Rating Methodology

5 November 2021

Request for Comment: Financial Guarantors

Industry-specific rating methodology

CCXAP publishes Request for Comment (RFC) on the proposed rating methodology for Financial Guarantors.

Summary

China Chengxin (Asia Pacific) Credit Ratings Company Limited ("CCXAP") proposes to introduce a new methodology for assessing the credit quality of financial guarantors. The proposed methodology applies to financial guarantors globally, including guarantee companies, re-guarantee companies and other credit enhancement institutions with similar characteristics.

This proposed methodology introduces the key determinants for rating financial guarantors and explains in detail our approach to assessing each key rating determinant. It also includes a discussion of the availability of external support as well as assumptions and limitations underlying the rating methodology.

Impact on Ratings

CCXAP does not have any existing rated entities that match the scope of application of the rating methodology for financial guarantors, so the adoption of this methodology is not expected to result in any rating changes.

How to Submit Comments

In this request for comment, CCXAP invites interested market participants to submit written comments on the proposed rating methodology by 5 December 2021 on the Request for Comment page or via email at info@ccxap.com. CCXAP will review and take all received comments into account before publishing the methodology.

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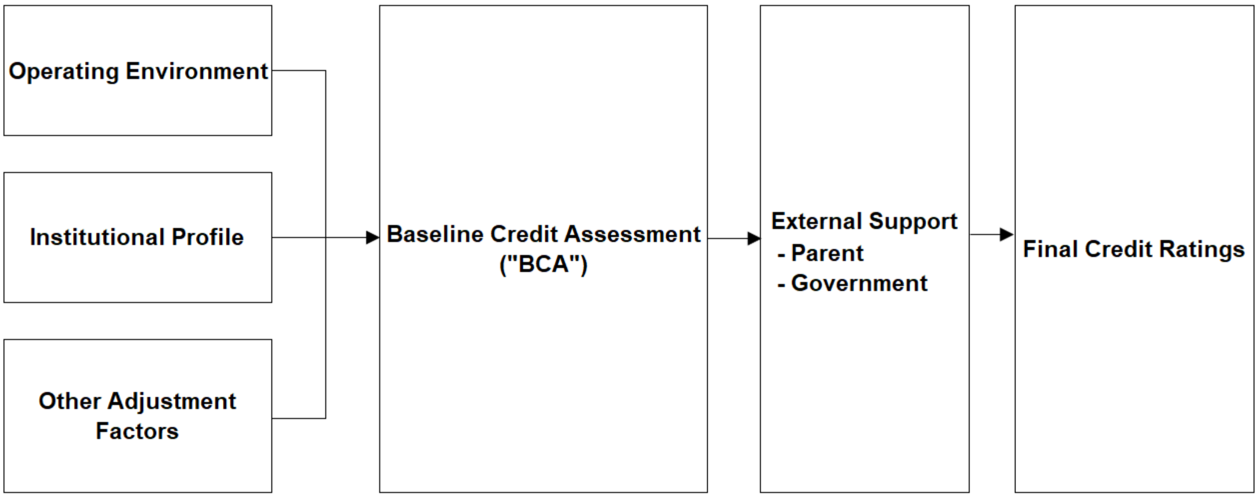
Introduction of Rating Methodology

Our analysis of financial guarantor follows the evaluation of the four key factors shown in Exhibit 1. It includes consideration of (1) operating environment, (2) institutional profile, (3) other adjustment factors, and (4) external support. The Baseline Credit Assessment ("BCA") is a combination of a financial guarantor's institutional profile, operating environment and other adjustment factors. After that, we will estimate the potential support from the shareholder or the government to reach the final credit rating.

Exhibit 1: Overview of CCXAP's approach to financial guarantor's rating assessment



Source: CCXAP research

This rating methodology provides a guideline that summarizes the important factors used in assigning ratings, but does not include an exhaustive description of all factors that CCXAP may use in its rating considerations. Thus, the mapped rating may not match the final rating of each rated entity.

