

Criteria Report

Short-Term Ratings Criteria
for Corporate Finance

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■ Short-Term Ratings

Short-term ratings are assigned on a scale running ‘F1’, ‘F2’, ‘F3’ (in investment grade) and ‘B’, ‘C’, ‘D’ in speculative grade. Issuers or their obligations which enjoy outstanding liquidity features in the ‘F1’ category are additionally denoted with a ‘+’ modifier, to give ‘F1+’ ratings. The time horizon of the short-term rating extends nominally to 13 months, reflecting the 390-day maximum period of short-term instruments, although, as discussed below, for investment grade short-term ratings, this is an intrinsic rather than a ‘time-limited’ view.

Relationship Between Short-Term and Long-Term Ratings

While there are a large number of discrete factors which drive short-term ratings, a linkage has always existed between short-term and long-term ratings. In part, this reflects the inherent importance of liquidity and near-term concerns within a longer-term assessment. Additionally, it ensures that the two scales do not intuitively contradict each other for a given issuer. This linkage is outlined in Chart 1, and displays a certain asymmetry, namely:

- a. higher relative short-term default risk implies an elevated risk of default in the near-term which cannot be separated from the long-term default assessment; but
- b. lower relative short-term default risk, perhaps through factors which lend the issuer’s profile temporary support, may coexist with higher medium- or longer-term default risk.

The ‘mapping’ table thus limits the potential for a combination of a particularly weak short-term rating with a high long-term rating. The other asymmetry – stronger short-term rating but weaker long-term rating – is addressed conceptually. The short-term rating within investment grade is a measure of intrinsic or sustainable liquidity, which excludes temporary or unsustainable support.

Assessing Short-Term Ratings – Sustainable Liquidity

The time horizon of investment-grade short-term ratings does not explicitly relate to the 13 months immediately following a given date. Instead, it relates to the continual liquidity profile of the rated entity that would be expected to endure over the time horizon of the long-term IDR, typically 3-5 years. This approach places less emphasis on favourable or unfavourable features of the liquidity profile which may be regarded as temporary, such as high cash balances which would not be expected to be maintained, or a high degree of contractual certainty on revenues/cash flows for the next 12 months which will then roll off with a lower likelihood of replacement.

As a result, it is possible that this sustainable liquidity profile on which the short-term rating is based could depart from the actual, stronger (albeit temporary) liquidity profile of an issuer over the following 13 months. While this is therefore not an immediate

Table 1: Relationship Between Long-Term IDRs and Short-term IDRs/Instrument Ratings

Long-term IDR	Short-term IDR
AAA	F1+
AA+	F1+
AA	F1+
AA-	F1+
A+	F1 or F1+
A	F1
A-	F2 or F1
BBB+	F2
BBB	F3 or F2
BBB-	F3 or F2
BB+	B
BB	B
BB-	B
B+	B
B	B
B-	B
CCC	C
CC	C
C	C
RD/D	D

Source: Fitch

measure of liquidity, investment-grade short-term ratings benefit as a result from more stability over time since they will link to the issuer's sustainable liquidity profile. They will not reflect the volatility associated with increases or decreases in liquidity due to temporary factors.

In contrast, for speculative-grade ratings, greater emphasis is generally placed on the actual expected liquidity profile of the issuer over the 13 months that follow, including the impact of temporary improvement or declines in liquidity.

Investment-grade short-term ratings imply a satisfactory level of liquidity on an ongoing basis. Liquidity is judged by assessing a mixture of the operational or internal cash flow, capital structure,

available resources and other factors, relative to demands on liquidity that conform to the standard stresses associated with that sector and rating category.

An initial view on the short-term ratings is usually obtained by considering the issuer's long-term ratings based on the mapping in Table 1, and, in a second step where the issuer's long-term ratings would be consistent with more than one 'F'-rating, by referring to specific liquidity criteria relevant to that sector. Examples of specific considerations are included in the annexes to this report. Where an issuer demonstrates strong, specifically liquidity-related features in a broad range of categories (and no major deficiencies in any category), the higher 'F'-rating will typically be assigned.

■ Issuer Ratings versus Instrument Ratings

Issuer Ratings

Fitch's short-term ratings for issuers are denoted as Short-term Issuer Default Ratings ("ST-IDRs"). Issuer Default Ratings are Fitch's primary rating scale for entities and, as the name suggests, reflect default risk. Issuer ratings do not reflect relative prospects of recovery given default.

Although most issuers will typically be assigned both short-term and long-term IDRs, both may be assigned independently of one another (i.e. an issuer may be assigned only a ST-IDR, or only a long-term IDR, or both).

Instrument Ratings

Short-term ratings may be assigned to instruments with an original maturity of 390 days or less. Unlike long-term instrument ratings, ratings for short-term instruments do not incorporate loss severity, and are thus indifferent to nominal status as secured or subordinated issuance. Consequently, commercial

paper and other such instrument ratings are generally set at the issuer's ST-IDR. A distinction is occasionally drawn between the short-term rating of the issuer and the short-term rating of its instruments. The two primary exceptions to this issue/instrument linkage are:

- in cases where explicit and limited enhancement was provided (letters of credit-backed commercial paper, for example). The short-term rating on the instrument is assigned at a level that reflects the explicit enhancement; and
- in certain limited cases where preferences exist under law for a class of rated short-term obligations, such as deposits at US banks, and where the comparable long-term rating of the same obligation is itself consistent with a higher short-term rating (e.g. where a US bank has an IDR of 'BBB+', with commercial paper rated 'F2', but also has a long-term deposit rating of 'A-' and hence a potential short-term deposit rating of 'F1'). This reflects a belief that the higher prospects of support for depositors from central authorities as a class in general grant a marginal uplift to the liquidity of those obligations for depositors due to preferences explicitly defined in regulatory capital documents.

