

ACRA

Methodology for Analyzing Relationships Between Rated Entities and the State

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Contents

1	Scope of methodology	3
2	Methodology basic principles	5
3	Analysis structure	6
4	Analysis procedure	7
4.1.	Systemic importance of a rated entity	7
4.2.	Level of state influence on a rated entity	8
4.3.	Final credit rating assignment	10
5	Assessment of sub-sovereign and municipal governing authorities' influence on the SCA.....	11

1 Scope of methodology

This Methodology for Analyzing Relationships Between Rated Entities and the State is used to evaluate the influence that the state represented by the Federal Government, subfederal and municipal authorities as well as other government institutions have on creditworthiness of rated entities, i.e., both financial and non-financial organizations.

Not being a comprehensive document, this methodology contains references to other methodologies of the Analytical Credit Rating Agency (hereinafter, ACRA, or the Agency), in particular, to those for assigning credit ratings under the national scale. This methodology is inapplicable for ratings of regional and municipal authorities or small and medium-sized businesses.

Rated entities, whose standalone creditworthiness assessments (SCA) have to be adjusted depending on the influence that the state has on them, are regarded as government-related rated entities. This implies that creditworthiness of such rated entity is determined not only by its standalone creditability, but also by its systemic importance for the national economy as well as by state influence on operating activities, financial standing and ownership structure of the rated entity.

Before applying this methodology, a preliminary rated entity SCA calculation is typically required. For that purpose, methodologies covering specific types of rated entities are applied, with possible adjustments for the influence of the state represented by the Government of the Russian Federation or regional authorities. If it is impossible to assess SCA but a rated entity is characterized by a very high level of importance for the national or regional economy and there is a significant or very significant state influence, the Agency sets a parity between a credit rating of a rated entity and a credit rating (credit estimate) of the Government of the Russian Federation or applies a discount to the sovereign risk level.

If a rated entity supported by the state is regarded as a part of a group or as a rated entity with foreign support, with those types of support playing the most significant role for this rated entity, then, in order to account for external support, dedicated methodologies (Methodology for Analyzing Relationships Between Rated Entities and Supporting Organizations Registered Outside the Russian Federation or Methodology for Analyzing Member Company Relationships Within Corporate Groups) shall have to be used.

This methodology shall be applied on a permanent basis until a new edition is approved by the ACRA Methodology Committee.

Credit ratings assigned according to this methodology shall be revised in compliance with the Federal Law of 13 July 2015 No 222-FZ On the Activities of Credit Rating Agencies in the Russian Federation, On the Amendment to Article 76.1 of the Federal Law 'On the Central Bank of the Russian Federation (Bank of Russia)' and the invalidation of certain provisions of legal acts of the Russian Federation, as well as in accordance with ACRA internal documents, but not later than 365 days past the date of the latest rating action.

In order to keep this methodology up to date, ACRA shall review and amend it in the following cases:

- over three instances of deviation from this methodology while performing rating activities over the course of one quarter;
- requirement for amendments based on the results of methodologies application monitoring conducted by the methodology group;
- conflict between this methodology and Federal Law of 13 July 2015 No 222-FZ On the Activities of Credit Rating Agencies in the Russian Federation, On the Amendment to Article 76.1 of the Federal Law 'On the Central Bank of the Russian Federation (Bank of Russia)' and the invalidation of certain provisions of legal acts of the Russian Federation;
- request for immediate revision of this methodology filed by the Compliance and Internal Control Service of ACRA.

ACRA shall review this methodology in accordance with its internal documents within one calendar year after the latest review date. A review may bring amendments to the methodology, or leave it unchanged until the next review.

Any deviation from this methodology in the course of its application shall be documented and disclosed on ACRA's official website www.acra-ratings.com simultaneously with a credit rating or a credit rating outlook publication and with an indication of reasons for such deviation.

If any errors that already affected or may potentially affect credit ratings and/or credit rating outlooks are detected in this methodology, ACRA shall conduct its analysis and review in accordance with the established procedure. Reports of each such instance and the updated versions of the methodology shall be submitted to the Bank of Russia in accordance with the set procedure. If errors discovered in this methodology may impact any previously assigned credit ratings, ACRA shall disclose such information on its official website www.acra-ratings.com.