Baseline Credit Assessment

The Baseline Credit Assessment ("BCA") represents the probability that a financial guarantor may fail to perform its obligations in the absence of external support from the government or the parent company. It mainly consists of three components: (1) operating environment, (2) institutional profile, and (3) other adjustment factors. This section discusses rating factors and sub-factors in detail, including their rationale and measurement standards and how they will affect ratings. The assessment is based on our forward-looking expectations and the historical results of the rated entities.

1. Operating Environment

The business performance of a financial guarantor will be affected by the operating environment in which it operates. We assess a firm's operating environment through (1) economic strength, (2) legal and regulatory strength, (3) industry structure, and (4) credit condition.

(1) Economic Strength

The intrinsic economic strength of an economy where a financial guarantor operates in makes a significant impact on its business prospects and performance. A country with robust economic base will increase its resilience to market fluctuations and strengthen its ability to sustain strong creditworthiness. We consider economic indicators such as size of GDP, GDP per capita, the diversification of industrial structure, GDP growth, and long-term trends. A firm operating in an economy with strong fundamentals can reduce the business risks that the firm needs to undertake. Conversely, a firm operating in a weak economy can be subject to high operating volatility.

(2) Legal and Regulatory Strength

The legal and regulatory environment is the base of business operations. A well-established legal system and a clear regulatory environment can help stabilize the regional financial system and reduce business risks. A well-regulated market environment requires financial guarantors to maintain a good management profile and avoid taking excessive risks. A prudent regulatory system has the following characteristics: high degree of transparency, independent regulator, and effective regulatory implementation and supervision. For countries with good protection of creditors, our score may also be higher.

(3) Industry Structure

Industry development and competitive landscape are of great significant to the long-term performance and creditability of financial guarantor. We have captured a number of the industry-wide factors that will influence a firm's performance as below:

- **Market size.** The size of the market is assessed such as the expected premium written or total industry revenue. The market size is a key determinant for the survival of the industry in the long run. It helps us understand the size of the risk exposure that can be tolerated within reasonable single-risk limits. If the market size is small, in the long run, it will restrict financial guarantors to generate meaningful profit to absorb the losses caused by the shock events. In addition, insufficient market scale would not allow them to undertake larger-volume issues and limit the market growth potential.
- **Market stability**. It measures the growth of the market size. A rapidly growing market may indicate a radical expansion of credit, which, given its high tail risk, makes financial guarantors more fragile against market shock. However, a contracting market, for example, having decreasing new underwritten business and premium rate, tends to impinge the profitability of financial guarantors.
- **Entry of barriers**. Low entry of barriers tends to intensify industry competition. This may put higher pricing pressure on premium rate and erode a firm's profitability in the long run.
- **Policy Support.** We may adjust this sub-factor score upward for good policy support to the industry.

(4) Credit Condition

We may make a downward adjustment in response to the poor credit condition of a financial guarantor. High level of debt or fast expansion in credit may cause credit quality problems. Higher outstanding debts relative to the national income may indicate more difficulty for the borrower to repay debt, thus increasing the risk undertaken by the financial guarantors. Meanwhile, the rapid growth of private sector credit may indicate greater risk-taking economic or credit activities, which often happen ahead of a crisis. In general, we use the ratio of domestic credit to private sector/GDP and the change in domestic credit to private sector/GDP to evaluate an economy's credit condition.

2. Institutional Profile

We use (1) business profile, (2) profitability, (3) quality and characteristics of portfolio, and (4) capability of risk resistance to assess the institutional profile of financial guarantees.

(1) Business Profile

We have summarized a set of factors to evaluate the business operations of financial guarantors. They include market position, market share, reputation, ability to acquire new business, the risk measurement capabilities, and operating history. A firm with strong market position and remarkable brand name is likely to attract business and has higher pricing power, compared with weaker firms. We also tend to give better scores for firms with reliable risk measuring skills, which in turn can avoid taking extra risks at the same price level. Firms that can get through economic cycles will score higher than firms with limited operating history. We may lower a firm's score due to poor operating history and notorious brand names.