■ Considerations for Commercial Paperⁱ

The short-term instrument most commonly rated by Fitch remains commercial paper. Separate but complementary considerations apply to banks from those applied to industrial, utility and finance company issuers.

Fitch's guidelines apply to all corporate and bank programs in the U.S. and Euro CP markets. The size and liquidity of financial markets in different countries vary substantially, and the policies recommended for issuers in the U.S. and Euro markets are not necessarily applicable to corporate issuers in less liquid national markets.

Fitch's corporate rating committees may vary from these guidelines based on the special circumstances of individual issuers. Additional backup coverage above the minimum guideline level would typically be expected to support business growth.

■ Corporate and Finance Company Commercial Paper

Reviewing liquidity policies and actual practices is an important part of Fitch's overall corporate analysis. If a company's liquidity provisions are inadequate, it affects both the long-term and short-term credit ratings.

An excessive reliance on CP and other liquidity-sensitive short-term funding can heighten liquidity risk for a company. For finance companies, matching of the tenor of liabilities with that of the asset portfolio is an important component of the liquidity analysis. In other industries, the appropriate amount of total short-term debt, including CP, is determined in relation to net working capital and seasonal borrowing needs or to an amount that can be liquidated by expected operating cash flows. However, some issuers have relied on a permanent layer of CP unrelated to the normal cash conversion cycle or inflated outstanding CP to fund acquisitions without sufficient contingency planning including stock repurchases. When a company does so, it increases its liquidity risk.

Maturing long-term debt can also expose corporations to liquidity stress if the term of the debt is not matched to internal cash flows or maturing assets. Laddering debt maturities can help limit liquidity strains. Repayment of material debt maturities would usually be planned in advance, with contingency plans in case capital market conditions interfere with any expected funding.

What is Commercial Paper?

Commercial Paper (CP) is a type of short-term note generally issued in multiples of \$1 million for tenors up to 270 (in some cases 390) days. The interest rate on each CP note is set at issuance. Industrial corporations, retailers, and utilities issue CP to fund short-term self-liquidating working capital needs tied to the normal cash conversion cycle (such as inventory and accounts receivable), fund seasonal increases in business volume, bridge to permanent financing for the company's longer-term capital needs, or provide initial funding for an acquisition. Finance companies and banks often use CP to match-fund a loan portfolio or to warehouse assets before issuing long-term debt or packaging the assets for securitization or sale. CP has become an increasingly important funding instrument for most large investment-grade companies due to its flexibility, ease of issuance, and relatively low cost.

CP is either sold through dealers, such as investment banks, or directly placed by extremely high-volume issuers. Each distribution channel has its own advantages. A dealer-placed program can be more efficient than a direct program for all but the very largest issuers. In a direct program, the issuer has direct contact with investors. As U.S. CP outstanding has grown, the share of directly placed CP as a percentage of the total market has declined.

Money market investment funds dominate the investor base in the U.S. CP investor base, and regulations affecting these funds' holdings, such as the minimum rating guidelines mandated by Securities and Exchange Commission Rule 2a-7 of the Investment Company Act of 1940, have made credit ratings important for the market liquidity of an issuer's CP. Rule 2a-7 requires that short-term securities purchased by money market funds must be rated within the two highest short-term rating categories (i.e. tier 1 or 2) by nationally recognized statistical rating organizations (NRSROs) or be deemed of comparable quality by the fund manager. Virtually all U.S. CP programs are rated by at least one of the larger NRSROs. Money funds that are not tax exempt are required by Rule 2a-7 to limit their exposure to tier 2 securities to 5% of the total assets. Also, many CP investors have internal policies and guidelines about eligible holdings, which are more stringent than those of Rule 2a-7.

In the Euro CP market, money market funds are not as dominant as they are in the U.S., and European regulatory mechanisms have rarely to date incorporated credit ratings. Ratings will increasingly feature in these markets, however as a result of the STEP (Short-term European Paper) initiative sponsored by ACI-The Financial Markets Association and Eurosystem.

Maturing long-term debt can also expose corporations to liquidity stress if the term of the debt is not matched to internal cash flows or maturing assets. Laddering debt maturities can help limit liquidity strains. Repayment of material debt maturities would usually be planned in advance, with contingency plans in case capital market conditions interfere with any expected funding.

Calculating Corporate CP Backup Coverage

Fitch calculates corporate CP backup coverage as the sum of all unused committed liquidity facilities — primarily committed bank credit agreements but under special circumstances including cash balances earmarked to refund maturing debt instruments — divided by the sum of CP and other short-term financial obligations anticipated to be outstanding, such as notes payable and master trust demand notes (excluding borrowings under committed bank credit facilities).

Liquidity Risks

Corporate CP issuers need sufficient liquidity reserves (including liquid assets, committed bank facilities, or liquidity from a parent or third party) to withstand two types of liquidity challenges: systemic risk and credit, or event, risk.

Systemic risk is the possibility of a broad market disruption affecting the entire CP market or a whole market tier. The U.S. CP market is actually composed of three market sectors based on different investor populations. These are the tier 1 CP market (encompassing corporate and asset-backed CP with ratings equivalent to Fitch’s ‘F1+’ or ‘F1’), the tier 2 market (CP with ratings equivalent to Fitch’s ‘F2’), and tier 3 (ratings equivalent to Fitch’s ‘F3’). The U.S. tier 1 CP market is nine to ten times larger than the tier 2 market and has proven during periods of stress to be substantially more liquid than the tier 2 market. Tier 3 CP makes up an insignificant percentage of the total market, and its market access is quite volatile. Even when the overall market is robust, CP rated ‘F3’ has historically tended to lose liquidity over year-end and quarter-end dates.

