

WHITEPAPER

Beyond numbers

Unravelling the art and science of credit ratings

ZANDERS
PERFORMANCE WHEN IT COUNTS

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At A Glance

- Credit ratings are widely viewed as a cornerstone of compliant transfer pricing.
- Chapter X of the OECD Transfer Pricing Guidelines 2022 emphasize the significance of evaluating a borrower's creditworthiness. Consequently, the vast majority of tax authorities stipulate credit ratings as a starting point for pricing intra-group loans.
- As a vital tool in a corporate treasurer's armoury, understanding the metrics and methodologies that form the basis of these opinions is important for all market participants.
- We highlight three factors that differentiate rating models – the subject of the rating (issuer or instrument), time horizon (short-term or long-term) and source (public or proprietary).
- We then explore the two core methodologies that can be used to determine a borrower's credit rating – the top-down approach and the bottom-up approach.
- As bottom-up is the standard for corporate borrowers, we delve deeper into the two stages of formulating ratings using this method, including considering a group's explicit and implicit support as required by the OECD Transfer Pricing Guidelines 2022.
- Finally, we shed light on specific practices, like notching adjustments and the credit rating cap, and how they add depth to the understanding of credit risk assessment.



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Introduction : Credit ratings and the quest for clarity

In today’s volatile environment, a clear view of credit risk is the holy grail for decision-makers when it comes to evaluating loans and investments. But attaining this clarity requires a common language for assessing creditworthiness. This is the domain of credit ratings.



The spotlight is on credit risk

A prolonged period of market uncertainty and elevated interest rates has increased attention on credit ratings. Chapter X of the OECD Transfer Pricing Guidelines 2022 emphasizes the significance of evaluating a borrower's creditworthiness. As a result, many tax jurisdictions all over the world now demand a credit risk analysis as part of arm's length pricing of intercompany financial transactions. In addition, accounting standards also often require a credit risk adjustment when valuing provisions or leases. In short, the necessity of credit rating assessments is mounting at multinational corporations.

Evaluating credit risk exposure

Credit rating scales are formed from a normalized view of the probability of default of a given investment (over a specified time horizon), combined with the seniority or collateral of a transaction. The resulting score indicates the likelihood of loss and recovery in the event of default (i.e., the amount that the lender will retrieve in the event of default). In other words, credit ratings take advantage of the vast volumes of data now available and distil it into a shorthand code that ranks the expected probability of a party missing a debt payment. This provides an objective opinion on the creditworthiness of borrowers, multinational groups, and financial instruments, forming a standardized metric for comparing the relative risks associated with borrowing.