(2) Profitability

Profitability is a key indicator of the ability of a financial guarantor to generate capital, absorb losses, and recover from shock events. Retained earnings are generally the primary source of capital accretion. A firm with strong and stable profitability can help it maintain a high level of retained capital and creditworthiness. A firm with weak profitability or persistent losses cannot overcome tail events such the 2008-09 financial crisis, which may significantly erode the firm's capitalization and liquidity within a short period. We use the return on equity (ROE) to measure a firm's profitability. The higher the ratio of a firm, the better its profitability. We also consider the stability of the firm's profitability as measured by the Sharpe ratio of ROE. The Sharpe ratio is calculated by dividing a firm's average ROE by the standard deviation of ROE over a five-year period. Even for firms with high profitability, if their profitability fluctuates significantly, we may negatively adjust this sub-factor score.

(3) Quality and Characteristics of Portfolio

The guarantee portfolio bears most of the inherent risks of the financial guarantor. Thus, the quality and characteristics of its portfolio is a very important factor in our study of the potential impact of tail events. The claim rate may of low-quality portfolios may increase sharply during a significant market downturn or large credit events. Generally speaking, we begin with the accumulated claim ratio (as measured by accumulated claim amount/released amount of guarantees) to evaluate the historical result of a firm's guarantee portfolio. In addition, we will adjust the score of this sub-factor score based on the below factors, which include:

- **Risk Concentration.** It measures the risk concentration of the single largest obligor, as well as sector and geographic distribution. If a financial guarantor has a concentrated portfolio, the exposure to tail risks and volatility of performance tends to be higher. We may adjust upwards for a firm with diversified and low risk guarantee portfolio.
- **Product Complexity.** We will lower the score for a financial guarantee with more complex product mix, such as structured securities. Complex products will increase the opacity of risk assessment with higher modelling risk, decreasing the predictability and sustainability of a firm's financial performance.
- **Growth of Claim Rate.** The rapid increase in claim rate may indicate a significant deterioration in the quality of the portfolio. It may also indicate that the high correlation among its portfolio may further erode its capitalization and profitability.
- **Recovery Rate from Loss.** We may adjust upward for a firm with high recovery rate from loss of claim. The strong ability in loss recovery can reduce the amount of actual loss.

(4) Capability of Risk Resistance

The financial guarantor undertakes large tail risk in its guarantee portfolio. The point-in-time capital and liquidity are very important to ensure that the firm remains in business and pay claims. We access a financial guarantor's capability to resist potential risks from three aspects, including provisions on outstanding guarantee, high liquid asset and equity.

- **Provisions on Outstanding Guarantee.** It measures the provision coverage of the outstanding guarantees. The higher the ratio, the stronger the firm's ability to cover its potential claims on guarantees.
- **High Liquid Asset.** High liquid assets are assets that can be readily sold or pledged for cash, such as cash and cash equivalent and trading securities, which are important resources to support a firm to withstand unfavorable conditions. We also consider giving better scores to firms that primarily hold high-quality assets, such as high-rating government bonds or money market funds, which can be easily converted into cash without discounts.
- **Equity.** Equity is a useful indicator of a firm's ability to provide funds for business expansion and absorbing losses. The larger the equity base, the more confident the firm will approach new clients and the more flexible it will be in executing business plans. Regulators also require firms to maintain a sufficient equity base to continue operations. We may also adjust the sub-factor score by the equity structure.

3. Other Adjustment Factors

We will evaluate a number of qualitative adjustments based on the combination of a financial guarantor's operating environment and its institutional profile to capture other considerations that have not been fully reflected in the previous analysis, such as corporate governance, quality of management, and financing capabilities.

(1) Corporate Governance

CCXAP considers corporate governance, internal control, management quality, policies and procedures, organizational structure, ownership structure and related transactions. A heavy emphasis is placed on the quality of management and the board of directors to ensure that the financial guarantor operates properly in the interest of its stakeholders. It also includes the output of its corporate governance, such as the quality of operational and financial information provided and overall information transparency. In most cases, we may notch down a firm on poor corporate governance, but rarely notch up for good corporate governance.