During market liquidity stresses, corporate tier 1 CP with an ‘F1+’ rating have tended to experience no loss of market access and have even benefited from investors’ flight to quality. CP in the ‘F1’ rating category also performed reasonably well. Corporate CP in tier 2 is considerably more exposed to systemic risk, and some or many ‘F2’ issuers were adversely affected during each of the recent liquidity

stresses. CP issues in the ‘F3’ category generally lose CP market access in such circumstances.

Credit risk in this area is less related to default risk than to rating migration risk, i.e. the possibility of an issuer-specific event — such as a hostile takeover offer announcement, an unexpected adverse decision in a law suit, or an unfavorable earnings announcement — warranting a credit downgrade that makes investors unwilling to buy new CP notes of that issuer. Although any corporate CP issuer can experience a reduction or loss of liquidity due to individual credit events, credits in the ‘F2’ and ‘F3’ categories face the most serious liquidity impacts, since a downgrade would greatly reduce or eliminate CP market access. Market access for tier 2 and 3 issuers can also be impaired by adverse news about another company in the same industry sector, even if the issuer is not directly affected.

In general, an adverse credit event or downgrade is likely to more modestly affect ‘F1+’ and ‘F1’ corporate CP issuers, since they have better financial resources and market reputations at the outset. However, not even blue-chip corporations are immune from event risk. On rare occasions, tier 1 corporate CP experiences such rapid deterioration of its creditworthiness that it falls below investment-grade status. Examples in recent years have included Xerox Corp. (Xerox), FINOVA Capital Corp. (FINOVA), Pacific Gas & Electric Co., and Southern California Edison.

Table 2: Relationship of Credit Ratings to Risk

Fitch	Market access	Systematic risk	Credit risk
‘F3’	Low	High	High
‘F2’	Moderate	Moderate to high	Moderate
‘F1’	High	Low	Low
‘F1+’	Very high	Very low	Very low

Source: Fitch

The credit rating is not the only factor affecting market access. Very large issuers offering CP continuously in the market and issuers whose products and brand identities are well known tend to have better market access than do sporadic issuers with small CP programs and a lower public profile. However, credit ratings generally correspond with levels of market access, systemic risk, and credit risk. Fitch’s conclusions regarding these are summarized in Table 2.

Why Liquidity Backup is Important

In the U.S. CP market, settlement occurs on the same day that notes are issued. The immediacy of U.S. CP settlement makes CP a potent short-term funding

tool and also increases potential liquidity risk for issuers, who must fund their maturing paper with immediately available funds. In other money markets, such as Euro CP, settlement may be delayed for several days. Same-day settlement is available, particularly in France, but currently, two-day settlement is typical, though in currencies where major time-zone differences exist between seller and buyer, three days may be agreed.

If a corporation's CP funding does not match its normal asset conversion cycle or operational free cash flow, the issuer must refund CP notes already in the market either with new CP notes or by issuing long-term bonds or bank loans. If the issuer does not have immediate funding, the company may not be able to repay maturing obligations. To mitigate liquidity risk, Fitch considers liquidity backup for outstanding CP and similar short-term debt obligations an important element in assigning instrument-level ratings.

Buyers of corporate CP backed by bank liquidity commitments should not, however, rely on these as direct credit enhancement. Liquidity backup exists primarily to protect the issuer's overall credit against the risk of default or insolvency caused by unsuccessful CP market rollovers. However, a default or insolvency by the issuer would, in nearly all cases, prohibit drawing under the credit lines. The rating of corporate CP backed by liquidity arrangements is therefore linked to the issuer's credit standing and is not tied to the ratings of liquidity providers.

Liquidity backup is either adequate or inadequate. "More than adequate" liquidity backup does not justify a higher short-term credit rating. On the other hand, when CP is explicitly enhanced, for example if it is backed by a direct-pay LOC or similar form of guarantee, the CP rating is enhanced to the rating of the credit enhancement provider (assuming the provider is rated higher than the issuer).

Bank-Provided Backup

Undrawn committed credit facilities provided by commercial banks compose the largest source of CP backup. Committed credit facilities typically are revolving credit agreements (RCs), credit lines that permit the borrower to draw funds provided certain conditions are met before borrowing. Other accepted means of backup include bank LOCs and, in the case of finance companies, committed receivables purchase facilities. Uncommitted lines of credit are not ordinarily considered backup.

While bank credit facilities will likely remain a primary source of backup liquidity, changes in the bank sector are affecting the availability and cost of credit. RCs, previously bilateral arrangements between a borrower and a bank, have now become one element with a commoditized syndicated loan market. As such, loan pricing and structure can be driven to the minimum levels that would still clear the market and allow agents to sell down their commitments. Consequently, relationship lending has become less relevant, and loan origination and distribution or syndication are emphasized.

Syndicated credit facilities and committed bilateral lines of credit each have advantages and disadvantages. The principal advantages of the syndicated RC are speed and simplicity for the borrower. A syndication agent supervises the structuring of the credit agreement and soliciting commitments from banks, and a designated bank handles all administrative burdens, calculates and distributes interest and fees, and centralizes the dissemination of information to the bank group. When a borrowing need arises, the issuer contacts a single agent instead of each individual bank. On the other hand, the advantage of bilateral lines of credit is that without an agent each lender is closer to the issuer and more likely to have ancillary business with the issuer, and therefore perhaps more incentive to support that issuer in a crisis. Bilateral RCs may have different maturities, terms, and pricing,

Table 3: Liquidity Backup Guidelines

Tier	Issuer's CP rating	Corporates, insurers and finance companies (%)	US banks	US bank holdcos & broker dealers (%)	Non-US banks ^a (%)
US Commercial Paper					
1	F1+	75	—	—	15
1	F1	100	—	—	15
2	F2	100	—	100	50
3	F3	100	—	100	100
Euro commercial paper					
1	F1+	75	—	—	—
1	F1	100	—	—	—
2	F2	100	—	—	—
3	F3	100	—	—	—

^a Banks with no material US banking operations which may be used as a source of dollar liquidity; amounts relate to "swingline" backup, measured as a percentage of outstanding issuance rather than program size
Source: Fitch

providing the borrower with greater diversity and control.

