Crisil Ratings

Crisil Ratings criteria for factoring parent/ group/government linkages

February 2025

a company of S&P Global

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Crisil Ratings

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Crisil Ratings may notch up the standalone ratings of government-related entities (GREs) based on the probability and extent of distress support that the government could provide to them. Crisil Ratings classifies GREs into four categories based on the policy role they execute, and the economic and political implications of their default on the government. Based on the classification, Crisil Ratings decides if, and the extent to which, notch-up is to be provided to the GRE's standalone rating.

Scope

Crisil Ratings applies its notch-up methodology to the ratings of public sector undertakings (PSUs) that are majority owned by the Government of India (GoI). The framework may also be applied to entities that are not directly held by the government, but are majority owned by PSUs. GREs, therefore, include the whole gamut of entities that are likely to receive distress support from GoI.[1]

Parameters for assessing likelihood of GoI support

Crisil Ratings may notch up a GRE's standalone rating based on assessment of the policy role played by the entity, the government's moral obligation to support the entity, and the implications of default (*see Chart1*).

Chart 1: Parameters for assessing extent of notch-up

A. Policy role	B. Implications of default / Moral obligation
A.1. Criticality of sector A.2. Strategic importance	B.1.Domino effect B.2.Political / social implications of default B.3.Public perception of sovereign backing B.4.GoI's stated posture

A. Policy role

Crisil Ratings evaluates the GRE's role as an instrument of public policy, and the government's intention to retain the policy role with itself or with the public sector over the long term.

The criticality of the sector in which the GRE operates, and the entity's strategic importance within that sector are factors Crisil Ratings takes into account:

A.1. Criticality of sector: Sectors are classified as strategic or non-strategic to GoI based on the government's disinvestment policy, allocation of funds to different sectors, and discussions with government officials. Sectors such as defence that GoI views as its obligation are considered highly strategic.

A.2. Strategic importance: The extent of private participation in a sector is treated as a proxy for the strategic importance of a GRE within the sector. GREs performing critical government functions and operating in sectors in which the private sector's role is expected to be limited are considered strategically important to the government.

GREs that fulfil functions that GoI views as its obligation, and in which private sector participation is likely to be limited, score high on policy role. For instance, special purpose vehicles (SPVs) set up by GoI to raise resources for projects,

[1] *For the previous version of this article, please refer to the link below:*
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/criteria-research/archive/criteria-for-notching-up-standalone-ratings-of-companies-based-on-government-support-aug2024.pdf

such as railways, power transmission and road development, score high on policy role. PSUs in manufacturing industries, however, where the private sector plays a large role, score low on this parameter.

In February 2021, the GoI has announced its policy of **strategic disinvestment of public sector enterprises**. As per this policy, the GOI, intends to have a bare minimum presence in the strategic sectors, and the remaining will be privatized or merged or subsidiarized with other GRE or closed. As strategic disinvestment might take time to implement as suggested by past track record and might take shape in multiple forms – privatization, merger/ subsidiarization with other GREs and/ or closure, Crisil Ratings will adopt a case-specific approach towards notching its ratings. Such analysis will depend on the contours of the disinvestment exercise for a specific credit with focus on how the exercise may impact the issuer’s functioning as a GRE in the future.

B. Implications of default / Moral obligation

The following parameters help gauge the economic, political, and social implications of default by a GRE in debt servicing:

B.1. Domino effect: This parameter captures the economic implications of default. Crisil Ratings determines whether the default would have a localised impact or spill over to other entities in the sector. In the financial sector (particularly banks), for instance, default by one entity could lead to loss of confidence, even liquidity constraints, in other entities in the sector.

B.2. Political / social implications of default: GRE’s employee strength, the extent of unionisation, and the amount of outstanding retail and foreign currency debt are assessed to determine whether GoI could face political pressures in preventing a default. There would be considerable pressure on GoI to also support GREs that fulfil a social role.

The following parameters reflect moral obligations on the government to support a GRE in distress:

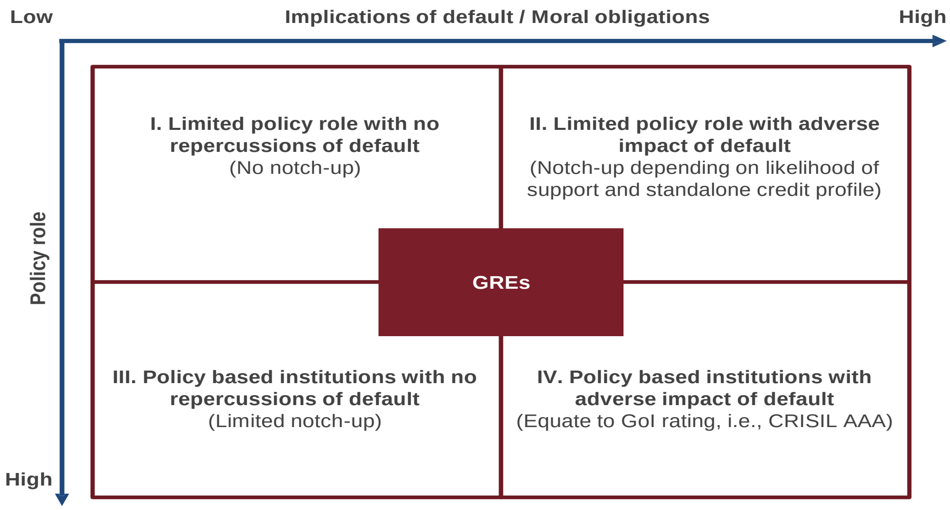
B.3. Public perception of sovereign backing: GoI often needs to intervene and support entities in case there is significant public perception of such support. For instance, GoI has set up SPVs to channelise funds to key sectors. The cash flow of many such SPVs are inadequate to meet the debt obligation. For such entities, resource availability from capital markets is based on a strong assumption of government support.

