FitchRatings

Country-Specific Treatment of Recovery Ratings Criteria

Cross-Sector

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This report updates and replaces *Country-Specific Treatment of Recovery Ratings Criteria*, dated 5 January 2021 and *Exposure Draft: Country-Specific Treatment of Recovery Ratings Criteria*, dated 10 January 2023.

Related Criteria

Corporate Rating Criteria (October 2022)

Corporates Recovery Ratings and Instrument Ratings Criteria (April 2021)

Insurance Rating Criteria (July 2022)

Non-Bank Financial Institutions Rating Criteria (January 2022)

Infrastructure & Project Finance Rating Criteria (July 2022)

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Scope

These criteria constrain the assignment of recovery ratings (RRs) and the upward notching of instrument ratings from Issuer Default Ratings (IDRs) to reflect a less predictable range of recovery outcomes in certain jurisdictions based on country-specific factors.

These criteria apply globally to new instrument ratings and RRs, and to the surveillance of these ratings for corporates, insurance companies and non-bank financial institutions. These criteria also include concepts that may be applicable to obligations rated under the *Infrastructure and Project Finance Rating Criteria*, as described in those criteria.

Key Rating Drivers

RR Caps by Country Groupings: Fitch classifies countries into four groups, each with different caps on instrument ratings and RRs. Instruments from issuers in countries in group A can be assigned RRs up to 'RR1'; group B up to 'RR2'; group C up to 'RR3', and group D up to 'RR4'.

The classing into groups is anchored on an assessment of each country's governance environment, using a simple average of three indicators reported by the *World Governance Indicators* project of the World Bank: Rule of Law, Regulatory Quality and Control of Corruption.

Qualitative Overlay: Fitch may apply a qualitative overlay (QO) to adjust downward the grouping of a country when we recognise material insolvency-specific factors not reflected in the broad governance assessment that may have a significant influence on the predictability of insolvency outcomes within a jurisdiction.

Exceeding the Cap: Fitch may exceed the cap in specific situations where the indicators used to derive the country caps do not reflect the risks specific to an issuer. When Fitch assesses that an issuer's foreign currency (FC) default would most likely be caused by exchange controls, RRs on FC instruments can be assigned above the cap. Ratings may also be assigned above the cap when an issuer is in distress, or in default, and recoveries are expected to be higher than implied by the cap.

Weighting of Factors Varies: The weighting between the above factors varies between entities and countries. It may vary over time, as the specifics of a country or an issuer evolve.

Classing Jurisdictions

Country Groups and Their Effect on Instrument and Recovery Ratings

Fitch's criteria assign countries to four groups, with the practical effects as described below.

Country Groupings

Country Grouping	RR Caps	Effect on RRs	Effect on Instrument Ratings
A	'RR1' (recoveries given default range from outstanding to poor).	No constraint to the assigned RRs. The most senior liabilities generally have sequentially higher ratings than junior obligations.	Ratings of secured or enhanced debt may be capped at two notches above the IDR when investment-grade and three notches above the IDR when speculative-grade; no other impact.

Country Groupings

Country Grouping	RR Caps	Effect on RRs	Effect on Instrument Ratings
B	'RR2' (recoveries given default range from superior to poor).	Caps of 'RR2' for the most senior obligations, potential compression of some senior obligation ratings.	Ratings of secured or enhanced debt may be capped at one notch above the IDR when investment-grade and two notches above the IDR when speculative-grade; no other impact.
C	'RR3' (recoveries given default range from good to poor).	Caps of 'RR3' for the most senior obligations, potential more likely compression of some senior obligation ratings.	Ratings of secured or enhanced debt may be capped at one notch above the IDR in both investment-grade and speculative-grade rating categories; no other impact.
D	'RR4' (recoveries given default range from average to poor).	Caps of 'RR4' appropriate for the most senior obligations, and little if any distinction made between obligations based on formal collateral. Most junior obligations, nonetheless, likely to still receive 'RR5' or 'RR6' ratings.	Ratings of secured or enhanced debt may be capped at the level of the IDR in investment-grade and speculative-grade rating categories (i.e., no credit given for security, or for creditor-friendly balance sheet structure or asset quality); no other impact.

Source: Fitch Ratings

Fitch focuses on three broad dimensions of governance mapping to indicators reported by the *World Governance Indicators* project of the World Bank (http://info.worldbank.org/governance/wgi/) to assess the implied governance environment of a country. Fitch selected the Regulatory Quality, Rule of Law and Control of Corruption indicators as a proxy for an assessment of the insolvency regime of a country and its consistent application to all entities under its jurisdiction. The table below provides the World Bank's summary description of the selected indicators.

Fitch uses the World Bank indicators in the criteria because of their comprehensiveness, methodological transparency, widespread use in other cross-country studies, and completeness of coverage geographically and over time.