Revolving Credit Structure

RCs often have two components: a multiyear tranche and a 364-day tranche. Fitch expects that short-term backup commitments will generally compose no more than one-third of total CP backup, because a large proportion of short-term credit facilities exposes a CP issuer to extension risk since some banks may be unwilling to renew their maturing commitments. This can ultimately place the CP program at risk, as occurred in 2000, when FINOVA was unable to extend its short-term facility for another 364 days because a small cadre of banks opted not to renew due to credit quality concerns. As a result, FINOVA did not extend its bank facility and instead refinanced all outstanding CP from the proceeds of its aggregate \$4.5 billion of committed bank revolvers. Companies with multiple long-term RCs can reduce extension risk by having tiered maturities for these facilities.

Bank Groups

Fitch evaluates the quality of bank groups. In general, the weighted long-term ratings of the banks providing credit should be 'A' or better; commitments provided by banks rated 'BBB+' or lower are excluded from the calculation of CP backup. Fitch maintains these standards to help ensure that, if an issuer needs to draw upon its committed credit facilities, the consortium of banks will have the financial wherewithal to fulfil their commitments. In a review of US back-up facilities in "*U.S. Corporate Commercial Paper Backup Credit Facility Review*", published December 2005, Fitch noted that the average lender ratings were 'AA-', amongst bank groups averaging 22 members, with five to eight lenders typically covering 40%-50% of the commitment.

Conditions of Lending and Covenants

A bank RC typically is not an unconditional obligation on the part of a bank to advance loans to the borrower. It generally includes conditions that must be fulfilled prior to the effectiveness of the agreement and any drawings by the borrower. It also includes a series of representations by the borrower and affirmative and negative covenants of the borrower. Events of bankruptcy or insolvency or violation of certain of the covenants typically relieve the bank from an obligation to make new advances. Conditions precedent to lending and financial covenants are generally less stringent the shorter the tenor of the credit facility and can be few or virtually nonexistent for borrowers with strong credit quality. Conversely, borrowers of lesser credit quality are likely to encounter more onerous conditions and

more stringent financial covenants, although competitiveness in the syndicated loan market lead to periodic weakening of lending discipline.

Some bank agreements incorporate a condition that would relieve the banks of their funding requirements when a material adverse change (MAC), or material adverse event, affects the borrower. In a highly competitive banking market, the strongest and most desirable borrowers can generally avoid the inclusion of a MAC clause. A borrower is assured of greater liquidity support if its bank agreements do not contain stringent financial covenants or MAC clauses that limit the banks' commitments to advance funds.

Financial covenants may include limitations on leverage and on incurring liens, a fixed-charge coverage test, a tangible net worth test, and change of control covenants. Credit facilities of issuers in the 'BBB' categories are occasionally secured. Fitch reviews the covenants to determine how much operating flexibility they provide and actively monitors compliance if a covenant is nearly tripped. If a covenant is likely to be triggered, ability to draw under the backup facility would depend on a waiver from the bank or banks, which would weaken the value and predictability of the backup facility.

The major findings of "*U.S. Corporate Commercial Paper Backup Credit Facility Review*" were that the vast majority of agreements contained material adverse change ("MAC") clauses, and that the number of financial covenants varied from zero to three. MAC clauses, which nominally allow the banks to refuse drawdown if a borrower is experiencing adverse circumstances, may be viewed as negotiating tools more than 'escape clauses'. For other covenants, most facilities contained only one covenant, with the single most frequently cited covenant measure referring to maximum levels of total debt divided by EBITDA.

Impact on ratings

MAC clauses generally do not limit the effectiveness of the back-up in Fitch's criteria. Covenants citing financial ratios generally do not limit the effectiveness of the backup when, as is usual, they relate to periodic audited accounts data and are set at levels well outside those consistent with investment grade parameters. The potential does exist, however, for more challenging financial covenants to render the back-up invalid for Fitch's calculations, if Fitch believes there is a reasonable likelihood that the covenants could be breached.

Alternate Liquidity Backup

Liquidity backup need not be in the form of bank facilities. For finance companies, asset securitization through committed conduits and receivable purchase facilities are important alternate sources of liquidity. In rare cases, companies with excess cash reserves or access to liquid assets may use the proceeds of asset monetization as a part of their backup arrangements, providing that the assets are truly available, they can be converted to cash in a few days, and a full contingency plan exists to mobilize these resources. In such cases, Fitch's periodic reviews of the credit include evaluations of the quality of the assets and the mobilization plan.

Extendible Notes

Some funding products are structured to shift liquidity risk from the issuer to the investor and, therefore, do not require external liquidity backup. This category includes extendible commercial notes (ECNs), exchangeable notes, and money market notes. ECNs are issued with an expected final maturity of anywhere from one to 90 days, but this can be extended by the issuer to a legal final maturity of 390 days after the issued date. Other funding products that incorporate an extension option include extendible multimodal bonds and structured liquidity notes.

Money market notes use a slightly different structure to reach a similar end; the notes incorporate a longer legal maturity, but the issuer may call and retire the notes at an earlier call date or step up pricing if it does not prepay the notes on the earlier date. In all of these products, investors effectively provide a backup liquidity option; issuers are expected to use the extension option after other liquidity sources have been tapped.