B.4. GoI’s stated posture: Letters of comfort or guarantees from the government for a GRE’s borrowing programme or capitalisation support reflect the government’s level of commitment towards it. Also, if a GRE is allowed by the government to issue tax-free bonds, there would be significant moral obligation on the government to extend support to the GRE if it falls into distress.

Extent of notch-up

Based on the assessment of these parameters, Crisil Ratings classifies GREs into four categories (see Chart 2):

Chart 2: Classification of GREs



I. Limited policy role with no repercussions of default: This category comprises GREs that are essentially commercial entities that play a limited policy role and whose default could have low political or economic implications. Such entities have low likelihood of support from GoI. Therefore, Crisil Ratings does not notch up ratings of such entities, and their ratings reflect their standalone creditworthiness.

II. Limited policy role with adverse impact of default: If an entity plays a limited policy role, but its default could have extreme adverse political and economic implications, Crisil Ratings believes GoI will intervene in time to avert such defaults. The extent of notch-up over the standalone rating may be much higher for such entities, and driven by the adverse impact of default and the difference between the standalone rating and GoI's rating.

III. Policy-based institutions with no repercussions of default: This category includes GREs engaged in sectors which have received significant government support through equity infusion and loans in the past. Crisil Ratings believes such support from the government is given to ensure solvency, but not necessarily to ensure timely debt servicing. Hence, Crisil Ratings may consider a limited notch-up over the standalone ratings of such entities.

IV. Policy based institutions with adverse impact of default: These entities carry out activities that are unlikely to be passed on to the private sector in the foreseeable future. Lack of government support to such entities may lead to funding and liquidity constraints, which, in turn, could impair resource allocation to target sectors envisaged by the government. Crisil Ratings, therefore, equates the ratings of such entities to GoI's rating, 'Crisil AAA'. For instance, regulatory agencies and SPVs established to channel resources (from capital markets) to key social or strategic sectors, and formed under special statutes, belong to this category.

Conclusion

Crisil Ratings government notch-up methodology factors in the likelihood that GoI extends support to the GRE in time of distress, depending on the policy role and implications of the entity's default on the government. Crisil Ratings classifies GREs into four distinct categories based on its assessment of the probability and extent of government support. The extent of notch-up to the standalone rating is determined by the category to which the GRE belongs.

Section II.

Crisil Ratings methodology for notching up standalone rating of companies based on parent support

Executive summary

While assessing the credit quality of subsidiaries, Crisil Ratings factors in the likely support from a higher rated parent in the event of distress. The extent of the support is based on a comprehensive framework that evaluates the economic benefits that will accrue to the parent due to its association with the subsidiary, and the moral obligation, corporate status, and demonstrated track record of the parent in extending such support.

Scope

This section[2] pertains to subsidiaries with significant shareholding by a clearly identifiable parent, and also JVs where two or more partners hold equal stake in the JV. The methodology may also be applied in case of step-down subsidiaries of an ultimate parent if Crisil Ratings believes that distress support to the step-down subsidiary will emanate from the ultimate parent, rather than the intermediate holding company.

Crisil Ratings notches up a subsidiary only when the credit rating of the parent is stronger than the standalone rating of the subsidiary. While the rating on the subsidiary is notched up for parent support, the likely impact of such support on the credit quality of the parent is also factored in.

The notch-up framework is typically applied when there is no explicit unconditional, irrevocable and continuing guarantee from the parent, but there is still intent on part of the parent to ensure timely support to its subsidiary, in the event of distress. In case notched-up rating is lower than the parent rating and if the debt instrument being rated is unconditionally and irrevocably guaranteed by the parent, backed by a robust payment mechanism, the rating on the guaranteed instrument of the subsidiary is equated with that of the parent, and suffixed by 'CE' (credit enhancement). This is done to highlight the credit enhancement in the form of guarantee and payment mechanism. For more details on guaranteed instruments, please *refer to section XI (Crisil Ratings methodology for instruments backed by guarantees) of 'Basics of Ratings', available on www.crisilratings.com.*