Selected World Governance Indicators

Dimension	Description
Regulatory Quality	Captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
Rule of Law	Captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.
Control of Corruption	Captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

Source: Fitch Ratings, World Bank

Fitch takes a simple average of the most recent percentile ranks of the selected World Bank Indicators to calculate the implied Governance Scores. The implied Governance Scores map to a grouping as shown in the table below.

Implied Governance Score Thresholds

Group/RR caps	Implied Governance Score
A/RR1	Above 80
B/RR2	Above 70
C/RR3	Above 60
D/RR4	Up to 60

Source: Fitch Ratings

For example, Fitch would classify a country with Regulatory Quality percentile rank of 75, Rule of Law rank of 82 and Control of Corruption rank of 72 into group B based on its implied Governance Score of 76.

Qualitative Overlay

Fitch may apply a qualitative overlay to adjust downward the grouping of a country when we recognise material insolvency-specific factors not reflected in the governance assessment by the *World Governance Indicators* project of the World Bank that may have a significant influence on the predictability of insolvency outcomes within a jurisdiction.

In this assessment, Fitch focuses on factors addressing three aspects: preservation of value during distress, the predictability of the distribution waterfall and the protection of secured creditors. These factors align with Fitch's approach to estimating recovery estimates outlined in the *Corporates Recovery Ratings and Instrument Ratings Criteria*.

Fitch expects the qualitative overlay to be applied infrequently but the presence of one, or many, of the factors listed on the next page may result in a downward adjustment of one level.

Examples of Qualitative Overlay Factors

Dimension	Example
Preservation of value	Liquidation is the most common outcome after default for large entities. Administrative costs to resolve insolvency are highly variable. The post-default recovery process often lasts more than three years.
Predictability of distribution waterfall	The distribution of value after default is often the result of an informal bargaining process, and may also be significantly influenced by government intervention or other external factors. Fitch views the court system as inefficient and/or ineffective at enforcing creditor rights upon default. The distribution of value often diverges from internationally accepted norms of creditor ranking.
Protection of secured creditors	Mechanisms for registering security and enforcing security holders' rights are weak or non-existent.

Source: Fitch Ratings

Monitoring and Publishing of Country Groups

For a listing of the Country Groups in use that were developed by Fitch through the application of these criteria see *Country Group Scoring Summary*, *Country Groups for Country-Specific Treatment of Recovery Ratings*, available at www.fitchratings.com.. When applied, the rationale and impact of a qualitative overlay to a country grouping is also disclosed in the document. The countries, territories and jurisdictions included in the linked document are those for which Fitch has credit ratings in place, or considers relevant to its rating analysis, as of the publication date of the linked report.

Fitch will review the country groupings following each update of the *World Governance Indicators* project by the World Bank (published annually at the end of September). However, for the assessment to be changed, a country must achieve an average score above/below the cut-off score for two consecutive years. Fitch will also review the classification of a country if there is a material change in its recovery framework that we believe could result in a different qualitative overlay. The updated country grouping would then be used in support of any ratings review.

If Fitch were to assign an international-scale rating to an issuer in a country that not does not appear in the linked exhibit, a Country Group for that country would be developed as part of the ratings analysis.

If a new or updated Country Group is not yet published in the linked exhibit, the new or updated Country Group would be noted by Fitch in Rating Action Commentaries on any issuer on which Fitch takes rating actions where the Country Group was material to the rating outcome.

Fitch expects to update the linked exhibit at least annually.

Issuer-Specific Considerations

Treatment of Issuers Operating in Multiple Jurisdictions

For issuers with assets in multiple jurisdictions, an issuer-specific cap will be derived based on the weighted average of the caps of the countries where the economic value of that issuer's business could be realised. When the country of incorporation of the parent company has a more restrictive cap than the average of the countries where most assets are located, the more restrictive cap of the holding company's jurisdiction would apply only if Fitch believes the recovery process would be negatively affected, directly or indirectly, by any legal processes at the parent company level (for example, the courts of the parent's jurisdiction order a stay of execution over the whole recovery process).

Treatment of Certain Foreign-Currency Obligations

When Fitch believes an issuer's FC default would probably be driven by exchange controls, RRs on FC instruments can be assigned above the cap. The assumption is that issuers that remain solvent and liquid but are prevented from servicing their FC obligations because of exchange controls, are less likely to enter bankruptcy proceedings and more likely to generate higher recoveries for creditors when the controls are eventually lifted or the issuer restructures its debt.

Fitch interpolates the resilience in recovery terms of an issuer to a FC instrument payment default resulting from exchange control restrictions by measuring the difference between its Local-Currency (LC) IDR and FC IDR. Fitch's approach establishes a maximum (implied or explicit) 'RR2' rating on FC unsecured debt for the most resilient issuers, when the gap between FC and LC IDR is four notches or more. When the gap between IDRs is two to three notches, the maximum recovery is 'RR3', and when the gap is less than two notches recovery is capped at 'RR4'.