The market for these extendible products has generally been shallow since inception. The first serious stress to the corporate ECN market occurred in December 2000 when Southern California Edison declared an extension on outstanding ECNs and soon thereafter defaulted on maturing CP notes. Before this, many large money market investors were not convinced that the existing corporate extendible instruments satisfied credit or return objectives; the investor acceptance of asset-backed extendible note products, such as structured liquidity notes, has been greater. In January and February 2001, some corporations reportedly had difficulty refunding maturing ECNs or other extendible corporate notes with similar extendible instruments. In its analysis of money market funds, Fitch considers money market funds' investments in corporate extendible notes to be classified as "illiquid" (see "*Money Market Criteria*," dated Apr. 6, 2007).

While the various extendible note products potentially offer an alternative to bank-provided backup arrangements, Fitch nonetheless expects that corporate issuers will not place excessive reliance on them as a source of short-term funding. Fitch's criteria do not incorporate a need for liquidity facilities to back up extendible notes before their expected maturity dates or first call dates, provided that the aggregate amount of them is not greater than 20% of total bank-provided liquidity backup. The liquidity backup guidelines that appear in Table 3 apply after an instrument passes its expected maturity or optional call date and approaches its legal final maturity.

■ Bank and Broker Commercial Paper

In contrast to the uniform treatment of corporate entities and finance companies, for bank and broker commercial paper, Fitch differentiates between the US and Euro CP markets in its analysis of backup liquidity. This reflects the fact that, generally, the backup needs are lower, reflecting the inherent liquidity strengths and practical market access of investment-grade financial institutions.

Euro CP

Fitch's guidelines for banks and brokers in the Euro CP market do not incorporate any backup liquidity needs for any investment grade bank issuer, reflecting in large part the longer settlement periods (two- or three-day rather than same-day) available to issuers, which in turn would generally permit investment grade banks and brokers to source alternative liquidity.

USCP

In contrast, backup liquidity is incorporated in the guidelines for two specific subsets of bank and broker dealer, in both cases only for the US CP market:

- Rating guidelines for US bank holding companies and broker dealers assume liquidity backup of 100% at the 'F2' and 'F3' levels for the US CP market.
- Rating guidelines for non-US banks with no material US banking operations which may be used as a source of dollar liquidity assume liquidity backup on a 'swingline' basis of between 15% and 100% as outlined in Table 3.

USCP – US Banks and Bank Holding Companies

US banks have historically not been CP issuers. For operating banks, as opposed to holding companies, Fitch has no explicit back-up requirements for banks reflecting their inherently liquid nature. Rather,

analysis focuses on the strength of an institution's liquidity management, cash flow, funding profile and liquid assets. Banks can meet short and intermediate term funding needs through more attractive channels including federal funds, banks notes, Federal Home Loan Bank (FHLB) borrowings, brokered certificates of deposit and repurchase agreements, as well as a variety of securitization vehicles, that are similarly available to financial and non-financial companies. While the federal funds and brokered CDs are subject to a credit decision process by counterparties, FHLB borrowings are generally not, as lines are determined by the amount of FHLB stock held by member institutions and certain eligible collateral requirements.

By regulatory design, bank holding companies are distinct from their constituent banks, restricted in their financial dealings with their subsidiary banks, and largely removed from the payment systems function. Yet within this framework, Fitch believes bank holding companies benefit directly and indirectly from the inherent liquidity of their operating bank subsidiaries, with such benefit remaining available to them even in times of severe capital market disruption or systemic crisis. In this regard, the agency does not require formal back-up facilities on 'F1' and 'F1+' rated bank holding company CP programs, but rather, reviews such programs on a case-by-case basis incorporating within its analysis eight primary points:

- the size of the program;
- primary use of the program;
- historical levels of cash and liquid assets of the holding company;
- assets of the bank holding company apart from its regulated bank subsidiaries;
- overall corporate debt levels and debt service requirements;
- the availability of unrestricted dividend capacity at the bank subsidiaries;
- earnings quality and trend; and
- bank subsidiary capitalization levels and mix.

Historically, Fitch had stipulated back-up facilities for bank holding companies that were similar to those required for finance companies. This methodology recognized that by general policy and practical application, back-up facilities provide liquidity and not credit enhancement. Along with a series of regulatory changes that have granted broader powers to banks (such activities such as merchant banking, insurance, and investment banking still carry restrictions), in large measure, CP funding at the parent bank holding company had become discretionary. CP is used to primarily finance mortgage banking, leasing or finance

company activities, all businesses which could be conducted at the bank level. In more recent years, such financing has, in fact, generally been shifted to the bank level.

In Fitch's opinion, most 'F1' and 'F1+' rated bank holding company CP programs will not require a dedicated back-up facility as they represent generally modest levels of the overall funding profile of the organization. In fact, CP levels tend to be fractions of the available liquid assets and unrestricted dividend capacity from subsidiary banks that is available to the holding company. However, for lower rated 'F2' and 'F3' rated bank holding company CP programs, Fitch will still generally expect 100% back-up, since these ratings are typically reflective of increased operating leverage.

Calculating Bank and Broker CP Backup Coverage

Fitch calculates bank and broker CP backup coverage as the sum of unencumbered cash and securities at the parent, dividends available to the parent (while all regulatory subsidiaries remain well capitalized) and fee-paid committed backup facilities divided by CP anticipated to be outstanding. Contingency funding plans will be evaluated for additional availability if back up facilities are no longer used. Fitch allows the assumption of cash inflows from asset securitization if the institution has demonstrated expertise in that market.