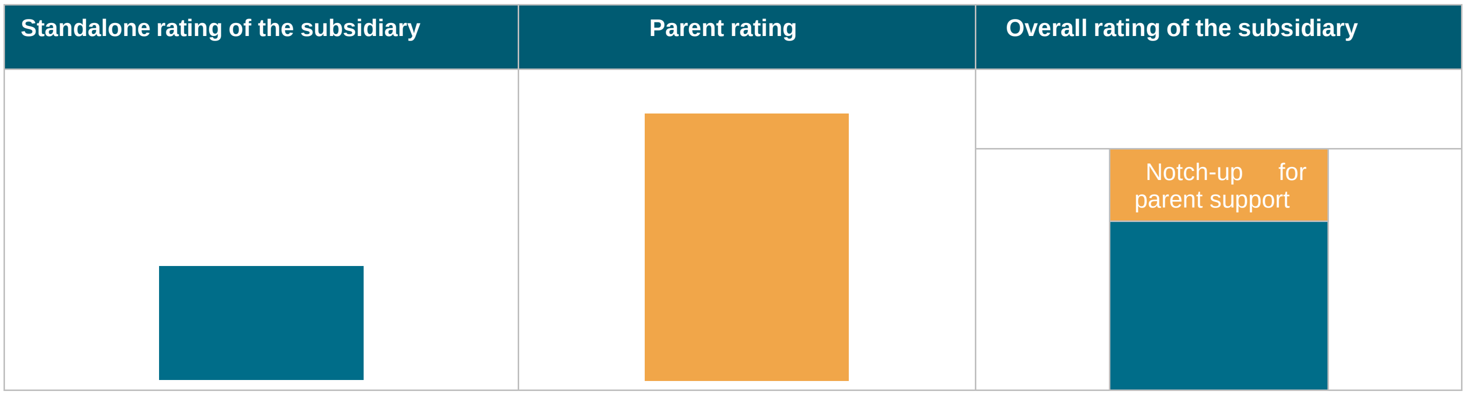
As for entities belonging to a strong group with common promoters and intra-group investments, Crisil Ratings adopts the methodology described below in section III on ' Crisil Ratings methodology for notching up standalone rating of companies based on group support'. When factoring in support from the government for government-related entities, Crisil Ratings employs its methodology described above in section I on 'Crisil Ratings methodology for notching up standalone rating of entities based on government support'.

Framework for notch-up based on parent support

The final rating of a subsidiary revolves around three critical aspects: the standalone rating of the subsidiary, the rating of the parent, and the extent of notch-up (*see Chart 3*).

[2] *For the previous version of this article, please refer to the link below: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/criteria-research/archive/criteria-for-notching-up-standalone-ratings-of-companies-based-on-parent-support-aug2024.pdf*

Chart 3: Overall rating of the subsidiary



Standalone rating of the subsidiary

This rating indicates credit quality without factoring in parent support. The rating is an assessment of the ability of the subsidiary to meet debt obligation on its own without relying on support from the parent, including for sustaining operations.

Parent rating

This rating indicates credit quality of the parent. Crisil Ratings factors the credit support extended to a subsidiary in the parent rating.

Crisil Ratings notches up ratings only when the parent rating is higher than the standalone rating of the subsidiary. The subsidiary's rating is notched up only in case the parent rating adequately captures the impact of the subsidiary's liabilities. For instance, in the case of ring-fenced special purpose vehicles (SPVs) set up by holding companies for executing projects (such as roads or power plants), the debt in such SPVs, due to their inherent riskiness, is usually structured with no or limited recourse to the parent. Support from the parent may be limited to meeting project cost overruns or shortfall in cash accrual to meet debt obligation only in the initial years. However, if Crisil Ratings believes that the linkage between the SPV and parent is exceptionally strong, the SPV may be fully integrated[3] with the parent, and in such cases, extent of notch up will be based on the framework described in the next section.

Extent of notch-up

Crisil Ratings employs its framework to estimate the extent of notch-up to be provided to the standalone rating of the subsidiary. The framework assesses the willingness of the parent to provide distress support and distinguishes between 'ongoing' support, when the subsidiary is doing well, and 'distress support', when the subsidiary is under financial stress. The framework is based on parameters that characterise the level of strategic and financial linkages between subsidiary and parent. These are broadly classified into factors that constitute the economic rationale of a parent for supporting the subsidiary, moral obligation on the parent to extend support, and the corporate status of the parent (*see Chart 4*). Crisil Ratings endeavours to hold periodic discussions with the management of the parent to ascertain their stance of supporting the subsidiary being rated and the parent's support philosophy is considered as an input while applying the framework.

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[3] *To understand how Crisil Ratings factors the impact of a subsidiary on its parent's rating, please refer to "Crisil Ratings criteria for consolidation" available on www.crisilratings.com*

Chart 4: Parameters for assessing the extent of notch-up

A. Economic rationale	B. Moral obligation	C. Corporate status of the parent
A.1. Strategic importance of the subsidiary to the parent A.2. Extent of parent holding A.3. Economic incentive to the parent	B.1. Extent of management control B.2. Shared name B.3. Domiciliary status B.4. Stated posture of the management	C.1 Listing status / Propensity to raise funds from capital markets

Economic rationale

The following parameters are evaluated in assessing the economic rationale for a parent to support its subsidiary:

A.1. Strategic importance to the parent: This is based on the relative size of the operations of the subsidiary with respect to that of its parent; the criticality of the subsidiary in terms of expansion plans, product launches, and market focus; and commonality in lines of business. Investments of the parent in other related subsidiaries having synergies with the subsidiary being rated are also considered. For captive finance companies, the extent of the parent's sales that are financed by these companies is taken as a measure of strategic importance.

A.2. Extent of parent holding (current and prospective): A higher shareholding of the parent in a subsidiary reflects greater commitment. Crisil Ratings notches up the rating depending on whether the parent is able to exert control over the subsidiary. For instance, the rating may be notched up even if the parent holds a stake of less than 50% provided the parent is the dominant shareholder and is able to wield control. In case of JVs where two or more partners hold equal stake, Crisil Ratings follows a different approach as described later in the section on JVs.

A.3. Economic incentive to the parent (current and prospective): A parent will be more likely to support a profitable subsidiary in temporary distress so as to prevent erosion of economic value of its investment. If a lossmaking subsidiary gets into distress, the parent may be reluctant to extend support beyond a point. Hence, economic incentive is a powerful reason for providing support, and is measured in terms of return on capital/assets employed, both in absolute terms and with respect to industry standards.

