Principles behind Credit Ratings

1. Objective 3
2. Credit ratings and credit quality 3
3. Assigning ratings to corporates and governments 4
4. Assigning instrument ratings to asset-backed transactions 5
5. Assigning ratings to hybrid entities or asset-backed transactions 6
6. External influence 6
7. The use of notching 7

1. Objective

This document forms the foundation for how EthiFinance Ratings (EFR) assigns and monitors credit ratings, whether for issuers or debt instruments. In areas where it has a critical mass in terms of the number of its credit ratings, such as corporates and securitizations, EFR has developed specific methodologies used to assign credit ratings which are available on its website and periodically reviewed.

This document considers the relationship between credit quality levels and EFR's credit ratings. It distinguishes rating approaches to assign ratings to entities such as governments and corporates, from asset-backed transactions such as securitizations or project finance, which have a finite life.

2. Credit ratings and credit quality

EFR's ratings are forward-looking opinions on the credit quality of an entity or an asset-backed transaction. These ratings should be broadly comparable across sectors and asset classes. This opinion expresses a distance to a potential default. The higher the rating, the higher that distance.

The rule of thumb when determining the driving factors of a credit rating is as follows:

- We expect that ratings will evolve over time, driven by the evolution of qualitative or quantitative factors related to the environment, the strategy and policies, or the performance of the rated entity or asset-backed transaction.
- The higher the rating, the more stable it is expected to be. EFR's rating approach for entities operating on a going-concern basis is a through-the-cycle approach which will tend to smoothen short-term cycles. For below-investment grade ratings, liquidity can potentially become a pressing concern. Therefore, below-investment grade ratings tend to be less stable, and EFR expects to adjust them more frequently in line with the operating environment, the financial performance, and the liquidity position of the rated entity.
- Over a credit cycle, investment grade ratings should display more stability than non-investment grade ratings, which EFR expects to review and adjust more frequently. Barring cases of fraud, an entity or asset-backed transaction rated BBB- or above is not expected to default over a moderate stress scenario over a time horizon of 3 years. We aim at having a maximum deviation of the credit rating of 3 rating categories over a 3-year period.
- If there is a high likelihood of default over the next 12 month, the rating of an entity or asset-backed transaction should be in the CCC, CC or C categories s. Rating scales definitions can be found on EthiFinance's website under the Credit Rating Agency's rating scales section https://www.ethifinance.com/rating-scales/ .
- EFR ratings typically do not exceed the sovereign rating of the country in which they operate. Exceptions to this principle may include, among others, supra-national entities, geographically diversified entities, or entities and transactions where EFR believes the sovereign risk has been mitigated.
- In broad terms, EFR ratings are assigned and monitored based on the assessment of the level and sustainability of future income and cash flows of an entity or transaction relative to its debt service, and all else being equal, the wider the difference, the better the rating. EFR generally combines the analysis of qualitative factors with quantitative factors to arrive at a rating.

3. Assigning ratings to corporates and governments

This section discusses the generic approach to rating financial and non-financial corporates, entities representing various levels of governments such as sovereigns and public finance entities, and supra-nationals such as multilateral development banks.

EFR first assesses the standalone credit quality of these entities excluding any form of external influence, such as guarantees, or effective control or influence by affiliates, governments or supra-national institutions, which we discuss in a subsequent section.

- Corporates

Corporates may include entities operating in a wide array of subsectors, including industrials, utilities, and entities operating in the financial sector but which are not regulated banks. To arrive at the standalone assessment of a non-financial corporate, EFR combines the evaluations of its business and financial risks. Qualitative factors underpinning EFR's business risk assessment include risks associated with the industry or industries in which the entity operates, its competitive positioning relative to sector peers, its management strategy and governance, and ESG factors. For utilities and non-bank financial companies, the assessment of the regulatory environment positioning is a key part of the business risk assessment. These factors will inform EFR about the level and sustainability of the entity's cash flows available for debt service. The assessment of financial risk is governed by quantitative factors specific to the sector, including leverage, interest coverage and capitalization ratios. The overall standalone assessment may be modified by considerations about country and liquidity risks.

