

# RAM

## CRITERIA & METHODOLOGY

August 2011

### Rating Approach for Government-Linked Entities

RAM Rating Services Berhad  
(763588-T)

Suite 20.01, Level 20  
The Gardens South Tower  
Mid Valley City  
Lingkaran Syed Putra  
59200 Kuala Lumpur

T +603 7628 1000  
+603 2299 1000  
F +603 7620 8251  
E [ramratings@ram.com.my](mailto:ramratings@ram.com.my)  
W [www.ram.com.my](http://www.ram.com.my)

# RAM

RATINGS



# CRITERIA & METHODOLOGY

## CORPORATE RATINGS

AUGUST 2011

### RATING APPROACH FOR GOVERNMENT-LINKED ENTITIES

#### Analytical Contacts:

*Adelia Abdul Rahim*  
Senior Analyst  
(603) 7628 1055  
adelia@ram.com.my

*Chong Van Nee*  
Senior Manager  
(603) 7628 1028  
vannee@ram.com.my

Government-linked entities ("GLEs") are defined as entities that are partly or wholly controlled by the Government, either directly or through government-linked investment companies ("GLICs"). The general methodology described in this paper excludes financial institutions ("FIs"). For details on RAM Ratings' criteria on rating FIs, please refer to our criteria and methodology on "Approach to Rating Financial Institutions", published in December 2008.

RAM Ratings' approach to rating GLEs begins by evaluating the relationship between the GLE and the Government. We will determine whether the GLE is "dependent" or "non-dependent" on the Government.

RAM Ratings classifies a dependent GLE as a specific-purpose entity, wholly owned by the Government to carry out specific government initiatives of national importance. We expect such an entity to operate on a non-commercial basis. On the other hand, a GLE that has less than 100% government ownership and runs on a commercial basis will be classified as a non-dependent GLE.

Some entities with little or no government ownership may also qualify as GLEs and could benefit from extraordinary support due to their vital roles as providers of crucial goods and/or services. Examples include entities in which the Government holds a golden/special share; this special share generally accords the Government the right to approve/veto major business and financial decisions, particularly of national interest.

This write-up describes our approach to rating a dependent GLE versus a non-dependent one. Obviously, determination of whether a GLE is dependent or non-dependent is crucial because each calls for a different rating methodology. It

Published by :

**RAM Rating Services Berhad**  
(763588-T)

Suite 20.01, Level 20  
The Gardens South Tower  
Mid Valley City  
Lingkaran Syed Putra  
59200 Kuala Lumpur

T +603 7628 1000  
+603 2299 1000  
F +603 7620 8251  
E ramratings@ram.com.my  
W www.ram.com.my

should be noted that the nature of the relationship between a GLE and the Government may change over time. Likewise, the methodology that we employ is not static. For example, the Government may reduce its shareholding in a previously dependent GLE, or that GLE may run on a more commercial basis in the future. RAM Ratings' approach will accordingly change from a dependent GLE to a non-dependent one.

### **Assigning a rating to a dependent GLE**

---

Dependent GLEs are primarily established to undertake specific functions on behalf of the Government. Their operations – including business direction – are, therefore, largely influenced by the Government. Funds for these entities are generally included in the Government's annual budget; any external financing will only be taken on with the Government's approval.

As they are not commercially driven, dependent GLEs normally rely on the Government for funds to sustain their operations. As such, the credit risk of a dependent GLE largely mirrors that of the Government. For this reason, the rating of the dependent GLE will generally be equivalent to the Government's, or notched down from it.

One such example is Pengurusan Aset Air Berhad ("PAAB"), a wholly owned subsidiary of the Ministry of Finance Incorporated. PAAB's Islamic debt securities (raised through a financing conduit in 2009) carry AAA/Stable/P1 ratings from RAM Ratings. PAAB forms part of the Government's efforts to restructure the nation's water-services industry, with the primary responsibility of developing the water infrastructure in Peninsular Malaysia, in line with the Water Services Industry Act 2006. PAAB's strategic importance is, therefore, unquestionable. Another example is Syarikat Prasarana Negara Berhad ("Prasarana"), whose debt issues are rated AAA/Stable/- by us. Prasarana is a 100%-government-owned company; it had been set up to own the assets of several public transport services under the Government's move to restructure the public transport system.