Crisil Ratings follows a forward-looking approach and takes a medium-term view on the economic prospects of the subsidiary, while also evaluating past trends and track record of performance. As for greenfield ventures, the timeframe set by the parent for the subsidiary to break even and the performance of the subsidiary in meeting specific targets set by the parent are also factored in while evaluating economic incentive.

Moral obligation

The following parameters constitute moral obligation on a parent to support the subsidiary:

B.1. Extent of management control: A subsidiary is considered to be under the control of its parent if:

- The parent exerts control over the board
- Daily operations are managed by the parent, or the parent conducts periodic reviews of operations
- Regular technical inputs are provided by the parent
- The subsidiary and parent have a common treasury

B.2. Shared name: This creates public awareness of the parentage of a subsidiary and displays the intent of the parent to associate itself with the subsidiary. As a result, moral obligation will be high on the parent to provide support. Even in the absence of a shared name, public perception of parentage – due to the sharing of brands, usage of the same logo, or acknowledgement of parentage on the website of the subsidiary – exerts pressure on the parent to provide support in case of distress.

B.3. Domiciliary status: This parameter assesses the relative ease with which a parent can transfer funds to its subsidiary, and the pressure exerted by common lenders and labour unions on the parent to support the subsidiary. Ease of transfer of funds and market pressure will be higher for a domestic parent vis-à-vis a foreign parent. In case of subsidiaries of foreign parents, the presence of common bankers, the role played by the subsidiary in the global supply chain and carved out bank lines of credit are factored in while evaluating the domiciliary status.

B.4. Stated posture of the management: The level of commitment of support is assessed on the basis of:

- Legally enforceable provisions, such as guarantees, put options, and cross-default provisions provided to the subsidiary's debt instruments
- Assurances from the parent, such as letters of comfort, keep fit letter, maintenance of a debt service reserve account, and shortfall undertakings
- Demonstrated track record of support in the form of regular equity infusion, extension of unsecured loans

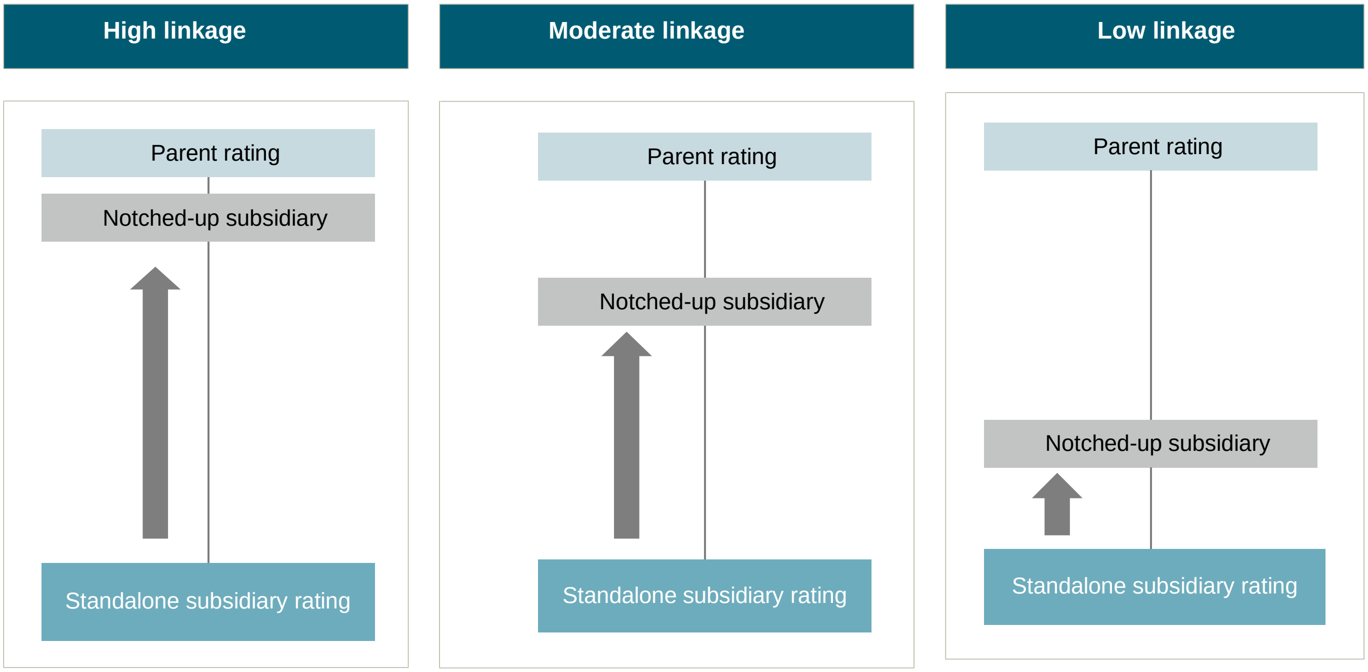
Corporate status of the parent

If the parent is a public limited company listed on a stock exchange, the propensity to support its subsidiary will be high as a default on debt obligation by the subsidiary may adversely affect any plans of the parent to raise funds from the capital market. For the same reason, unlisted public limited or private limited companies regularly raising funds from capital markets also have a high obligation to support their subsidiaries. An unlisted public limited company has a larger number of stakeholders than a private limited company, and hence, has a higher obligation to support its subsidiary.

Final rating of the subsidiary

Crisil Ratings does not notch up the standalone rating of a subsidiary if the linkages between the subsidiary and parent are weak as per the evaluation of the parameters listed in Chart 4. If the linkages are assessed to be very strong, the final rating of the subsidiary is equated with the rating of the parent. If the linkages are assessed as moderate, the final rating of the subsidiary would be somewhere between its standalone rating and the rating of the parent. (See Chart 5).