- Banking Institutions

EFR ratings recognizes the confidence-sensitive and systemic nature of regulated banks, banking groups, and credit cooperatives operating domestically and internationally. Consequently, to arrive at the standalone assessment on a bank, EFR combines the evaluation of the macroeconomic and sector environment, including regulatory aspects, its competitive profile, ESG risks and strategy relative to sector peers, and its financial profile. The evaluation of macro and competitive factors informs EFR about the institution's earnings sustainability, and hence its capacity to maintain appropriate solvency and loss absorption during periods of stress. The financial risk assessment evaluates the bank's earnings, solvency, funding and liquidity, including its access to central bank liquidity. The overall assessment may be further adjusted to account for internal and external support mechanisms.

- Insurance Companies

EFR's insurance ratings cover companies engaged the life and non-life sectors, such as property and casualty insurance, trade credit insurance, and reinsurance organizations.

EFR follows a similar approach to assign ratings on insurers as it does for banks, combining the evaluation of the macroeconomic and sector environment, including regulatory aspects, its competitive profile, strategy relative to sector peers, and its financial profile. As with EFR's bank rating methodology, the evaluation of macro and competitive factors will inform EFR about the sustainability of the insurer's profitability, and hence its capacity to maintain appropriate solvency and loss absorption during periods of stress. The overall assessment may be further adjusted to account for internal and external support mechanisms.

- Asset managers

When rating an asset manager, EFR usually assesses several key factors, including the macroeconomic environment, the asset manager's business model, governance practices, and financial performance. Additionally, EFR analyses the potential for external support.

This assessment is structured around three main categories. Firstly, the "Operating Environment" category assesses the asset manager's external context by evaluating factors such as sovereign risk, industry strength, and regulatory landscape. Secondly, the "Business Profile" category evaluates the asset manager's business model, market positioning, and the quality of its management and governance. Thirdly, the "Financial Profile" category analyses the asset manager's financial performance and its ability to generate earnings. Finally, when analysing the potential for external support, EFR evaluates the supporter's creditworthiness and the likelihood of providing support to the entity.

- Sovereigns, Sub-sovereigns and government-supported entities

The government asset class includes sovereign governments, local and regional governments, and entities with a meaningful economic and policy link with the central, local and/or regional government.

EFR considers quantitative factors related to the macroeconomic environment, public finances, and the sovereign's ESG performance as well as qualitative factors that address structural aspects not captured by the quantitative variables. Variables related to the macro-economic environment and ESG factors inform EFR about the level and sustainability of a sovereign government revenues, and hence its borrowing capacity all else being equal.

For sub-sovereign governments, qualitative factors relating to the institutional framework and the government's effectiveness and quantitative factors regarding the macroeconomic and social environment provide an assessment of the level and sustainability of the government's revenues. The overall assessment is complemented with a quantitative evaluation of the fiscal situation.

For government-supported entities, EFR will usually rely on applicable criteria for the corresponding asset class, combined with the assessment of external influence as detailed in section 6 of this document.

4. Assigning instrument ratings to asset-backed transactions

EFR includes a wide range of sub-asset classes under the term asset-backed transactions, such as securitizations backed by a diversified portfolio of credit assets (e.g. mortgages, credit card receivables, loans or bonds); project finance transactions secured by infrastructure or industrial assets (e.g. wind farms, ports, toll roads); and debt transactions secured by real assets (e.g. aircrafts, inventories, real estate).

EFR considers both qualitative factors and quantitative factors to assign and monitor instruments ratings on securitized asset-backed transactions.

Qualitative factors generally include an assessment of the legal structure of a transaction and related documentation. The most common approach to an asset-backed transaction is one where the assets are transferred to a Special Purpose Vehicle (SPV), but others exist. The insolvency remoteness of the assets means that the assets are protected from the insolvency risk of parties involved in the transaction (particularly the originator). When in doubt regarding the insolvency remoteness, EFR will consider linking the rating of the transaction to the creditworthiness of the asset originator.

Additional considerations include the assessment of mechanisms that bring creditor protection such as cash management provisions, payment priorities in case of debt subordination, commingling risk for tranched debt transactions, or performance covenants, to name a few.