USCP – Non-US Banks

Unlike U.S. financial institutions, generally non-US banks do not have a natural source of dollar liquidity and therefore are exposed to a greater degree of default risk (either technical or due to liquidity problems) than domestic institutions, especially during times of 'stress'. As a result, Fitch has specific guidelines regarding liquidity and backup facilities through dedicated "swinglines" when rating non-U.S. financial institutions' U.S. CP programs. However, back-up requirements for those banks that have U.S. banking subsidiary operations and, thus, a high degree of dollar liquidity, are effectively the same as those for U.S. bank programs. Namely, there are no specific back-up requirements reflecting the liquidity of banking institutions, rather Fitch focuses on traditional funding and liquidity measures, as well as the relationship between parent and subsidiary. In contrast, Fitch's basic policy is that a U.S. CP program issued by a non-US financial institution with no US presence has to be backed by sufficient, readily available dollar facilities. Coverage rates are detailed in Table 1.

In addition, Fitch expects that of the total coverage, a percentage has to be in the form of a 'swingline'. Swinglines are basically a higher quality form of back-up facility as they are available for same day utilisation providing the drawer typically gives the provider notice that morning. By contrast, standard back-up facilities may require two working days' notice. Naturally, because of their superior quality, swinglines tend to be more expensive. The need for the additional comfort of swingline facilities reflects the unique currency, time zone and settlement risks associated with crossborder programs.

Currently, the percentage expected to be in 'swingline' form amounts to 15% of potential outstandings, across all rating categories (i.e. 15% backup for 'F1+' and 'F1' non-US banks, of which all is swingline; 50% backup for 'F2' non-bank issuers, of which the additional 35% need not be swingline; 100% backup for 'F3' non-US banks, of which the additional 85% need not be swingline). In certain cases, Fitch may include dollar-denominated highly liquid assets in its computation of backup provision for non-US banks, though this would typically not reduce the swingline amount below 15%.

Broker Dealers

Fitch places significant emphasis on liquidity management and alternative funding plans in assessing the liquidity and financial flexibility of securities firms rather than a reliance on backup facilities. Firms are no longer reliant on just the commercial paper market to raise short-term funds. Rather, firms have actively expanded into medium term note (MTN) programs, as well as the retail and wholesale bank deposit market with recently chartered FDIC insured bank and or thrift subsidiaries. These actions have improved investor diversification and reliance on the CP market is no longer necessary. The ability to survive market disruptions is directly related to a firm's stability of funding as well as the composition of the assets and risk appetite for high-yield, less liquid or illiquid instruments. In evaluating flexibility, Fitch reviews the maturity structure and composition of short-term to long-term debt and also considers investor concentration limits.

Internal liquidity monitoring generally uses the concepts of net cash capital coupled with internal liquidity ratios, the latter calculated based on hypothecation of collateral and on liquidation of inventory. Net cash capital measures the excess of long-term funding over that which would be necessary to shift to a secured funding environment. It compares long-term debt and equity available to the sum of illiquid assets and firm-wide haircuts on

Table 3: Indicative Hypothecation

Security type	Haircut (%)
US govts and agencies	2-5
Money markets (F1+/F10)	3
Investment-grade corporates	10
High yield debt	10-50
Mortgage-backed securities	5-10
Common stock	50

Source: Fitch

the actual mix of inventory. Haircuts are based on periodic surveys of major banks collateral requirements, as well as prespecified advance rates in the firm's committed secured credit facilities. The tolerance or minimum net cash capital will fluctuate within a variable target level.

Liquidity ratios monitor the balance sheet and ability to repay short-term funds with current liquid assets. These ratios monitor cash, unencumbered securities and liquid assets relative to total unsecured short-term borrowings (i.e., those that are maturing within the next 12 months). Again, target levels are maintained on a firm by firm basis with a rating incorporating the cushion or reliance desired. Fitch expects that this ratio be maintained at a minimum 100% for 'F1' and higher rated institutions.

Alternative funding plans are reviewed for an assessment of the firm's risk tolerance and flexibility in funding. Such plans should allow for relatively normal business operations during extended periods of market stress or firm-specific liquidity problems. Under typical contingency scenarios, access to short-term unsecured funding is eliminated, forcing the firm to fund operations through secured sources. Fitch requires that the consolidated firms maintain at least 100% alternative liquidity for all short-term unsecured obligations, including CP. This may be accomplished through a variety of means including increased use of secured funds (recognizing a potential increase in haircuts), sale of 'excess' inventory, drawing down on either unsecured or secured committed facilities, reduction in trading assets, or potential access to funds from a parent owned investment portfolio. Firms designated with the 'F1+' rating provide sufficient alternative sources of funds to remain out of the short-term debt market for twelve months and may include the use of committed facilities to reach that time frame.

Fitch also expects the maintenance of sufficient long-term capital to fund less liquid and illiquid assets, including fixed assets and goodwill. This is tracked regularly with the expectation that coverage of such assets will be in excess of 100% for firms designated 'F1' and generally in excess of 200% for those designated 'F1+'.

From an operational perspective, Fitch expects that securities firms will periodically test the ability to access secured borrowing lines and effectively pledge unencumbered inventory. In addition to on-balance sheet borrowing sources, highly-rated

securities firms maintain excess securities at the parent level or alternatively committed bank facilities that typically remain undrawn under normal circumstances and act as another source of liquidity support.

■ Annex

Questionnaires

The attached questionnaires represent a selection of the kind of topics which may be considered by Fitch analysts. Actual questions asked will vary by issuer over time. Where data is unavailable from individual issuers on specific questions, Fitch will incorporate assumptions based on its experience of the sector and the relative likelihood of adverse exposure on undisclosed elements of the issuer's profile.

■ Annex A

Liquidity Questions for Corporations

Operational Cash Flow

1. What is the issuer's free cash generation profile?
2. Is it consistent through seasonal and business cycle volatility?
3. Does the issuer have a positive or negative working capital cycle?
4. Does the issuer's business potentially require significant collateral or margin requirements?
5. Is the issuer's capital investment programme predictable or highly variable?
6. What percentage of planned annual investment is genuinely discretionary?
7. Does the issuer have measurable pressure to maintain certain levels of dividend payout or operate a rolling stock buyback programme?