All FC instrument ratings will, in any case, be limited to the level of the equivalent LC obligation.

Cases with Particular Circumstances

When an Instrument Enters a Distressed or Defaulted State

When an issuer in any jurisdiction is in distress or has defaulted, instrument ratings may be assigned above the cap when Fitch has reason to believe that recoveries in that individual case will be consistent with a higher RR (and hence instrument rating). Naturally, distressed or post-default RRs may also be lowered should Fitch's analysis indicate that recovery prospects have worsened relative to the agency's previous evaluations.

When an Instrument Benefits from a Third-Party Partial Guarantee

The presence of a partial credit guarantee may support the upward notching of an instrument rating beyond the country-specific caps set out in this report. See Third-Party Partial Credit Support Rating Criteria for further information.

Limitations to Uplift for Economic-Regulated Utilities

Country-specific recovery considerations may also influence the application of the recovery uplift for debt instruments of utilities. Fitch believes higher rates of recoveries for utilities' senior debt are less predictable in a weaker sovereign environment than in an idiosyncratic default of any single utility. The one-notch uplift for higher expected recoveries on senior unsecured debt instruments issued by economic-regulated utilities is not applied when this would result in the instrument rating exceeding the relevant country's sovereign IDR. In that case, the senior unsecured debt rating is aligned with the regulated utility's IDR. See *Appendix*

2: Notching and RR Criteria for Utilities in the Corporates' Recovery Ratings and Instrument Ratings Criteria for further information about the uplift that may apply to the instrument-level ratings of economic-regulated utilities.

Certain Insurer Financial Strength Ratings

Insurer Financial Strength (IFS) ratings, which apply to policyholder obligations, typically assume a recovery that aligns with an 'RR3' recovery rating when insurance regulation is viewed as effective. In such cases, Fitch assumes regulators will intervene early enough in a distressed scenario to preserve assets to support an above-average recovery for the insurer as a whole, and thus policyholders. When insurance regulation in a given country is viewed as ineffective, a lower recovery assumption is often used. Fitch may or may not apply the 'RR4' cap discussed in this criteria report for IFS ratings in group D countries based on whether or not the agency believes the strength of the insurance regulatory regime offsets weakness in general creditor laws or how they are applied.

Rating Assumption Sensitivity

Ratings are sensitive to assumptions around the relative governance environment and predictability of a country's insolvency framework guided, respectively, by the World Bank's *World Governance Indicators* scores and Fitch's assessment.

Criteria Disclosure

In Fitch's Rating Action Commentaries and Rating Reports, the agency expects to disclose, as applicable, how these criteria have been applied, including:

- a jurisdiction's RR cap, when the cap constrains the assigned RR to a rated debt instrument; and
- when RRs have been raised above the country-specific cap.

Variations from Criteria

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis, and full disclosure via rating commentary strengthens Fitch's rating process while assisting market participants in understanding the analysis behind our ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their impact on the rating when appropriate.

A variation can be approved by a ratings committee when the risk, feature, or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but when the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

Data Sources

The key assumptions and issue ratings for these criteria are based on the most recent *World Governance Indicators* by the World Bank and Fitch's analysis of various corporate finance defaults over many years, information received from market participants across fixed-income markets, and general market observations determined by experienced analytical rationale.

Criteria Limitations

- In the absence of significant default and recovery data for capital markets instruments in the majority of markets in which Fitch assigns ratings, and in order to provide an analytically consistent framework across jurisdictions, this country overlay is based on analyst expectations and research studies.

- The governance rankings are based on the assessments by the World Bank, and have not been independently verified by Fitch.
- Information flows for companies close to default can become erratic, which may reduce Fitch's visibility in completing its recovery analysis.
- Enterprise valuations play a key role in the allocation of recoveries across creditor classes for corporate (including financial institutions) issuers. Fitch assigns these based on cash flow multiples (for a going-concern analysis), and advance rates (for a liquidation analysis). The analysis that determines an RR is therefore led by conservative forecasts based on Fitch's expectation about the issuer's performance and its markets. Fitch analysts form this expectation by considering post-restructuring cash flow, achievable exit multiples and appropriate advance rates, all of which are subject to substantial volatility before and during a restructuring process.
- Legal decisions can sharply affect recovery expectations. A single instrument's rating level provides only limited insight into the broad range of possible outcomes to legal decisions rendered during each bankruptcy proceeding.
- Out-of-court settlements will be influenced heavily by creditor composition and local political and economic imperatives, which are subject to volatility.
- Neither IDRs nor RRs address creditor composition, as this is a constantly changing component that is impossible for Fitch to effectively monitor. Creditor composition is nonetheless a major factor in the resolution of many administration, bankruptcy, insolvency, and restructuring scenarios.
- Further limitations relevant to credit ratings can be found in Fitch's Ratings Definitions available at https://www.fitchratings.com/site/definitions