If the planned amendments to this methodology are significant and affect or may potentially affect the current credit ratings, ACRA shall do the following:

- 1) file with the Bank of Russia and disclose on its official website www.acra-ratings.com the full information about the planned amendments to the current methodology, with an indication of reasons and consequences that such changes may entail, including impact on credit ratings assigned in accordance with this methodology;
- 2) assess the need for revision of all credit ratings assigned in accordance with this methodology within six months after the latest amendment date;
- 3) revise credit ratings within six months after the date of the assessment mentioned in the above paragraph, if the results of the assessment prove the need for their revision.

2 Methodology basic principles

The state represented by the Government of the Russian Federation possesses the highest creditworthiness level under the Agency's national scale (or the highest credit estimate).

This statement is based on the ability of the federal government to issue money, manage budget reserve funds, amend existing legislation, in particular, establish tax burden, govern cross-border cash and trade flows, allocate tax revenues among budgets of various levels as well as control activities of corporate entities and financial institutions associated with the state. Consequently, the state represented by the Government of the Russian Federation can shift fiscal and other cash flows in its favor, thereby ensuring continuous cash inflows into the federal budget for timely servicing and repayment of debt, nominated in national currency of the Russian Federation.

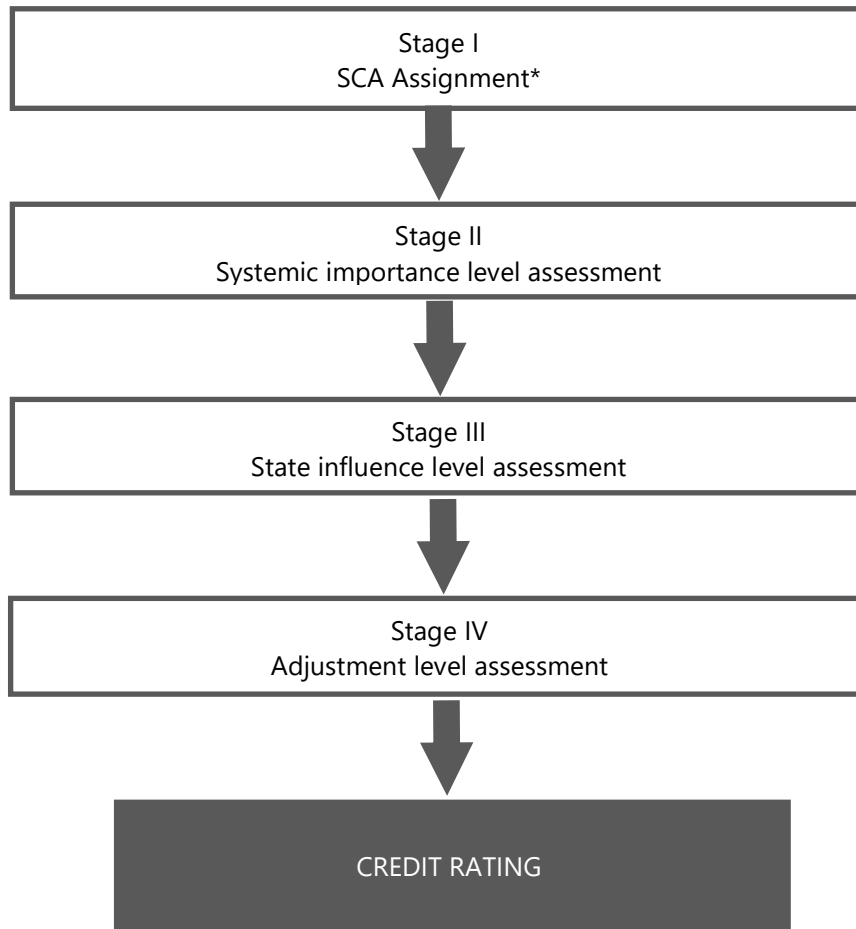
The main criterion that calls for SCA adjustments within the framework of this Methodology is the likelihood of state authorities providing extraordinary support to a government-related rated entity in the event of potential severe deterioration of the latter's finances.

It has to be taken into account that a significant stake in the share capital of a rated entity owned by the state shall not be regarded as a necessary and sufficient condition for credit rating adjustment for state support. At that, within this methodology not only state support of rated entities under direct control of the state can be assessed, but also that of rated entities, not owned by the state.

If the state provides direct guarantees for financial obligations of a rated entity, ACRA regards risks of such instruments as equal to the level of a sovereign risk and assigns the respective rating to them. If the state guarantee covers only a part of financial obligations of a rated entity or its selected financial instruments, a rated entity's SCA shall not be automatically adjusted to the sovereign risk level.