Chart 5: Determining the extent of notch-up



Usually, infrastructure SPVs are not notched-up / notched- up only to a limited extent of 1-2 notches for parent support. This is because, these entities are generally structured as ring fenced entities that raise debt without explicit recourse to the parent.

Moral obligation on financial sector parent

The implications of letting a subsidiary default are higher for a financial sector parent as money is the raw material for these entities. If such a default materialises, it will negatively impact the reputation of the parent and dent investor confidence, create trust deficit and adversely affect its business prospects. Hence, Crisil Ratings places higher weightage on moral obligation for subsidiaries of financial sector parents.

Joint ventures

Crisil Ratings exercises caution while notching up ratings on JVs where two or more sponsors hold equal stakes, considering potential conflicts that may arise between sponsors. Crisil Ratings may attribute support to a sponsor that articulates distress support to the entire debt of the JV. The attribution of support to one sponsor more than the others depends on the extent of criticality of the JV to that sponsor, business and operational linkages, perception of the bankers, infrastructure sharing, and managerial control. The extent of notch-up for the JV is as per the notch-up framework for parent support.

In exceptional cases, Crisil Ratings may attribute support to two sponsors with strong credit profiles, if Crisil Ratings believes that the JV is equally critical to both the sponsors holding equal stakes, the sponsors articulate distress support to the JV and Crisil Ratings believes that the sponsor interests are aligned

PE/Sovereign/Pension/ Insurance Funds

Typically, funds (floated by PE/Sovereign/Pension/ Insurance) invest in companies for limited duration before exiting for a profit. In these cases, the funds may not provide any distress support to the investee company. However, in the recent times, few large funds floated by PE players, sovereign funds, pension and insurance funds, have grown in size and have changed their orientation from a mere short-term investment to a medium-to-long term strategic support.

The change in orientation could be in one or more than one characteristic mentioned below:

- Longer duration of investment
- Majority controlling stake with an active treasury and management control
- Commitment to provide distress support to the company in case of any shortfall to meet debt repayment

In the above cases, the parent-notch up framework may be used to arrive at a moderate level of credit support, if any, from the funds to the investee company.

Conclusion

Crisil Ratings methodology for notching up ratings of entities based on parent support factor in three critical aspects:

- Performance of the subsidiary as represented by its standalone rating
- Ability of the parent to extend distress support as indicated by its rating
- Willingness of the parent to support the subsidiary, as determined by the notch-up framework

The extent of notch-up is based on parameters, such as the economic rationale and moral obligation of the parent to support the subsidiary, and the corporate status of the parent. Moral obligation is accorded greater weightage in case of subsidiaries of financial sector parents. The ratings of JVs with two or more partners holding equal stakes may be notched up for one sponsor depending on the criticality of the JV to the identified sponsor. In exceptional cases, support may be attributed to two sponsors holding equal stakes, if the JV is critical to both the sponsors.

Section III.
Crisil Ratings methodology for notching up standalone rating of companies based on group support

Executive summary

Indian business houses have a history of operating several companies in diverse lines of businesses. A group of companies may be identified by the presence of

- Common promoters,
- Significant cross-holdings and
- Sometimes, a shared name or logo.

While assessing the credit quality of companies belonging to a group, Crisil Ratings factors in the likely support that the companies may receive from the group. The benefit of a notch-up is, however, provided only to companies belonging to a group with a reasonably strong credit quality. Crisil Ratings considers the presence of a clearly identifiable parent as more favourable than being part of a group. Therefore, while there is no restriction on notch-up for parent support, the extent of notch-up for group support is typically limited.

Crisil Ratings employs a framework to decide if a company belonging to a group can be notched up, and the extent of it, for group support. The framework captures the degree of integration between the company and the group, and is based on a set of economic parameters, and moral obligation on the group to support the company.

Scope

This section[4] pertains to companies belonging to a group, held by common promoters or other companies in the group. In case of subsidiaries with a clearly identifiable parent, Crisil Ratings adopts the methodology described above in section II on *'*Crisil Ratings methodology for notching up standalone rating of companies based on parent support*'*.

The methodology applies to large groups with operations in multiple sectors and a relatively complex holding structure. These have ability to raise resources based on their brand or reputation in the financial markets. Most companies in the group may be listed, and each will have a professional management and a strong, independent board. However, the promoters will retain a sizeable stake (could be as low as 30%), and exercise control over companies in the group and over the board.

The methodology may not be applicable to a homogenous corporate group, operating as one single entity, under a common promoter or promoter family. Many promoters or families run medium-to-small groups in one or two business segments, but with several companies. These are typically termed homogenous group give high fungibility of cash flows, inter-company transactions and in certain cases, debt of companies are cross guaranteed.

For more details on such homogenous corporate groups, please refer to section II of *'Crisil Ratings criteria for consolidation'*, available on www.crisilratings.com.

Group support is factored into the ratings when the group company's debt is not explicitly guaranteed by another company in the group. If the instrument being rated is unconditionally and irrevocably guaranteed by another group company, backed by a payment mechanism, the rating of the instrument is equated to the rating of the guarantor, suffixed with the tag, CE (Credit Enhancement), to highlight the credit enhancement in the form of the guarantee and payment mechanism. For more details, please refer to *section XI (Crisil Ratings methodology for instruments backed by guarantees) of 'Basics of Ratings',* available on www.crisilratings.com.