Capital Structure

8. What is the maturity profile of the issuer's financial debt?
9. Do any of the financial obligations have put options or other event-related redemption triggers?
10. Does the issuer have other material contingent liabilities (litigation, warranties etc.)
11. If so, within what timescale would payment be required?
12. What is the rate profile of the issuer's debt – the proportion of fixed rate to variable rate?
13. What is the currency profile of the issuer's financial debt?
14. What is the potential currency fluctuation on interest and principal payments within a year?
15. What is the potential exposure of the issuer to margin calls under any commodity or currency hedging?
16. Does the issuer operate a commercial paper programme?
17. If so, what does the issuer use the CP programme to fund?
18. What committed facilities does the issuer maintain?
19. What is the maturity profile of these facilities?
20. What are the average seasonal drawings under these facilities?
21. What covenanted or other restrictions are there on the use of proceeds from drawings?
22. Are there any potentially onerous conditions precedent or representations & warranties related to the committed facilities?
23. Do the committed facilities contain a Material Adverse Change clause?
24. Do the committed facilities contain cross-default clauses to other legal entities?
25. What is the composition and quality of the bank group providing committed facilities?
26. Are there any conflicts/fusions of interest between committed facility providers and long-term term bank loan providers?
27. Does the company operate with a central treasury which pools all cash receipts, or does it fund at multiple levels with holding company debt serviced from dividends?
28. If the issuer relies upon subsidiary or project dividends to service debt, are there any potential legal, regulatory, jurisdictional or other structural issues (e.g. cash traps covenanted within subsidiary debt) that could impede dividend flow?
29. Does the issuer have assets of sufficient value and tradability that they could be used as collateral to secure a bank loan *in extremis*?

Available resources

30. Does the issuer maintain substantial cash balances?
31. How consistent is the level of these cash balances, and why are they maintained rather than used to retire debt?

32. Are cash balances legally unrestricted (e.g. no pledge to debt service reserves) and directly available (e.g. not held at a subsidiary or project) to the issuer for debt service?
33. Are cash balances, though not explicitly pledged, nominally held against any form of expected financial obligation (pension, warranty, litigation etc.)?
34. Does the issuer commingle available cash in any form of money pool with entities that do not also guarantee the issuer's debt?
35. In which currency is cash held?
36. In which institutions are cash holdings held?
37. What are the treasury policies on acceptable short-term investments?
38. How have marketable securities been valued?
39. Does the issuer maintain demonstrably excess inventory which could provide liquidity at a time of liquidity stress?
40. How consistent is the maintenance of such inventory levels expected to be?
41. Does the issuer maintain any readily disposable tangible or intangible assets?
42. What is the realistic timeframe, including anti-trust and various other regulatory and board approvals, within which any such disposal could be completed?
43. At what discount to book value would inventory, receivable or other 'accelerated' asset disposals be expected to occur?
44. Can the issuer demonstrate any compelling case that access to fresh equity capital would be available at a time of liquidity stress?

Other Factors Considered

45. To the extent that they are available and the product of a liquid and reliable market, what indications, relative to the direction for the market as a whole, do the following provide for the issuer's access to additional bank or capital market liquidity:
 - Credit Default Swaps
 - Bond Spreads
 - Share Price
 - Direction of margin, tenor, commitment volumes and any over-subscription on the most recent committed facilities negotiated, relative to prior facilities.
46. Have there been any accounting irregularities, restatements or changes in auditor which could threaten timely completion of financial statements, and which in turn could block access to either capital market refinancings or drawings under existing committed facilities?

■ Annex B

The attached questionnaires represent a selection of the kind of topics which may be considered by Fitch analysts. Actual questions asked will vary by issuer over time. Where data is unavailable from individual issuers on specific questions, Fitch will incorporate assumptions based on its experience of the sector and the relative likelihood of adverse exposure on undisclosed elements of the issuer's profile.

Liquidity Questions for Insurance Groups

Operational Cash Flow

1. What is the issuer's cash generation profile?
2. What are subsidiary company cash flows: insurance operating company's cash flows (i.e. Surplus notes, common dividends, management agreements, capital contributions etc.) or additional non-regulated company cash flows?
3. Is it consistent through seasonal and business cycle volatility?
4. Does the issuer require significant working capital?
5. Does the issuer's business potentially require significant collateral or margin requirements?
6. Does the insurance operating company's business potentially require significant reserve or capital requirements?
7. Is the issuer's investment program predictable or highly variable?
8. Are the insurance operating company's reserve growth / capital needs predictable or highly variable?
9. Does the issuer have measurable pressure to maintain certain levels of dividend payout or operate a rolling stock buyback program?

Capital Structure

10. What is the maturity profile of the issuer's financial debt?
11. Do any of the financial obligations have put options or other event-related redemption triggers?
12. Does the issuer have other material contingent liabilities (litigation, warranties etc.)
13. If so, within what timescale would payment be required?
14. What is the rate profile of the issuer's debt – the proportion of fixed rate to variable rate?
15. What is the currency profile of the issuer's financial debt?
16. What is the potential currency fluctuation on interest and principal payments within a year?
17. What is the potential exposure of the issuer to margin calls under any commodity or currency hedging?
18. Does the issuer operate a commercial paper program?
19. If so, what does the issuer use the CP program to fund?
20. What committed facilities does the issuer maintain?
21. What is the maturity profile of these facilities?
22. What are the average seasonal drawings under these facilities?
23. What covenanted or other restrictions are there on the use of proceeds from drawings?
24. Are there any potentially onerous conditions precedent or representations & warranties related to the committed facilities?
25. Do the committed facilities contain a Material Adverse Change clause?
26. Do the committed facilities contain cross-default clauses to other legal entities?
27. What is the composition and quality of the bank group providing committed facilities?
28. Are there any conflicts/fusions of interest between committed facility providers and long-term term bank loan providers?
29. Does the company operate with a central treasury which pools all cash receipts, or does it fund at multiple levels with holding company debt serviced from dividends?
30. If the issuer relies upon subsidiary or project dividends to service debt, are there any potential legal, regulatory, jurisdictional or other structural issues (e.g. cash traps covenanted within subsidiary debt) that could impede dividend flow?
31. Does the issuer have assets of sufficient value and tradability that they could be used as collateral to secure a bank loan in extremis?