3 Analysis structure

Figure 1. Structure of analyzing relationships between a rated entity and the state



* If it is deemed impossible or impractical to determine the rated entity's SCA, Stage I can be omitted.

Source: ACRA

4 Analysis procedure

4.1. Systemic importance of a rated entity

In order to define the likelihood of state authorities providing support to a rated entity, ACRA analyses the latter’s systematic importance for the national economy and social sphere.

If a rated entity is an integral part of the national economic infrastructure or if it performs socially important functions, it may be an indication of its systemic importance. Termination or malfunction of a systemically important rated entity may entail negative economic and social consequences for the national or regional economy and cause reputational damage to the government.

Criteria for assessing systemic importance may include not only rated entity’s influence on functioning of separate sectors of economy or its economic role for a selected region, but also its importance as a source of income for federal or regional budget.

The Agency distinguishes the following levels of systemic importance of rated entities:

- **Very high** — a rated entity is an integral part of the national economy or performs socially important functions.
- **High** — a rated entity is an important part of the national economy or performs socially important functions.
- **Medium** — termination of rated entity’s operations will entail limited economic, social or reputational consequences for the national or regional economy.
- **Low** — termination of rated entity’s operations will not entail negative economic, social or reputational consequences for the national or regional economy.

Systemic importance level is defined by the Agency in accordance with assessment of factors, summed up in Table 1.

Table 1. Systemic importance level assessment

Systemic importance level	Very high (level 1)	High (level 2)	Medium (level 3)	Low (level 4)
Basic factors				
Affiliation with markets of strategic importance	Key player on a market of strategic importance for the state	Dominant player on a market of strategic importance	Significant player on a market of strategic importance	Marginal player or no affiliation with markets of strategic importance
Impact of a rated entity’s default on the economy	Threat for the national economy functioning. High risks for the population.	Threat for the existence of a separate sector and prospects of a significant deterioration for related industries. Moderate risks for the population.	Prospects of a significant deterioration for separate sector and related industries. Low risks for the population.	Marginal impact on the economy

Risks for the budget	Very significant loss of budget funds/very significant shortfall in revenue ¹	Significant loss of budget funds/significant shortfall in revenue	Moderate risks for the budget	No risks for the budget
Modifying factors				
Large employer on a national scale or a city-forming enterprise	Yes		No	
Supporting the needs of MIC	Yes		No	
Development institution	Yes		No	

Source: ACRA

Having been assessed, the above factors shall be weighted. The weights shall be distributed in equal proportion among three basic factors (each having 33.3%). However, if there are any modifying factors, the weights shall be proportionally redistributed (in the presence of all three modifying factors, the weights of each factor equals 16.7%). As a result of weighing all the factors, a rated entity systemic importance shall be assigned to one of the above four levels: "Very high", "High", "Medium" or "Low".

4.2. Level of state influence on a rated entity

When assessing a level of state influence on creditworthiness of a rated entity, the Agency relies upon economic nature of existing interrelation rather than on formal criteria of a legal status or exposure to state regulation.

ACRA distinguishes the following levels of state influence on a rated entity, which may lead to SCA adjustment:

- **Very strong influence:** operating activities and financial results of a rated entity fully depend on state decisions and actions.
- **Strong influence:** operating activities and financial results of a rated entity significantly depend on state decisions and actions.
- **Moderate influence:** operating activities and financial results of a rated entity (extraordinary support) depend on state decisions and actions in exceptional cases.

¹ Loss of budget funds implies shortfall in dividends, taxes, loss of public funds (incl. regional funds) and/or loss of state company funds deposited into accounts, invested in debt securities of a defaulted bank.

- **Weak influence:** operating activities and financial results of a rated entity depend on state decisions and actions in accordance with current legislation, which is taken into account with regard to SCA assignment in dedicated methodologies.

The level of state influence on creditworthiness of a rated entity is built on a number of factors including shareholder control as well as operational and financial control. ACRA takes into account not only the state’s actual stake in the rated entity’s share capital, which in itself is not a sufficient condition for very strong influence on a rated entity, but also the actual degree of the state involvement into its operating and financial activities. One of the key criteria is assessment of actual ongoing state support as well as its extraordinary support. State support may include direct financing of operating or capital expenditures, subsidizing tariffs or interest expenses, guarantying market debt obligations, taking part in state projects or other actions that help to improve rated entity’s operating results. Main criteria, used by the Agency for assessing the level of state influence, are summed up in Table 2.