[4] For the previous version of this article, please refer to the link below:
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/criteria-research/archive/criteria-for-notching-up-standalone-ratings-of-companies-based-on-group-support-aug2024.pdf

Assessing credit quality of group

The overall credit quality of a group is assessed to gauge its ability to support its members. The first step is to identify the companies that constitute the group. A company may be part of a group based on holdings by common promoters, investments by other companies in the group, or a shared name or logo. Crisil Ratings also evaluates the promoters' and management's willingness to identify a company as a member of the group.

The group's overall credit profile is analysed by factoring in the financial, business and management risks of its major constituent entities. Crisil Ratings also factors in diversity benefits from holdings in entities operating in multiple sectors, and the financial flexibility available to the group in the form of market value of its shareholdings.

The ability of stronger entities in the group to support other companies and the impact of such support on the overall credit quality of the group are evaluated. If the group's credit quality is pressurized on account of honouring the liabilities of weaker entities, it will impact the rating of the major constituents of the group.

Extent of notch-up

Crisil Ratings employs its group notch-up framework to estimate the extent of notch-up to be provided to the standalone rating of a company. The framework assesses the level of strategic and financial linkages between the company and group, and is based on the following parameters: the economic rationale for the group to support the company; and, factors that create a moral obligation on the group to support the company (*Chart 6*).

Chart 6: Parameters for assessing extent of notch-up

A. Economic rationale	B. Moral obligation
A.1. Relevance of company to group A.2. Extent of shareholding by group / promoters A.3. Economic incentive to group	B.1. Extent of management control B.2. Shared name / common logo B.3. Commonality of resources B.4. Management's stated posture

A. Economic rationale

The following parameters are part of the economic rationale for a group to support a group entity:

A.1. Relevance of company to group: The relevance of a company to its group may be evaluated based on the relative contribution of the company towards the consolidated turnover and profits and criticality of the company to the group's overall strategic interests. The promoters' outlook on the company's business is also factored in during the evaluation.

A.2. Extent of shareholding by group/promoters (current and prospective): This reflects a greater commitment towards the company. Crisil Ratings also takes into account holdings by other stakeholders, including dealers and employees, if their interests are aligned with those of the promoters.

A.3. Economic incentive to the group (current and prospective): If a firm is not profitable, its group may be reluctant to extend support beyond a point. But if a profitable firm falls into temporary distress, timely support by the group will prevent erosion of the economic value of the investment held by the group. Crisil Ratings follows a forward-looking approach on the profitability of the firm, taking a medium-term view on the company's prospects, but balanced by its past performance. In case of companies in the project stage, the timeframe set for the company to break even and contribute positively to investments made by the group is also factored in when evaluating economic incentive.

B. Moral obligations

The following parameters constitute moral obligations on a group to support an entity:

B.1. Extent of management control: The group's active involvement in managerial decisions and daily operations, sharing of systems and expertise between group and company, and the presence of a common treasury determine the extent of management control.

B.2. Shared name/common logo: This creates a moral obligation on the group to bail out the company in times of distress. Even in the absence of a shared name, integration of the company with the group may be manifested in the form of a common logo, or acknowledgement of group membership on public platforms, such as the company's website.

B.3. Commonality of resources: Market pressure in terms of common bankers, common location of operating units would increase the group's moral obligation to support the rated company. The pressure to bail out the rated company would also be high from the market, government and common lenders.

B.4. Management's stated posture: The track record of the group in extending financial support to group companies is considered an indicator of the management's stated posture. Crisil Ratings may not notch up companies in a group if the track record of supporting group companies is unsatisfactory. Guarantees and assurances, such as letters of comfort, or shortfall undertakings from one or more group companies also reflect the group's commitment to the rated company.

Final rating of group company

Crisil Ratings does not notch up the standalone rating of a group company if the strategic and financial linkages between the said parties are weak on evaluation of parameters listed in *Chart 6 (above)*.

In case of subsidiaries, it is possible to identify a single-parent entity that will provide distress support. However, if support is expected from a group of companies, it may not be possible to identify a single entity as the source of distress support, resulting in uncertainty regarding the extent and timeliness of support. Therefore, the extent of notch-up for group support is typically limited. This is in contrast to the notch-up of subsidiaries for support from a clearly identifiable parent, where no such restrictions apply.

Conclusion

Crisil Ratings group notch-up methodology factors in the ability and willingness of a group to support its group company in times of distress, depending on the strategic and financial linkages between the company and group. These linkages are captured in a framework, which is based on a set of parameters characterising the economic rationale for the group to support the company, the moral obligation on the group, and demonstrated track record of the group in supporting its companies. This framework is used to determine if, and the extent to which, the rating of a company is to be notched up for group support.

Section IV.
Crisil Ratings methodology for notching down standalone rating of companies based on support extended to parent

I. Executive summary

A parent, as the economic owner of a strong subsidiary, can - and often does - justifiably access funds generated by its subsidiary to support its own operations. While assessing the credit quality of subsidiaries, Crisil Ratings factors in the likelihood of a weaker parent using the subsidiary to support its credit profile. Crisil Ratings decides if the rating of a subsidiary is to be notched down for such support, and the extent to which this needs to be done, based on a framework that assesses the parent's ability and inclination to access the cash flows of the subsidiary.