In most asset-backed transactions, evaluating credit quality involves assessing the resilience of underlying assets under adverse economic conditions. This evaluation primarily relies on a detailed cash flow analysis using a bespoke quantitative model. Such a cash flow model incorporates the transaction's payment structure, related expenses, and credit enhancements, allowing simulation of various stress scenarios—from typical market fluctuations to severe economic downturns—to determine the maximum losses the transaction can withstand without defaulting on its debt obligations.

In the case of securitized transactions, and depending on specific asset characteristics, supplementary quantitative models or statistical simulations may also be employed to refine loss estimations across different rating categories. These models usually analyse factors such as asset concentration and diversification. In cases where historical performance data is unavailable, comparable transactions involving similar assets, academic research papers, or industry-specific studies may be used as proxies or references within these quantitative assessments.

Ultimately, the assigned credit rating reflects the maximum acceptable losses identified through these combined cash flow and quantitative analyses. However, if the transaction significantly depends on a third party, the rating may be constrained by that party's credit quality unless effective mitigating measures are implemented.

5. Assigning ratings to hybrid entities or asset-backed transactions

EFR at times may be asked to rate entities or transactions that call for an assessment mixing different analytical approaches. These could include, among many others, transactions straddling corporates and structured finance analysis, such as corporate infrastructure credits, public-private partnerships, covered bonds or different types of funds, real estate developers also acting as real estate investments companies. When confronted with such an entity or transaction, EFR will take a modular approach by combining principles from different corresponding asset classes.

6. External influence

Once EFR has assessed the standalone credit quality of an entity or a transaction, it considers the potential rating impact, positive or negative, from the influence that a third party may have on that entity. These considerations often arise with entities that are part of a group, or that have an economic and / or policy link with a government.

For example, EFR may limit the rating on a subsidiary with a stronger credit quality than its parent to the level, or close to that of its parent. Conversely, it may raise the rating on a weaker entity that plays an important role within a government.

Absent a guarantee from an entity with a stronger credit quality, EFR will assess the capacity and willingness of the influencing entity to support a weaker entity in an event of financial distress to determine whether a rating uplift is warranted. History shows that a parent or government with the capacity to support a weaker entity may decide against it in the event of financial stress as it concludes that this entity is non-strategic for them.

As the credit quality gap widens between an influencing entity and the weaker entity, EFR expects to see increasing concrete demonstrations of support to grant a rating uplift on the weaker entity. These demonstrations from the parent could include, for example, past or committed capital infusions, cancellation of distributions, preferred intercompany terms or operational support. Additionally, absent formal expressions of support, EFR may consider such factors as the degree of strategic importance of the weaker entity for its controlling parent, the level of management control and investment in the weaker entity and the domicile of the parent and the entity, among other aspects.

Only in rare cases would EFR consider raising the rating of the weaker entity near or to the level of its parent's rating if the credit quality gap is important. These cases could include, for example, situations where an entity plays an absolutely essential role for a government or a corporate parent. In most cases, however, EFR expects the rating uplift to be limited to a few notches, if any.

If an entity or transaction benefits from an irrevocable and unconditional guarantee, or an equivalent such as bond insurance, EFR focuses its analysis on the credit quality of the guarantor, and in most cases, the guaranteed entity or transaction is rated at the level of the guarantor's rating. The guarantee or equivalent must be on demand and one of payment, not collection.

7. The use of notching

EFR derives the rating of a particular debt instrument/issue from a rated entity's issuer rating but may also assign different ratings to debt instruments based on its specific priority ranking , its relative recovery prospects. For example, a well-secured instrument (eg, covered with guarantees, collateralised assets) may be notched up to signal higher recovery prospects of that instrument relative to others in the debt structure of an issuer. Conversely, EFR may notch down a debt instrument that is subordinated to others.

Of particular note, EFR may also notch down debt instruments that are structurally subordinated to others to signal their lower recovery prospects. Structural subordination arises within a group in which an operating entity and a holding company both issue debt. The holding company's debt is said to be "structurally subordinated" to that of the operating entity. In an event of insolvency, the holding company debt holders would only have a residual claim on the operating entity's assets.