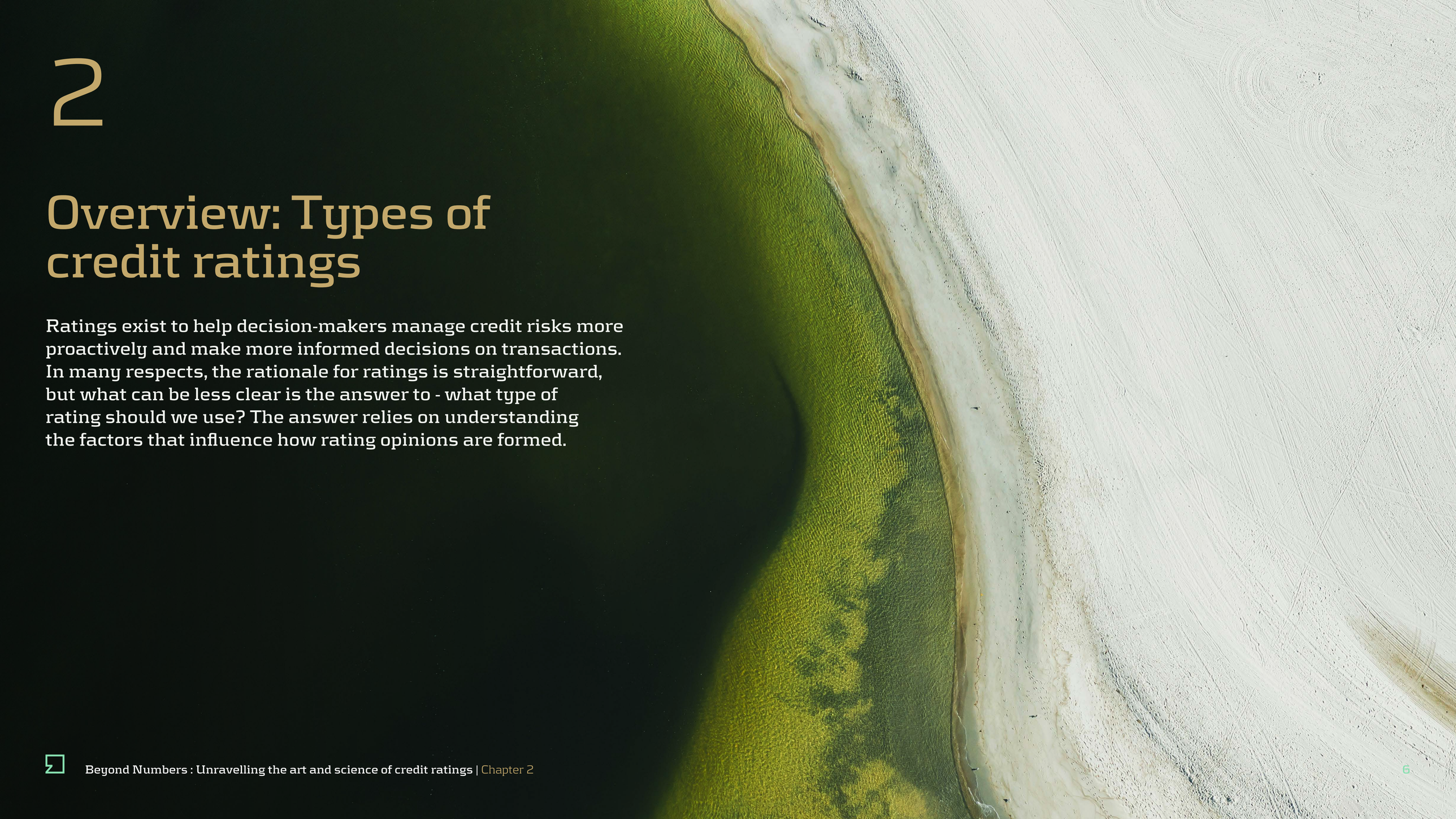
Beyond numbers

Credit ratings have become a vital component when benchmarking the pricing of intra-group loans. However, optimal use relies on investors and stakeholders understanding the multi-dimensional nature of credit ratings and the impact of various influences on them. The objective of this paper is not only to explain the theoretical foundations of credit ratings (the science), but also to look beyond the OECD Guidelines to explore how you can optimize their application in the real world (the art). To achieve this, we explore best practice rating methodologies, various types of ratings, the effects of group support, and the notching approaches commonly used when evaluating creditworthiness.

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Overview: Types of credit ratings

Ratings exist to help decision-makers manage credit risks more proactively and make more informed decisions on transactions. In many respects, the rationale for ratings is straightforward, but what can be less clear is the answer to - what type of rating should we use? The answer relies on understanding the factors that influence how rating opinions are formed.



Differences in opinion

Understanding the different types of credit ratings and their methodologies is vital for all market participants. In this section, we clarify the main factors that differentiate ratings models and their methodologies. This can be broken down into three core categories:

- Subject of the rating: Issuer credit rating versus financial instrument credit rating
- Time horizon of rating: Long-term credit rating versus short-term credit rating
- Source of rating: Publicly available credit ratings versus credit ratings based on proprietary models

1. Issuer rating vs financial instrument rating

Credit ratings can relate to an entity itself or be assigned to specific financial instruments.

