

RAM

CRITERIA & METHODOLOGY

AUGUST 2011

LETTERS OF SUPPORT

RAM Rating Services Berhad
(763598-T)

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

T +603 7638 1000
+603 2299 1000
F +603 7620 8251
E ramratings@ram.com.my
W www.ram.com.my

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Analytical Contacts:

Wong Yin Ching CFA
Senior Manager
(603) 7628 1117
yinching@ram.com.my

Promod Dass
General Manager
(603) 7628 1190
promod@ram.com.my

RAM Ratings has rated debt papers backed by letters of support ("LOS") from the Federal Government, government-linked entities ("GLEs") and state governments; an LOS can also be provided by a private entity. Apart from debt issues, the LOS providers may even extend an LOS to an entity for the latter's overall debt obligations.

The objective of this paper is to explain RAM Ratings' approach to determining the level of enhancement, if any, accorded to the ratings of such debt papers or entities. This article is related to our criteria papers, *Rating Approach for Government-linked Entities* and *Parent-Subsidiary Rating Links*, published in August 2011.

RAM Ratings notes that legal opinions are mixed on the enforceability of such letters. However, the LOS generally is not tantamount to a guarantee and is not, from a credit-rating perspective, deemed legally enforceable. We emphasise that our qualitative assessment of the intention of the LOS, the likelihood of timely and adequate financial support in the event of need, and the form of support will determine whether we accord any rating benefit to the rating of the issue or issuer and the extent of such benefit.

The final section of this policy paper focuses on how an LOS plays a part in our rating assessment of development financial institutions ("DFIs"), where the provision of an LOS is a common occurrence. DFIs play a unique social and economic role in the overall development of the nation, and normally enjoy strong ties with the Government. In this context, the availability of an LOS is merely another indicator of the close rapport between the DFI and the Government, and cannot be taken as the sole factor driving the rating of that DFI or its debt papers.

Published by :

RAM Rating Services Berhad
(763588-T)

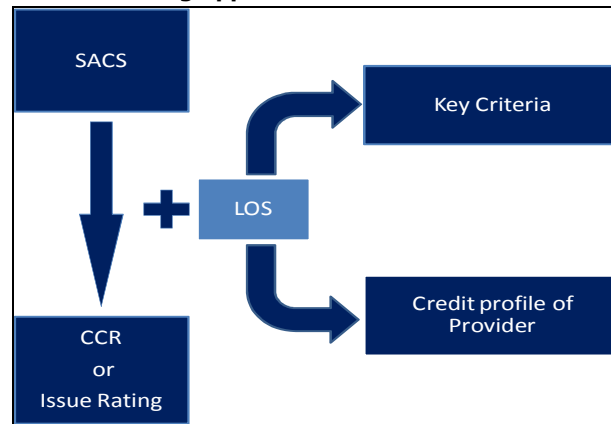
Suite 20.01, Level 20
The Gardens South Tower
Mid Valley City
Lingkaran Syed Putra
59200 Kuala Lumpur

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

Snapshot of Rating Approach

RAM Ratings’ assessment always starts from the stand-alone credit strength (“SACS”) of the issuer, which reflects its industry, business, management and financial attributes, and also ongoing support¹ by virtue of its relationship with the LOS provider. Once the SACS has been assigned, RAM Ratings will apply a set of key criteria when considering the potential rating benefits from an LOS; this is done in tandem with an evaluation of the LOS provider’s credit profile. This process will determine the issue rating or corporate credit rating (“CCR”). The rating is not derived from a legal perspective since RAM Ratings does not view such letters as being legally enforceable.

Chart 1: Rating approach



Key Criteria

- 1) Strategic importance of the issuer to the LOS provider
 - a) *If the LOS provider is a government*

The strategic importance or nature of the issuer to the Government plays a critical part in our analysis. We will observe how the issuer fulfils the Government’s key policies or broad agendas, and the extent of the potential economic, social and political consequences or repercussions the Government would experience if the issuer does not receive timely and adequate support to meet its financial obligations.

¹ Refers to various forms of ongoing support, such as tariff adjustments, pass-through mechanisms and regular subsidies or grants.

b) *If the LOS provider is a corporate*

Our assessment will establish if the issuer is a core or strategic business unit of the LOS provider.

- 2) Percentage of ownership (current and prospective), management control and the likelihood of privatisation that could weaken the strategic link with the LOS provider (in the case of GLEs).
- 3) The level of influence and extent of integration between the issuer and the LOS provider.
- 4) The significance of the LOS provider's investment in the issuer and the potential loss of credibility (and the extent of that) and/or damage to the LOS provider's reputation should the issuer default.
- 5) Demonstration of support extended in the past. In this instance, RAM Ratings will also note the reasons for such support, as they may no longer be relevant.
- 6) The provider's rationale or intention when extending the LOS to the issuer, and the stated financial policies of the LOS provider (if any), especially in relation to the provision of such financial support.
- 7) A shared/common name if the LOS provider is a corporate.
- 8) The capacity/financial strength and willingness of the LOS provider to extend support, viewed in conjunction with the relative size of the issuer's debt facility and the LOS provider's other obligations or commitments.
- 9) The likelihood and form of support that may materialise.

Generally, if RAM Ratings concludes that there is doubt on the timeliness and extent of financial support from the LOS provider to the issuer or issue, no rating benefit (or only limited) will be derived from the LOS.