Scope

Crisil Ratings applies its notch-down methodology[6] only when the parent's credit quality is weaker than that of the subsidiary. If the parent is stronger than the subsidiary being rated, Crisil Ratings may notch up the subsidiary's rating, as described above in section II on ' Crisil Ratings methodology for notching up standalone rating of companies based on parent support*'*. Crisil Ratings may also notch down companies that have higher standalone ratings than the group they belong to. For the purpose of this methodology, the terms 'parent' and 'group' may be used interchangeably.

While assessing the credit quality of the parent, Crisil Ratings typically takes a consolidated rating view of the parent and all its subsidiaries, including the subsidiary being rated.

Manifestations of support to parent

A weaker parent may access its subsidiary's cash flows usually through intercompany transactions which may include the following:

1. Purchase or sale of goods / services

- **Pricing terms:** The terms of the contract or agreement may be structured to maximise benefits, including margin, for the parent. This will enable the parent to book profit from operations carried out by the subsidiary. Furthermore, a subsidiary may offer higher discounts or incentives to its parent.
- **Credit terms:** The subsidiary may extend credit to its parent on more lenient terms compared with those offered to non-group customers in the normal course of its business, or may not actively manage its receivables due from parent and ultimately write them off as bad debt.

2. Borrowing or lending transactions

- **Funds exchange:** The subsidiary may extend inter-corporate deposits (ICDs) to the parent at concessional rates — or below the prevalent market rates — of interest. The parent entity can also extend ICDs to the subsidiary and charge higher interest payments. Alternatively, the parent may choose to raise fresh debt in the subsidiary's books, to be ultimately channelled onto the parent's balance sheet.
- **Guarantees:** The parent entity's debt may be guaranteed by the subsidiary. Providing such a guarantee could ultimately result in the subsidiary being required to meet the guaranteed debt obligation out of its own funds.

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[6]*For the previous version of this article, please refer to the link below:*
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/criteria-research/archive/criteria-for-notching-down-standalone-ratings-of-companies-based-on-support-extended-to-parent-aug2024.pdf

3. Equity investments

- **Special dividends:** The parent may route its subsidiary's funds to itself through 'special dividends'. The quantum of such a payout is typically significant and may be coincidentally close to the date when the parent is required to make payment on its maturing debt.

Extent of notch-down

Crisil Ratings employs its notch-down framework to estimate the extent of notch-down to be accorded to the standalone rating of the subsidiary. The framework assesses the ability and inclination of the parent to access its subsidiary's funds, and is based on parameters that gauge the degree of control exerted by the parent on the subsidiary and the ease of transfer of funds from the subsidiary to the parent (*see Chart 7*).

Chart 7: Parameters for assessing extent of notch-down

A. Management control	B. Ease of transfer of funds
A.1. Extent of parent's shareholding in subsidiary A.2. Parent's ability to wield control over subsidiary A.3. Corporate status of subsidiary	B.1. Common country of domicile B.2. Common treasury operations / bankers B.3. Past instances of not-at-arm's-length transactions / Parent's stated posture B.4. Regulatory or legal restrictions

A. Management control

The following parameters are typically evaluated by Crisil Ratings to assess management control exerted by a parent on its subsidiary:

A.1. Extent of parent's shareholding: The percentage of shares held by the parent influences the extent of control the parent may have over its subsidiary. The higher the holding, the greater is the parent's access to the subsidiary's cash flow. However, the presence of strong minority shareholders or multiple partners may prevent the parent from gaining unrestricted access to the cash flow of the subsidiary, and is factored in for gauging the extent of management control by the parent.

A.2. Ability to wield control: When the parent is able to exert control over its subsidiary, either through a common board of directors (or a common chief executive or financial officer; CEO/CFO) or through several common directors, there is high likelihood of unrestricted movement of funds from the subsidiary onto the parent's books. On the other hand, if there is a strong minority shareholder in the subsidiary with representation on the board, or if the subsidiary is listed and has independent directors on its board, the parent's access to the subsidiary's cash flow may be limited.

A4. Corporate status of subsidiary: Proprietorships, partnerships, or private/closely held companies are less strictly governed or regulated and, therefore, tend to be less transparent than listed entities. Also, the disclosure norms for listed entities are more stringent. So, the risk of the parent diverting cash flow from its unlisted subsidiary onto its own books is very high. If a subsidiary is listed, chances of a parent diverting funds from the subsidiary to itself are very remote, given strict disclosure norms.

B. Ease of transfer of funds

The following parameters are typically evaluated to assess the ease with which a parent can access its subsidiary's funds:

B.1. Common country of domicile: If the parent and its subsidiary are domiciled in the same country, the parent can gain easy access to the subsidiary's funds, because of no or limited legal or regulatory restrictions. This could translate into a high degree of commingling of assets or funds between the two entities. However, where the two entities operate out of different countries, the parent's ability to gain control over the subsidiary's funds may be constrained because of restrictions arising out of tax and regulatory barriers of moving funds from one jurisdiction to the other.

B.2. Common treasury operations/bankers: When the treasury functions/operations of a subsidiary and its parent are common or if they access common sources (such as common bankers) for meeting their funding requirements, the financial or operational integration between the two entities is high. In such cases, there are possibilities of the parent raising debt on the subsidiary's books, and ultimately routing the obtained funds onto its own books.

B.3. Past instances of not-at-arm's-length transactions/ Parent's stated posture: Regular instances of transactions between the parent and its subsidiary (in the form of ICDs or purchase-sale transactions) that are not transparent, or are not at an arm's length basis, indicate high chances of the parent to access the subsidiary's funds. Such transactions also reflect the parent's stated posture on deploying its subsidiary's funds, and may include concessional interest rates on ICDs advanced to the parent by the subsidiary, higher interest rates on ICDs advanced to the subsidiary by the parent, sales-purchase transactions designed to maximise benefits to the parent or instances of special dividend to the parent.