- Issuer ratings evaluate the overall creditworthiness of an entity, such as corporations, sovereign nations, or municipalities. They reflect the borrower's ability to meet its financial commitments on a broad scale and encompass all its debt obligations. A comprehensive analysis of a borrower's financial health is performed to reach the rating. This encompasses revenue stability, debt levels, liquidity, and profitability. Qualitative factors such as management quality, competitive positioning, and regulatory environment are also considered. The outcome is a long-term perspective on the borrower's capacity to serve its debts.
- Financial instrument ratings provide a forward-looking opinion on the creditworthiness of a borrower with respect to a specific financial obligation. Issuance credit ratings are targeted assessments of the risks associated with a specific debt security – such as bonds, notes, and loans. They, therefore, consider not only the ability of a company to repay its debts, but also the specific features of the debt being evaluated. This approach considers the relationship between this debt and other financial obligations from the borrower, notably, the rating of the debt under analysis.

In general, the issuer credit rating relates to a senior unsecured type of debt instrument. Therefore, in most cases, the issuer credit rating will match the issue-specific credit rating for the senior unsecured bonds the issuer has issued.

2. Short-term vs. long-term credit ratings

A rating estimates the capacity of the rated entity to meet its credit obligations during a given time horizon. The term covered is therefore an important factor in any credit rating analysis.

- Short-term credit ratings assess the issuer's ability to meet its obligations over a brief period, typically less than one year. These ratings are essential for commercial papers, short-term bonds, and other money market instruments. The primary focus is on liquidity risk and the borrower's cash flows and cash reserves.

- Long term credit ratings are opinions on the relative credit risk of fixed income obligations with an original maturity of one year or more. They examine the possibilities that a financial obligation will not be fulfilled and reflect both the likelihood of default and any financial loss suffered in the event of default.

3. Publicly available credit ratings vs. proprietary models

There are two main sources of credit ratings – public credit ratings and proprietary models. Both models serve similar purposes but differ significantly in their development, accessibility, and usage. Here we outline the main differences.

- Publicly available credit ratings, provided by well-known agencies like Standard & Poor's, Moody's, and Fitch, offer an independent assessment of the creditworthiness of entities such as corporations or sovereign states. These ratings are based on analyses of financial statements, market position, and other macroeconomic factors.

- Proprietary credit rating models are developed in-house by financial institutions, investment, consulting, or credit risk management firms. They are not available to the public. These customized models are tailored to the organization's specific needs and often incorporate a broader set of data, including non-traditional and real-time information, to assess credit risk. This allows for the reflection of all relevant characteristics of the financial instrument and borrower.

Both public and proprietary models play a vital role in financial decision-making. The choice between them depends on the specific requirements and capabilities of the user. A key consideration for transfer pricing, is in most cases publicly available credit ratings are only available for the group. There are two alternative routes available to determine a rating for a specific subsidiary. Firstly, by applying quantitative and qualitative analyses (described in Chapter 4) of the individual characteristics of the subsidiary using publicly available financial tools. Or alternatively, by employing the proprietary modelling offered by independent credit rating specialists.

In summary, while publicly available ratings provide a standardized benchmark for creditworthiness and are widely available, proprietary models offer more flexibility and can be adapted to evaluate niche markets and unique transaction types.



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Methodologies: Top-down vs. bottom-up

There are multiple approaches to determine the credit rating of a borrower. However, in the context of transfer pricing, the OECD Guidelines present two core methodologies: the top-down approach and the bottom-up approach.

Although the bottom-up approach is recommended as the standard for corporate borrowers, the guidelines recognize that, under certain circumstances, a top-down approach may be more suitable, depending on the specific context. In this section, we provide an overview of the two methodologies, followed by a deeper dive into the bottom-up approach in Chapter 4.

- **The top-down credit rating approach** begins with the credit rating of the entire group or the parent entity. Specific adjustments are then made to derive the credit rating of the individual borrower. The extent of these adjustments – for example, a single or two notches – depends on the subsidiary's role and importance within the group. Typically, the subsidiary is identified as core, highly strategic, or of strategic importance. This classification influences the degree of adjustment applied. However, such categorization of an entity is not supported in some jurisdictions. More information on the subsidiary's importance within in a group is provided in Section 4 under '*Implicit support*'.