Available Resources

32. Does the issuer maintain substantial cash balances?
33. How consistent is the level of these cash balances, and why are they maintained rather than used to retire debt?

34. Are cash balances legally unrestricted (e.g. no pledge to debt service reserves) and directly available (e.g. not held at a subsidiary or project) to the issuer for debt service?
35. Are cash balances, though not explicitly pledged, nominally held against any form of expected financial obligation (pension, warranty, litigation etc.)?
36. Does the issuer commingle available cash in any form of money pool with entities that do not also guarantee the issuer's debt?
37. In which currency is cash held?
38. In which institutions are cash holdings held?
39. What are the treasury policies on acceptable short-term investments?
40. How have marketable securities been valued?
41. Does the issuer maintain any readily disposable tangible or intangible assets?
42. What is the realistic timeframe, including anti-trust and various other regulatory and board approvals, within which any such disposal could be completed?
43. Can the issuer demonstrate any compelling case that access to fresh equity capital would be available at a time of liquidity stress?

Other Factors Considered

42. To the extent that they are available and the product of a liquid and reliable market, what indications, relative to the direction for the market as a whole, do the following provide for the issuer's access to additional bank or capital market liquidity:
 - Credit Default Swaps
 - Bond Spreads
 - Share Price
 - Direction of margin, tenor, commitment volumes and any over-subscription on the most recent committed facilities negotiated, relative to prior facilities.
43. Have there been any accounting irregularities, restatements or changes in auditor which could threaten timely completion of financial statements, and which in turn could block access to either capital market refinancings or drawings under existing committed facilities?

Insurance Operating Company Considerations

44. What is the maturity profile of the insurer's financial debt?
45. What is the company's exposure to institutionally placed liabilities such as GICs or EMTN programs?
46. Do any of the financial obligations have put options or other event-related redemption triggers?
47. What are the company's ALM profile and capabilities?
48. Are EMTN's asset and liabilities cash flow matched or duration matched?
49. How efficient are the company's hedge programs?
50. What percentage of fixed annuities are available for withdrawal at book value without market adjustments?
51. What is the company's 90 day, 180 day 1 year liquidity requirement coverage?
52. What is the company's stressed 90 day, 180 day and 1 year liquidity requirement coverage?
53. What is current market value to book value of bond portfolio?
54. What is percentage of commercial mortgages, private placement bonds, real estate and affiliated investments are in invested asset portfolio?

■ Annex C

The attached questionnaires represent a selection of the kind of topics which may be considered by Fitch analysts. Actual questions asked will vary by issuer over time. Where data is unavailable from individual issuers on specific questions, Fitch will incorporate assumptions based on its experience of the sector and the relative likelihood of adverse exposure on undisclosed elements of the issuer's profile.

Liquidity Questions for Banks

Operating Cash Flow/Available Resources

1. A list of the twenty largest providers of deposits and other funding.
2. What has been the historical stability of the bank's retail funding base?
3. What standby lines of credit are available to the bank? Are these confirmed or unconfirmed lines.
4. How dependent is the bank on any major shareholder[s] for funding?
5. Under normal circumstances, how long can the bank meet its dated obligations and normal at sight withdrawals from normal client inflows of cash? Would it be able to meet all obligations for at least five business days?
6. Breakdown of liquid assets by type.
7. Would the standby lines of credit be available if the bank were to face some kind of liquidity crisis? Would they be available in the event of a systemic crisis?
8. What is the rationale underlying the bank's holdings of high quality marketable debt instruments and/or placements with banks? What proportion of these investments are realisable in one day? One week?
9. What value of debt or other financial instruments is eligible to be repo'd with the central bank? Is the central bank obliged to repo all available eligible instruments in order for the bank to meet its own liquidity obligations?
10. Has the bank ever securitised any assets/issued any covered bonds? Who were the investors? Does it plan to securitise any assets/issue any covered bonds and, if so, which assets and to which value? How long would it take to perform another operation of this kind and how large might it be?
11. Has the bank made any special arrangements with another commercial bank or with the country's central bank to have access to liquidity in the event of a company specific or systemic liquidity crisis? What is the nature of these arrangements?

Capital Structure

12. In case of bank borrowing, what is the concentration of such borrowing, the currencies involved and the countries of origin of the lenders.
13. Are there any significant long-term borrowings which will mature this year?
14. Details of outstanding debt in issue, including the type of debt, currency and maturity.
15. Funding plan for the next 12 months, including the likely form (senior, subordinated, etc.) and timing of any debt issuance?
16. Contractual and expected maturity of assets, liabilities and off-balance sheet items in each currency (GAP analysis). If there are any negative gaps, how does the bank plan to find the necessary liquidity?

Other

17. If available, regulatory returns relating to liquidity ratios.
18. In the (unlikely) event of a crisis, what contingency plans has the bank drawn up? What were the assumptions used in order to draw up these plans? Have the plans ever been tested?
19. Some banks have tried to estimate what the impact would be on their liquidity and business of a sudden two notch downgrade of the IDR/Long-term rating. Has the bank performed such a study or, in any case, what would be the most likely effects of a two notch downgrade on the bank's liquidity?

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