### **Assigning a rating to a non-dependent GLE**

---

RAM Ratings' principal methodology when rating a non-dependent GLE is summarised below:

- a) We begin with an evaluation of the creditworthiness of the GLE, without regard for any form of extraordinary government support. This is termed as the stand-alone credit strength ("SACS") of the GLE.

- b) We then assess the likelihood of extraordinary government support. We consider extraordinary support as being temporary, entity-specific and relating to the financial distress of the GLE, to enable the sufficient and timely repayment of its debt obligations.
- c) We will then determine the issuer rating (or corporate credit rating, or “CCR”) using a notch-up approach to the SACS. The number of notches or enhancement given (if any) will hinge on our opinion of the likelihood of extraordinary government support.



### 1) Determining the stand-alone credit strength of a non-dependent GLE

A GLE's SACS takes into account all aspects of its business model, including industry, business, management and financial attributes, as well as ongoing support and influence from the Government (whether positive, negative or neutral) by virtue of their relationship. Various forms of ongoing support, such as regular operating subsidies or grants and supportive regulatory regimes, are incorporated into our assessment of the SACS as it is an important element that supports the GLE's operations while playing a part in driving its credit metrics.

Compared to a dependent GLE, extraordinary support from the Government for a non-dependent entity is less certain, although it is often a beneficiary of ongoing government support in assorted forms. Therefore, a distinction must be made between potential extraordinary support and ongoing backing received by a GLE in the ordinary course of its business. Ongoing government support (if any) is considered in our assessment of the GLE's stand-alone credit strength. The likelihood of extraordinary government support is one of the factors that support the enhancement of the GLE's SACS to its CCR. In cases where the GLE largely operates as a commercial enterprise in a liberalised sector and government support is at "arm's length", then RAM Ratings may use its corporate methodology on parent-subsidiary rating links to rate the entity.

**Table 1: Examples of ongoing government support/influence**

Positive	Negative
Regular operating subsidies or grants	Price ceilings
Capital injections	Risky investment-project mandates
Access to preferential funding	Directives to provide goods/services at non-commercially viable rates/prices
Monopolistic position	Liberalisation of operating environment that introduced competition
Favourable contracts	
Supportive regulatory regimes	
Transfer of strategic assets	
Expedition of administrative processes	

## 2) Assessing the likelihood of extraordinary government support

RAM Ratings' assessment of the likelihood of extraordinary government support focuses on 2 parameters:

- a) The importance of the GLE's role to the Government.
- b) The strength of the relationship between the GLE and its government shareholder.

As mentioned earlier, support is considered extraordinary when it is temporary, entity-specific and relates to the financial distress of the GLE. It is also important to distinguish between the support extended by the Government to avoid default on the GLE's debt obligations, and backing that is aimed at ensuring the continuation of the GLE's services and safeguarding employment. The second instance would not necessarily reduce the likelihood of the GLE defaulting on its financial obligations, even though some form of support has been extended by the Government.

### a) Assessing the importance of the GLE's role on the Government

Here, RAM Ratings looks at the very function of the GLE. We will assess the essentiality of the infrastructure/goods/services provided by the GLE and if this can be easily undertaken by private entities. GLEs that provide essential goods/services, are not easily replaced, and/or operate in vital sectors are viewed to be of greater significance to the Government. The Government would thus be more likely to extend support to the GLE, should the need arise.

Our analysis will also consider the probable implications of a default by the GLE. Would it be disruptive to the GLE's activities and/or would it have a measurable impact on the general economy? If the answer is yes, then there should be a high likelihood of timely support. On account of the systemic risk posed by the failure of the GLE, we would expect the Government to step in to prevent a potential default.

In general, the more important the GLE's role, the greater the likelihood that it will receive some form of extraordinary government support in times of need.

Based on the preceding assessment, we will categorise the GLE as either "critical", "very important", "important" or "of limited importance".

### **b) Assessing the strength of the relationship between the GLE and the Government**

Our assessment of the strength of the GLE-government relationship is generally based on the following key areas.