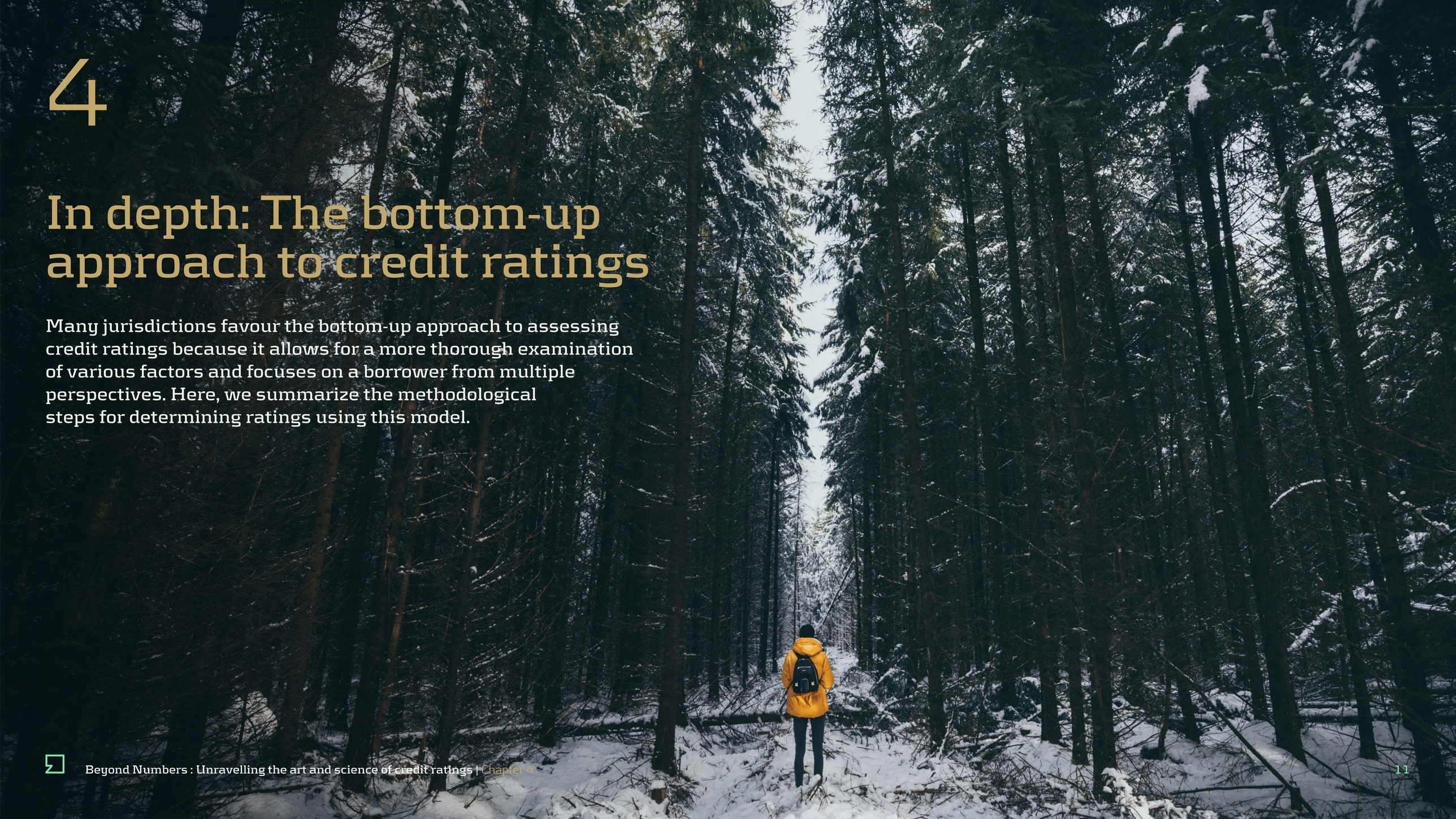
- **The bottom-up approach** focuses on the borrower's intrinsic characteristics, considering the broader industry and economic context as secondary factors. The analysis first evaluates the individual financials of a subsidiary to determine a stand-alone, individual credit rating applicable to the borrower. This consists of a detailed analysis of the borrower's financial health and business model. As a second step, the credit rating of the group is considered. Based on various qualitative elements and other factors, the rating for the subsidiary is notched-up towards the group rating. Depending on the importance of the subsidiary within the group, including the hypothetical willingness to provide support to the borrower, certain adjustments are made to determine the applicable credit rating for the borrower.

