps ("notches"). In the case of more than one public owner, the rating of the most relevant owner is the upper limit. In the case of multiple owners without absolute or qualified majorities, a weighted average of all associated owners can also be the upper limit.

Based on the determined **spread** between the stand-alone rating of the company or project and the sovereign/ municipal rating of the associated public owner, the potential upgrading is calculated with the help of the predefined percentage ranges for the five **probability levels** of public support (see above). The results are finally rounded **down** to the nearest integer (notches).

Example: *A company or project is rated **BB+ (stand-alone)**. The creditworthiness of an associated public owner was rated **AA-**, which results in a maximum upgrade potential of **7 notches** (capability). The likelihood of public support to avert potential payment incidents, over-indebtedness or impending insolvency proceedings of the issuer or project was assessed as "**High (51%-70%)**" with the help of the rating criteria.*

- *51% of 7 notches equals 3 full notches (3.57)*
- *70% of 7 notches equals 4 full notches (4.90)*

*The notching range thus corresponds with **3 to 4 notches**, so that the company or project rating (starting from "BB+") could be upgraded to the range of "**BBB+**" to "**A-**".*

In general, the notching range increases the larger the spread between the stand-alone rating and the rating of the public owner is. In the case of very large notching ranges, benchmark comparisons with similar cases and the exact score from the analysis are also examined in order to identify trends within the assigned public support category.

Exceptional cases in which, for example, a weak credit rating of the associated public owner can have a negative impact on the stand-alone rating of the company or project (default correlation), or in the case of private ownership where public support is nevertheless likely due to an inherent systemic importance ("too big to fail"), are assessed on a case-by-case basis by the rating committee.

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