#### Level of ownership

As a starting point, we will look at the Government's shareholding in the GLE. The higher the stake, the closer and stronger the relationship between the 2 entities. For example, we believe that the relationship with the Government is closer and strong for an 80%-owned GLE than a minority-owned ones, e.g. below 30%-ownership. The latter is likely to enjoy less rapport with its government shareholder.

#### Level of influence and integration

In addition to the level of ownership, we also appraise the level of influence that the Government exerts over the GLE. Is the Government an active investor/manager, or is it a passive shareholder? As an active investor, the Government is usually able to make key management appointments for positions such as managing director or chief executive officer, and appoint board representatives. Board and management control translates into a strong degree of government influence on the GLE's business and financial directions; this indicates a close relationship between the GLE and the Government. On the other hand, the Government may just be an inactive shareholder and not be involved in the management of the GLE.

Most non-dependent GLEs are indirectly owned by the Government via GLICs. We acknowledge that these GLICs may have different mandates and investment strategies with regard to their asset portfolios. Where possible, we will strive to meet up with the relevant GLIC to understand its strategy concerning its investment portfolio or a specific asset. This will help deepen our understanding of the Government's involvement in the GLE and the objectives set for it.

#### Privatisation status

In consonance with the aforesaid ownership factor, the status and motivation of the Government to privatise<sup>1</sup> or reduce its stake in the GLE is sometimes an indicator of the strength of the GLE-government relationship. We will look out for the Government's stated intention of reducing its stake in the GLE, or if there is a requirement for the Government to maintain a legal minimum stake in the GLE. We will also pay attention to any efforts by the Government to liberalise certain sectors of the economy, which could lead to keener competition for the incumbents.

#### Willingness to support vis-à-vis reputation risk

If the GLE is of national interest, this may encourage the Government to preserve the entity's creditworthiness because a default by the GLE could have major repercussions on the Government's reputation. We also believe that the likelihood of extraordinary support from the Government is high for a GLE that is high-profile and/or a frequent borrower in the international capital markets. Again, a default by such an entity would have major implications on the Government's reputation. It could also result in higher borrowing costs for the Government and adversely affect its ability to access the international capital markets.

Meanwhile, the Government may provide a full or partial guarantee on a GLE's debt obligations. It may also issue a public statement of support for the GLE, or provide letters of support. These are factors that may incline the Government towards extending timely support, should the need arise. For details on RAM Ratings' criteria on letters of support, please refer to our criteria and methodology on "Letters of Support", published in August 2011.

#### Government's general inclination to provide support

The Government's willingness to extend support to a GLE should be viewed hand-in-hand with its general inclination to intervene to provide backing. In some instances, while the Government may have a strong incentive and willingness to support a GLE, political, social, regulatory, and/or administrative constraints may prevent it from providing such support in a timely manner. Where the Government's policy on the provision of extraordinary funding is not prohibitive, and there have been instances of extraordinary support in the past, we tend to believe that the Government would lean more towards intervening and providing support. In such a case, the GLE-government relationship is perceived to be strong. That said, we are still mindful of the circumstances under which that extraordinary support had been extended in the past, as the reasons that had triggered such a reaction from the Government may not necessarily apply in the present situation. All said, the support assumptions would be reviewed if and when called for by developments, such as changes in administration.

---

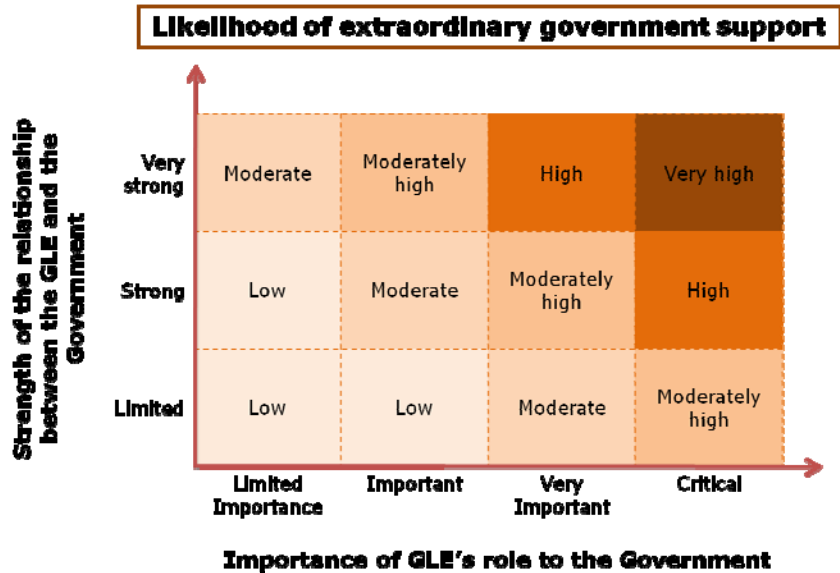
<sup>1</sup> By privatisation, we mean transfer of ownership in a business/entity, from the Government to private shareholders.