The bottom-up approach is recommended as the standard for corporate borrowers

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In depth: The bottom-up approach to credit ratings

Many jurisdictions favour the bottom-up approach to assessing credit ratings because it allows for a more thorough examination of various factors and focuses on a borrower from multiple perspectives. Here, we summarize the methodological steps for determining ratings using this model.



The bottom-up methodology determines a standalone credit rating for a company. The analysis driving this rating is multifaceted, incorporating both quantitative financial metrics and qualitative assessments of business operations. This holistic approach ensures it presents a meaningful reflection of an entity's financial health and operational robustness.

A two stage process

In general, the bottom-up approach includes two main steps:

1. Determination of a standalone credit rating of a borrower, considering quantitative and qualitative elements and utilizing proprietary credit rating models.

2. Assessment of potential group support and performance of the relevant adjustments in the context of transfer pricing.

Bottom-up methodology – a holistic approach to provide meaningful reflection of financial health and operational robustness

Step 1 - Determination of a standalone credit rating

Whether within the context of transfer pricing or not, establishing a standalone credit rating for a borrower typically involves both quantitative and qualitative evaluations.

Quantitative assessment

The objective of the quantitative assessment is to gauge the borrower's ability to meet its financial obligations. This involves analysis of financial statements – including balance sheets, income statements, and cash flow statements – with particular focus on financial ratios such as debt-to-equity, gearing, solvency, interest coverage, and operating margins. Quantitative assessment can also involve trend analysis and forecasting future financial performance.

Glossary: Key financial ratios used in quantitative assessment

The financial ratios that play a critical role in assessing creditworthiness are:

- **Debt-to-equity:** Indicates the proportion of equity and debt used to finance the company's assets. A higher ratio suggests more debt, implying higher risk.
- **Debt-to-EBITDA:** Measures the amount of earnings available to pay down debt before deducting interest, taxes, depreciation, and amortization. The lower the ratio, the higher the probability of the company successfully paying and refinancing its debt.
- **Interest coverage ratio:** Measures the company's ability to meet its interest obligations from its earnings. Lower ratios indicate potential difficulties in servicing debt.
- **Liquidity ratios (e.g., current ratio, quick ratio):** Assesses the company's ability to pay off short-term liabilities with its short-term assets. The higher the ratio, the greater the cushion between current obligations and a company's ability to pay them.
- **Gearing ratio:** Indicates the company's reliance on (often expensive) interest bearing debt. A higher gearing ratio implies a higher default probability.
- **Solvency ratio:** Measures how much a company relies on creditors to fund assets. The lower the ratio, the greater the financial risk.
- **Return on capital employed:** Indicates how successful management has been in generating profits (before financing costs) with all of the cash resources provided to them, which carry a cost, i.e., equity plus debt. It's a primary measure of overall performance, combining margins and efficiency in asset utilization. A higher ratio implies a lower default probability.
- **Operating margin:** Measures the proportion of a company's revenue left over after paying for variable costs of production – such as wages, raw materials, and other costs. A higher operating margin implies a lower default probability.
- **Turnover growth:** Indicates the annual percentage change in turnover. A higher turnover growth implies a lower default probability.

Qualitative assessment

The qualitative assessment considers factors beyond the financial statements. This analysis includes the portfolio diversification within the group, the quality of financial reports, the competitive position within the industry, the regulatory environment, market risks, and the overall business model's sustainability. The assessment is subjective and relies on the analyst's expertise to evaluate how these factors impact the borrower's creditworthiness.