Table 2. State influence level assessment

State influence level	Very strong (level 1)	Strong (level 2)	Moderate (level 3)	Weak (level 4)
Control	Shareholder and operating control	Operating control, no shareholder control	Shareholder control, no operating control	No control
Ongoing support	Ongoing direct subsidizing, investment program financing	Participation in state procurement and projects	Indirect support through demand stimulation	No ongoing support
Extraordinary support	Multiple cases of getting support from the state, willingness of the state to provide support in the shortest possible time	Several cases of getting support from the state in the past	One-off cases of getting support from the state	No cases of getting support from the state

Source: ACRA

As a result of assigning and weighing (each having 33.3%) all the above factors, state influence on a rated entity shall be assigned to one of the above four levels: “Very strong”, “Strong”, “Moderate” or “Weak”.

If a significant part (above 70–80%) of a rated entity’s debt is guaranteed by a supporting state government body, or a rated entity’s budget allows for the debt servicing and repayment, the Agency reserves the right to expertly adjust the state government body’s influence upwards — up to the “Very strong” level.

4.3. Final credit rating assignment

The higher the level of systemic importance and the stronger the state influence on a rated entity, the more significant the SCA adjustment. There are two methods, which can be used by the Agency to take into account the state influence on a rated entity's SCA:

- **Parity:** setting a rated entity credit rating on a par with a credit rating (credit estimate) of a public authority (or with a discount to its credit rating (credit estimate)) if there are indications of a very high systemic importance and exceptional dependence of the rated entity's financial position and operating activities from the state.
- **SCA adjustment:** adjusting a rated entity's SCA several notches up depending on the level of state influence on its financial position and operating activities.

The maximum level and type of SCA adjustment are defined in accordance with Table 3.

Table 3. Assignment of a final credit rating to a rated entity (the maximum credit rating level is specified)

		Systemic importance level			
		Very high	High	Medium	Low
Level of state influence	Very strong	Parity	Parity – [from 1 to 5 notches]	Not exceeding SCA + 3	Not exceeding SCA + 1
	Strong	Parity – [from 1 to 3 notches]	Not exceeding SCA + 3	Not exceeding SCA + 2	Not exceeding SCA + 1
	Moderate	Not exceeding SCA + 3	Not exceeding SCA + 2	Not exceeding SCA + 1	SCA
	Weak	Not exceeding SCA + 1	Not exceeding SCA + 1	SCA	SCA

Source: ACRA

In the course of assigning a final credit rating a certain adjustment level is selected basing on an expert estimate of quality and volume of state support.

In some cases, the criteria for assessing systemic importance and the level of state influence may not fully reflect the possibility and amount of extraordinary support received by the rated entity (these rated entities include state corporations, legal entities under public law, companies directly controlled by the Bank of Russia, government bodies that can provide support on a regular basis at the expense of available funds, and other organizations). The default of these rated entities may lead to distinct economic, financial and reputations risks for the state or create a domino effect. In such cases, the Agency may apply a 1–3 notch positive SCA adjustment to the final rating or limit the minimum rating to “parity minus 2 notches” in accordance with the approach to assigning the final credit rating to a rated entity described in Table 3. This methodology cannot be used for assigning credit ratings to companies with very high levels of systemic importance along with moderate or weak levels of state influence if it is impossible to assign SCA to them.

5 Assessment of sub-sovereign and municipal governing authorities' influence on the SCA

In the event of a rated entity receiving support from a sub-sovereign or municipal authority, ACRA shall take into account that the latter's credit rating (credit estimate) acts as a constraint providing the maximum possible amount of support. In this case, a rated entity's basic factors and systemic importance modifying factors should be assessed within the context of the supporting state government body, not within the country's context as a whole.

When the credit rating (credit estimate) of a sub-sovereign or municipal governing authority is assessed as "BB+(RU)" or lower (or the correspondent category of the credit estimate), the maximum permissible rated entity SCA adjustment is limited to two notches up and applies only when the governing authority exerts a strong or very strong influence on the rated entity.

If the credit rating (credit estimate) of a sub-sovereign or municipal governing authority is assessed above "BB+(RU)" (or the correspondent category of the credit estimate), the SCA adjustment shall be carried out in line with Section 4 of this methodology.

If determining the SCA is deemed impossible or unreasonable, but the systemic value of the rated entity for the regional economy is regarded as high and regional or municipal governing authorities have a strong or very strong level of influence on the rated entity, then in line with Section 4 of this methodology, the Agency shall assign a final credit rating based on the credit rating (credit estimate) of the sub-sovereign or municipal governing authority.

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