Based on our assessment, the strength of the relationship between the GLE and its government shareholder will be classified as either “very strong”, “strong” or “limited”.

**3) Enhancement of SACS to determine GLE’s CCR**

RAM Ratings uses a combination of the importance of the GLE’s role to the Government and the strength of the relationship between the GLE and the Government to arrive at an opinion on the likelihood of extraordinary support - which we label as “very high”, “high”, “moderately high”, “moderate” or “low”. Refer to Figure 1 below.

Figure 1: Assessing the likelihood of extraordinary government support



Depending on the category of likelihood of extraordinary government support, the level of enhancement (if any), i.e. number of notches of rating uplift, is applied to the GLE’s SACS to arrive at its CCR. As we move down the scale, from “very high” to “low” likelihood of extraordinary government support, the gap will narrow between the GLE’s SACS and its final issuer rating (or CCR).

For those with the likelihood of extraordinary support ranging between “moderate”, “moderately high” and “high”, the rating enhancement usually does not exceed 1 rating category or 3 notches from the SACS of the GLE. No rating enhancement will be accorded to the GLE that falls within the “low likelihood” category. Where the likelihood of extraordinary government support is deemed very high, the rating

enhancement could extend beyond 1 rating category. In this case, our opinion that the Government will likely extend extraordinary support in times of financial distress is generally a significant credit factor.

All said, financial support from the Government will only be possible if it has the financial capacity to provide such backing. The financial capacity of the Government to support the GLE is typically measured by or reflected in the credit strength of the Government. Therefore, the credit profile of the Government will be the rating ceiling for the GLE. For example, if the GLE's SACS is  $A_2$ , and the Government is rated  $AA_1$ , then the highest possible rating the GLE can attain is  $AA_1$ . Of course, the GLE may be rated lower than  $AA_1$ , depending on our view of the likelihood of extraordinary government support.

#### **Rating a GLE's subsidiaries**

When it comes to rating a subsidiary of a GLE, RAM Ratings will primarily employ the parent-subsidary rating approach. For details, please refer to our *Criteria and Methodology: Parent-Subsidiary Rating Links*, published in August 2011. It is generally assumed that the likelihood of extraordinary government support is significantly less for the subsidiary than for the parent GLE. The exception would be when the subsidiary itself is performing a function that is vital to the Government and its relationship with the Government is of significance. The subsidiary could then qualify as a GLE, and the GLE rating methodology explained here will also apply.

## Criteria & Methodology Corporate Ratings

No statement in this paper is to be construed as a recommendation to buy, sell or hold securities, or as investment advice, as it does not comment on the security's market price or suitability for any particular investor.

While every effort has been made to incorporate the salient points of RAM Ratings' experience in relation to the methodology, we note that the information contained could be updated and altered depending on changes in our internal views, market conditions, accounting practices and regulations. The methodology is also based on factors relevant to Malaysia and may require adaptation to local conditions.

Published by RAM Rating Services Berhad  
Reproduction or transmission in any form is prohibited except by  
permission from RAM Ratings.  
© Copyright 2011 by RAM Ratings

RAM Ratings receives compensation for its rating services, normally paid by the issuers of such securities or the rated entity, and sometimes third parties participating in marketing the securities, insurers, guarantors, other obligors, underwriters, etc. The receipt of this compensation has no influence on RAM Ratings' credit opinions or other analytical processes. In all instances, RAM Ratings is committed to preserving the objectivity, integrity and independence of its ratings. Rating fees are communicated to clients prior to the issuance of rating opinions. While RAM Ratings reserves the right to disseminate the ratings, it receives no payment for doing so, except for subscriptions to its publications.