A comprehensive evaluation of the borrower's business model is crucial. This includes analysing the entity's competitive position, market share, and the sustainability of its business model. Factors such as market dominance and adaptability to market changes can be considered. The assessment of management involves evaluating the experience, governance practices, and strategic decisions of the entity's leadership. Effective management is often correlated with strong financial performance and strategic resilience.

Qualitative assessment: Wider factors

The qualitative assessment also considers broader industry and market conditions, including:

- **Market volatility:** Entities operating in highly volatile markets may face more significant risks, impacting their creditworthiness.
- **Business risk:** Changes in regulations can significantly affect an entity's operational landscape and financial stability.
- **Economic trends:** Broader economic trends, such as inflation rates, interest rates, and economic growth, influence the entity's performance and its ability to meet debt obligations.

> The qualitative assessment considers factors beyond the financial statements such as portfolio diversification within the group, market risks, the overall business model's sustainability and various other elements

Step 2 - Assessment of potential group support

In light of the OECD Transfer Pricing Guidelines 2022, the effect of group membership may be an economically relevant factor that affects the subsequent pricing of financial instruments. Most tax authorities across the globe have taken comparable positions, concluding that the standalone approach doesn't mean that the affiliate should be treated as being independent from the group to which it belongs. Hence the credit rating assessment should take into consideration the fact that it's part of a group and therefore consider the operational and financial support it receives from the group.

Group credit ratings take into account the financial interconnections and support mechanisms within a corporate group. This holistic approach recognizes that a company's financial health can be influenced to a certain extent, or even significantly, by its relationship with parent companies and affiliates. As a result, a subsidiary's credit rating can be notched up to reflect the potential support from the group. We address notching adjustments in more detail later in this section.

Explicit support

Explicit support refers to legal agreements or guarantees provided by related parties to support the company in question. These agreements can significantly enhance an entity's credit rating by providing additional security to creditors.

Types of explicit support

Explicit support typically takes the form of the following written and binding instruments:

- **Guarantees:** Legally binding commitments by a parent company or affiliates to fulfil specific financial obligations of the entity.
- **Net-worth declaration:** Statements provided by a parent company or affiliates to maintain a minimum net worth in the subsidiary.

> A holistic approach recognizes that a company's financial health can be influenced to a certain extent, or even significantly, by its relationship with parent companies and affiliates

Implicit support

The OECD Transfer Pricing Guidelines emphasize the need to assess implicit group support in addition to explicit support. Implicit support encompasses rationally expected, though not legally binding, assistance from the group, i.e., the parent or subsidiary's affiliates. This type of support is based on the presumption of financial backing in times of need, reflecting the strategic importance of the company within the group.

Forms of implicit support

Indicators of implicit group support are typically the following:

- Historical precedents: Past instances where support was provided to the entity or others within the group.
- Strategic importance: The extent of the entity's role in the group's overall strategy.
- Shared branding/name and reputation: The extent to which the entity's brand is integrated within the group and the potential for reputational risks for the parent company in the case of a default.

Case law: Implicit support

Two landmark cases help corporates to better understand the details of implicit support – GE Capital and Chevron Australia.

- **GE Capital:** The criterion of this case largely overlaps with those set out by the OECD. It mainly gives practitioners more insight on how to interpret the 'strategic importance and operation integration' of the entity. During the case, it was concluded that this is linked to the size of the subsidiary and the longevity of the subsidiary, as well as the financial and managerial integration with the group.
- **Chevron Australia:** This case also deals with the definition of 'strategically important' entities. Corporates should therefore be aware that the OECD's definition of 'strategic importance' is not per se identical to the S&P definition (i.e., core, highly strategic, strategically important, moderately strategic, and non-strategic). However, the major issue addressed in this case is how to translate the level of implicit support into an upward adjustment of the stand-alone rating in terms of notches.

Finetuning a credit rating

The final bottom-up rating can also be impacted by the following factors: rating caps and ring-fencing and notching adjustments.