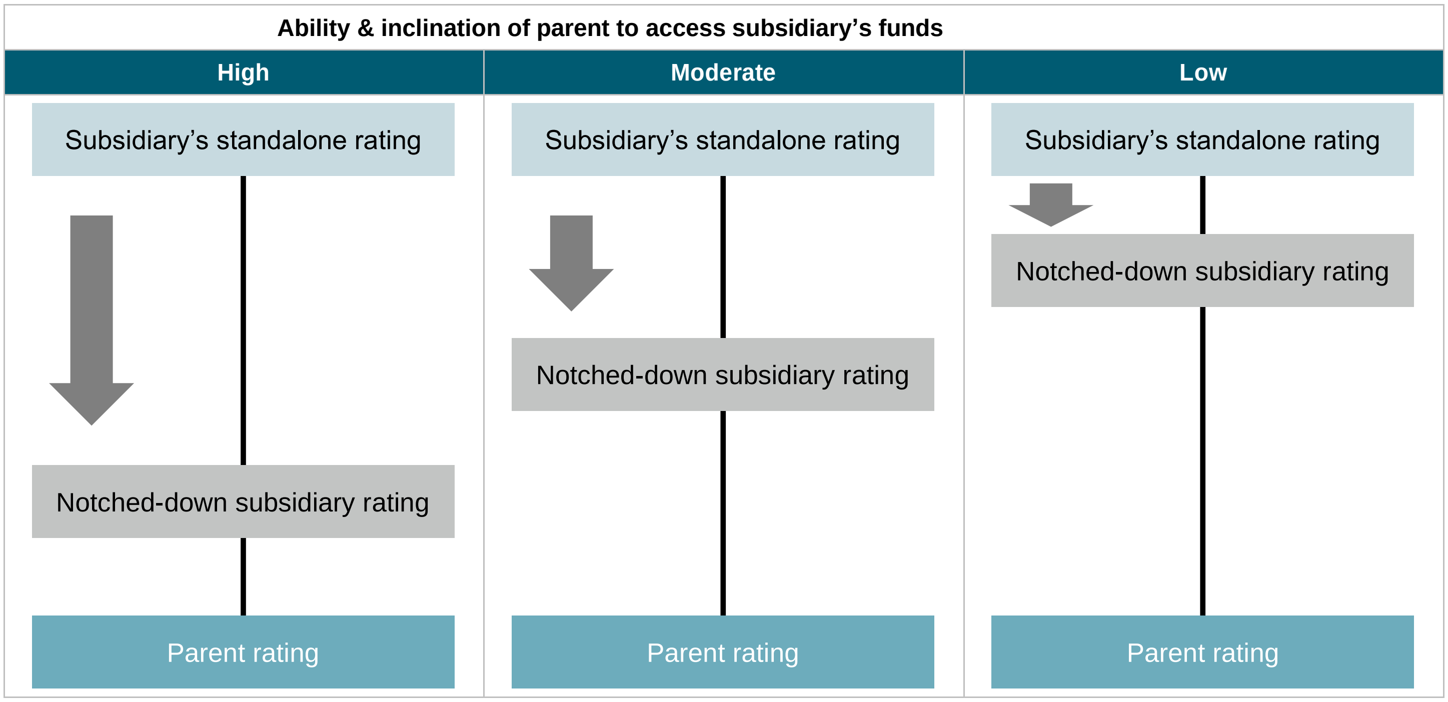
B.4. Regulatory or legal restrictions: Regulatory restrictions can limit the movement of cash flows from the subsidiary to the parent. These restrictions stand good even if the parent defaults, due to the lack of financial or liquidity support from its subsidiary. Unrestricted (not ring-fenced by covenants/regulations) access to dividends from the subsidiary points towards the parent's ability to route funds out of its subsidiary to itself.

Among these parameters, Crisil Ratings accords a higher weightage to the third parameter ("past instances of not- at-arm's-length transactions/parent's stated posture"). That's because these transactions provide the parent unrestricted access to the subsidiary's funds. While these transactions may not prima facie appear detrimental, they can potentially wipe out the entire networth or significantly impair financial flexibility of the subsidiary. The lower the transparency in dealings, the greater will be the parent's ability to act against the interests of its subsidiary's creditors/lenders.

Final rating of subsidiary

Crisil Ratings does not notch down the standalone rating of a subsidiary if the ability and inclination of the weaker parent to access its subsidiary's cash flow are considered to be very low, as per the evaluation of the parameters listed above (*see Chart 7*). If the assessment indicates very strong ability and inclination of the parent to route the subsidiary's funds to itself, the final rating of the subsidiary is equated with the parent's rating. In case the assessment is moderate, the final rating of the subsidiary would be somewhere between the parent rating and the standalone rating of the subsidiary.

Chart 8: Determining the final rating of subsidiary



Conclusion

Crisil Ratings may notch down the standalone rating of a subsidiary if its parent is rated lower than the subsidiary. Crisil Ratings employs a framework for determining whether the rating of the subsidiary needs to be notched down, and the extent of the notch-down. The framework is based on a set of parameters characterising the extent of control exerted by the parent on the subsidiary, and the ease of transfer of funds from the subsidiary to the parent, with higher weightage given to past instances of not-at-arm’s-length transactions/parent’s stated posture.

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