RAM Ratings will continually assess the dynamics of the qualitative factors under the key criteria. Examples include a change in the issuer's role or a shift from its initial objectives, gradual divestment of the LOS provider's stake in the issuer, or a stated intention to privatise a government-owned company. Such changes, if deemed sufficiently material, could necessitate a reassessment of the rating,

especially if they erode the LOS provider's incentive to continue providing timely and adequate financial support to the issuer or issue.

Types of LOS

There are many variants of LOS; some are weaker or more loosely worded while others are strongly worded. Nevertheless, RAM Ratings focuses more on the *contents* of such letters and the intention behind the provision of the LOS, apart from other considerations such as the issuer's strategic importance to the LOS provider.

If the LOS is Viewed to be Weakly Worded

In a weakly worded LOS, the provider of the letter acknowledges that the issuer will be issuing debt securities. The former typically gives its assurance that it will use its "best endeavour" to ensure that the issuer complies with and performs its obligations according to the terms and conditions of the facility agreement.

From RAM Ratings' perspective, the LOS in itself, does not provide any credit enhancement to either the issue or the issuer. Generally, we adopt the bottom-up approach to arrive at the rating for the particular debt issue or issuer. The wording of the LOS, together with our assessment of the factors listed under the aforesaid key criteria, will determine the level of enhancement, i.e. the number of upward notches from the SACS. It should be noted that there could be instances where no enhancement be accorded at all. The rating "lift" from the issuer's SACS should also not cause the issue rating or CCR to be better than the credit profile of the LOS provider.

If the LOS is Viewed to be Strongly Worded

RAM Ratings views the LOS to be strongly worded when the provider's obligations are explicitly stated in the letter. Typically, this sort of LOS incorporates the provider's firm intention to support the issue/issuer, and the extent of such support. For example, "*...the LOS provider ensures, either by equity, advances, grants or other forms of loans, that the issuer will be in a position to promptly and fully meet its obligations to the bondholders...*". Although the LOS is not deemed a guarantee, RAM Ratings opines that such strong expression of support underlines the provider's obligations to the bondholders, and increases the strength of the letter. However, we emphasise that the provision of a strongly worded LOS will not automatically result in a credit enhancement. Any rating benefit will depend on our qualitative review of the factors under the set of key criteria discussed earlier.

It is possible for RAM Ratings to adopt the top-down approach for debt securities backed by a strongly worded LOS from the Government, when warranted. The number of notches down from the Government's rating will depend on our assessment of the key criteria, and will also take into account the practical considerations discussed in the next section. For strongly worded LOS extended by corporates, however, factors such as the adequacy of the LOS provider's financial strength to support the issuer or issue will play a greater role in the assigned rating.

Practical Considerations

As part of the rating process, RAM Ratings also considers the practical implications of the LOS. For example, the signatory of the letter should be a high-ranking or key decision-making officer of the company; this person should be authorised by the board of directors to sign such letters. Moreover, the act of issuing the LOS must not contravene the provider's memorandum and articles of association, and must be in accordance with any relevant government procedures or Act, if applicable. RAM Ratings' analysts will also meet up with the representatives of the LOS provider, to gain a better understanding of its intentions for providing the LOS and the strategic importance of the issuer to the provider.

Our analysis is complemented by a review of the mechanism or process vis-à-vis the flow of funds from the LOS provider in meeting the debt obligations, if required. Bond structures that incorporate milestone or trigger events that call for financial support from the LOS provider are important considerations, given that such mechanisms will increase the likelihood of timely fund infusions from the provider in avoiding a default. Such trigger mechanisms may include terms that require formal notification from the trustee to the LOS provider, to ensure that financial support will be extended within a stipulated period.

Conversely, potential escape clauses that allow the LOS to be nullified, e.g. in the event the provider ceases to be a majority stakeholder, will be viewed negatively. As far as possible, the transaction documents should clearly prohibit any sell-down of the LOS provider's stake in the issuer throughout the tenure of the debt securities, as this may weaken the provider's incentive to extend financial support to the issuer in times of need.

How the LOS Plays a Part in Rating a DFI

DFIs are effectively special-purpose vehicles of either the Federal Government or a state government, set up with a specific mandate to develop targeted key sectors that are considered of strategic importance to the overall socio-economic development of the country or the state. While RAM Ratings will first assess the SACS of the DFI, the strategic link between the DFI and the Federal or State Government is a paramount consideration in our rating of DFIs. In assessing the strategic link, RAM Ratings considers the following:

- 1) The strategic importance of the DFI with regard to its public-policy role in the socio and/or economic development of the state or country, and if such services can be easily undertaken or replicated by other financial institutions.
- 2) The State/Federal Government's track record of financial support for the DFI, such as capital injections or deposit placements.
- 3) The level of ownership by the State/Federal Government and the risk of privatisation that could weaken the DFI's strategic link to the Government.
- 4) The level of influence or degree of control exercised by the State/Federal Government over the business objectives and/or operations of the DFI.
- 5) If an LOS is issued by the Government, whether the letter is provided to the DFI or the debts issued by the DFI, the contents of the letter and the intention behind the provision of the LOS.

The LOS is therefore only a part of RAM Ratings' multi-faceted analysis of DFIs, and not the principal basis on which the rating is assigned. The provision of an LOS and the assessment of the language used merely form part of our evaluation of the credit link between the DFI and the State/Federal Government and, ultimately, our view on the likelihood of timely and adequate financial support being extended to the DFI in times of financial stress.

Criteria & Methodology

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.

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