Rating cap and ring-fencing

A credit rating cap is a limitation or ceiling placed on the credit rating that can be assigned to an entity or financial instrument, regardless of its intrinsic credit quality. A company's credit rating is typically capped by the rating of the parent company, since the company may be negatively impacted by any credit events related to the group. However, in the case of ring-fencing, the parent cap should not be applied. There are various reasons for an entity to be ring-fenced, such as recent acquisitions and regulations.

> A credit rating cap is a limitation or ceiling placed on the credit rating that can be assigned to an entity or financial instrument

Notching adjustments

Notching adjustments in credit ratings refer to the practice of making modifications to the credit rating of the specific debt instruments of a company relative to its individual credit rating. They can result in ratings that are either higher or lower than the entity's general credit rating. The objective is to provide a more nuanced view than a single, blanket credit rating, helping investors understand the relative risks and ranking of various obligations of a borrower.

Notching adjustments are based on the particular characteristics or risk profiles of the financial transaction. This will depend on factors such as the priority of claims in the event of a default, the presence of collateral, the term to maturity, and the legal structure of the debt issuance.

This means, for example:

- Senior unsecured debt might have a different rating than subordinate debt issued by the same entity because the former would likely have a higher claim on assets in the event of bankruptcy or liquidation.
- Secured debt could be notched higher due to the additional security provided by collateral.
- Potential group support (explicit or implicit) might result in a notching adjustment of the borrower's credit rating.

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Conclusion: The art and science of credit ratings

In this paper, we've presented the core theoretical foundations of credit ratings (the science) and also the real-world considerations that will help you apply them in the most relevant and impactful way (the art).



Credit ratings serve as a crucial tool in the financial landscape, offering valuable insights into the creditworthiness of companies and their financial instruments. They facilitate informed decision-making by providing a standardized measure of the credit risk associated with borrowers and investment opportunities.

But it's important to also explore what's happening beyond the numbers – there's an art to applying credit ratings too. This requires investors and stakeholders to recognise and understand the multi-dimensional nature of how opinions on creditworthiness are formed and the various factors that influence them.

In this paper, we've explored the nuanced differences between the different types of credit ratings, best practices, and approaches typically applied in the course of assessments, with a particular focus on the bottom-up approach. In sharing this, our aim is to empower investors and stakeholders to approach credit ratings with knowledge, a critical eye, and with adequate consideration of all factors and their potential impact on their rating assessments.

When approaching credit ratings, it's crucial to delve deeper than just the numbers

Zanders Transfer Pricing Suite

With the growing complexity and constantly evolving practices in Financial Transaction Transfer Pricing, it is crucial for multinational entities to move ahead of the curve. Technology offers a once in a lifetime opportunity to minimize the compliance risks while freeing up time and resources.

The **Zanders Transfer Pricing Suite** is an innovative, cloud-based solution designed for companies looking to automate the Transfer Pricing compliance of financial transactions. With over five years of experience and trusted by more than 60 multinational corporations, the platform is the market-leading solution for intra-group loans, guarantees, and cash-pool transactions. Clients love us because of the:

- Transparent and high-quality embedded intercompany rating model
- Pricing model based on a search of comparable transactions
- Automatically generated 40-page OECD compliant TP report
- Benchmark rates, sovereign spreads and bond data are all included in subscription
- Hassle-free onboarding within a day!

The use of technology and automation offers several advantages:

- **Coherent methodology:**
  Automation ensures a coherent methodology across all transactions and entities, helping minimize risks and maintain consistency. This allows groups to have better control over the process and manage audits more efficiently.
- **Time savings:**
  Automating the analyses frees up resources, allowing tax and treasury professionals to focus on more strategic activities, enhancing the overall efficiency of the teams.
- **Reducing costs:**
  Automating the compliance process significantly reduces the costs associated with Transfer Pricing analyses typically charged by external advisors.

In conclusion, technology and automation, such as the Zanders Transfer Pricing Suite, play a crucial role in enabling corporates to implement a robust Transfer Pricing methodology while optimizing the use of time and resources.

More information on this solution is available on zanders.com

Are you taking the best approach to credit ratings?

Contact us today to explore how Zanders could help you apply credit ratings to accurately assess your credit risk exposure and form more informed opinions on intra-group loans.

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