

Criteria for notching down standalone ratings of companies based on support extended to parent

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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 criteria¹ 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 per its '*Criteria for notching up standalone ratings of companies based on parent support*', available on www.crisil.com. CRISIL Ratings may also notch down companies that have higher standalone ratings than the group they belong to. For the purpose of this criteria, 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.

¹ This article is being republished following a periodic review of criteria in August 2021, with no major revisions. The previous version of this article, which was published in August 2018, can be accessed here: https://www.crisil.com/content/dam/crisil/criteria_methodology/criteria-research/archive/Criteria-for-notching-down-standalone-ratings-of-companies-based-on-support-extended-to-parent-aug2018.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 1*).

Chart 1: 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	B.1. Common country of domicile
A.2. Parent's ability to wield control over subsidiary	B.2. Common treasury operations / bankers
A.3. Corporate status of subsidiary	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.

A.4. 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.

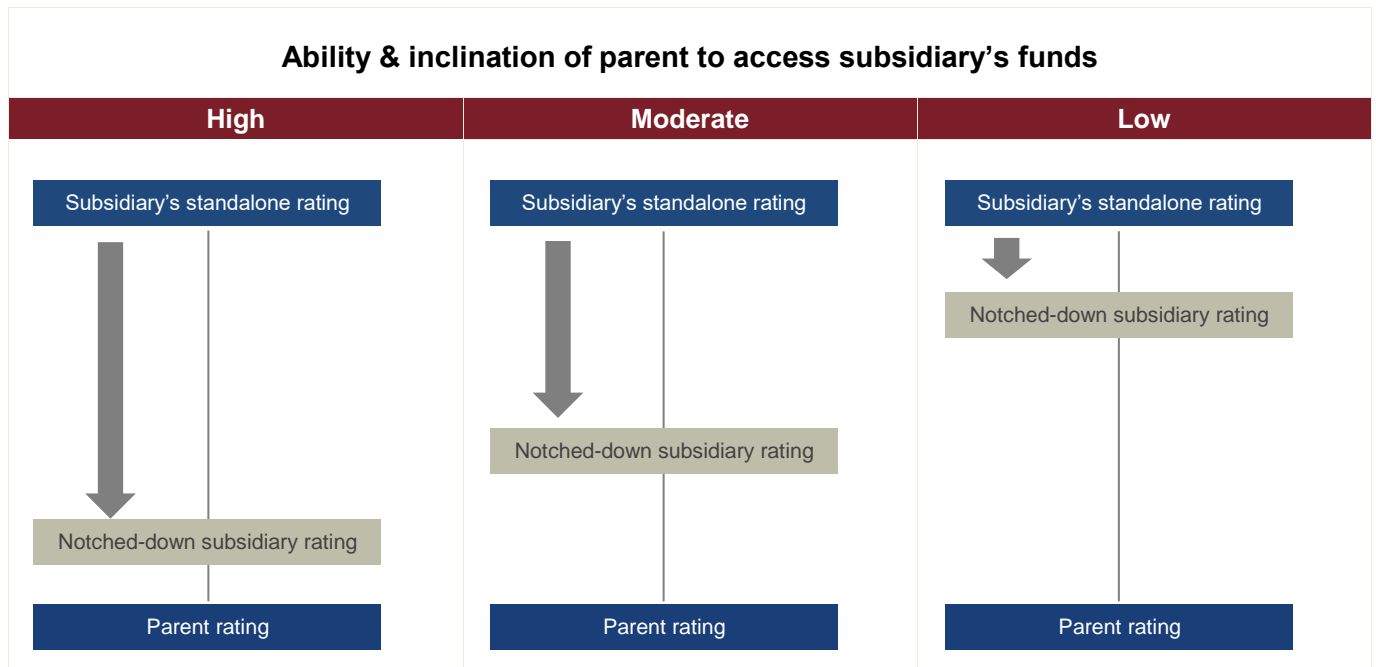
B.4. Regulatory or legal restrictions: Regulatory restrictions can limit the movement of cash flows from the subsidiary to the parent. These restrictions stand good even if the parent defaults, due to the lack of financial or liquidity support from its subsidiary. Unrestricted (not ring-fenced by covenants/regulations) 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 1*). 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 2: 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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