(2) Quality of Management

We evaluate a financial guarantor's quality of management through its management behavior and development strategy. Management behavior includes their risk appetite and control. It can be assessed by the management's setting in underwriting standard, investment strategies, and growth appetite. We may notch down a firm on aggressive risk attitudes, such as loosening credit assessment policy, providing unreasonably high incentives on financial performance, and encouraging short-term risk-taking behaviors. For a new financial guarantor, we may lower its score for insufficient record on the quality of management. Conversely, even though it is unlikely, we may notch up a firm on an effective long-term strategic plan and conservative risk management that can materially improve its credit profile.

(3) Financing Capability

We mainly assess a financial guarantor's ability to access different funding on reasonable terms and cost. We recognize the importance of the fund-raising ability of a firm to maintain confidence in the capital market. A financial guarantor may face capital pressure on material unexpected events, such as acquisitions, large number of claims, or execution of growth plans. Easy access to fresh capital will be credit positive because it will provide the firm with higher financing flexibility. We will consider a firm's track record of capital market activities and the propensity for further fund-raising from capital markets.

External Support

In terms of external support, CCXAP considers both parent company support and government support that a financial guarantor would receive to decrease the likelihood of default.

Shareholder Support

The support from shareholders is conducive to the company's future development and overall credit worthiness. In assessing shareholder support, CCXAP considers the nature of the holding company, industry competitiveness and financial status. In addition, CCXAP uses a company's development strategy, market position, ownership structure and importance to shareholders to evaluate the availability of shareholder support.

Government Support

Government support means that when a company is facing severe pressure of debt servicing, the government would provide support to pay for the company's debt or take other actions to avoid default. In assessing the support from the government, CCXAP considers factors such as the importance of the company's assets to the government, the legal requirements and degree of oversight from the government, government support and bailout histories, and the financial strength of the government.

Assumptions and Limitations

The final ratings assigned are based on CCXAP's forward-looking opinions, which we assume any changes of the macro environment are aligned with our expectations, and do not incorporate any unanticipated changes, such as outbreak of war and destructive natural disaster.

CCXAP assumes that there is a strong correlation between the sovereign credit risk and the rated entity, while refinancing capability is the key driver of credit risk. The debt rating assigned is based on our view that legal priority of claims is the key factor affecting the ratings for different classes of debt issued by the same issuer. Also, we assume that the data used in the rating is true, legal and does not incorporate misleading statements.

The ratings incorporate our expectations of the rated entity's future performance, which are mainly deduced from the historical information via our forward-looking model. Under some circumstances, the expectations would incorporate confidential information. In addition, our expectations would consider the industrial trend, rival analysis, and other considerations. In any case, predication is subject to substantial uncertainty. Therefore, the mapped ratings may not match our final ratings. The ratings may include some qualitative factors. CCXAP would evaluate these factors in an objective and precise approach, but the assessment may be unavoidably affected by subjective view in some cases. Therefore, the weighting of rating considerations could be varied. Specifically, the variation in weighting would happen if the rated entity were in default or approaching to be in default.

Furthermore, the ratings rely on public information and information provided by the rated entity and underwriters. Despite the fact that CCXAP can ensure the integrity, truthiness, and completeness of the data, due to the delay of information, the ratings may on some occasions not reflect the rated entity's credit risk in a timely manner.

Apart from that, the ratings are decided by our rating committee and could be influenced by their empirical views which may not be incorporated in the rating methodology. As a result, the final ratings could be varied with the mapped rating from the methodology.

A credit rating is the analytical result of current credit worthiness and forward-looking opinion on the credit risk of a rated entity or a debt issue. Credit ratings issued by CCXAP are opinions on the current and relative future credit risk of the rated entities or debt issues, but do not address any other risks, including but not limited to liquidity risk, market price risk, and interest rate risk.

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