TP AND CREDIT RATINGS: DETERMINING THE ANCHOR RATE

Although commercial tools are widely used by transfer pricing (TP) practitioners and tax authorities to determine the risks posed by borrowers with no previous credit ratings, there are some grey areas on how to apply the arm's-length principle.

One of the most important factors in the pricing of loans, guarantees or other financial instruments is the credit profile of a borrower. The credit profile of a borrower is often expressed as a credit rating.

Formally, credit rating agencies such as Standard & Poor's (S&P), Moody's or Fitch, determine credit profiles. The process of retrieving such a formal rating is capital intensive and time consuming and thus, from an administrative perspective, not always feasible. In practise, more practical approaches are emerging to determine the credit profile of a borrower. Commercial tools have been developed that are designed to rate borrowers for which no formal credit rating is available. These commercial tools are widely used by TP practitioners and tax authorities.

However, because of the absence of detailed guidance, a grey area remains in the application of the arm's-length principle.

The relevance of detailed guidance is increasing because discussions on the use of credit ratings (and specifically the effect of implicit support on credit ratings) are one of the rarer TP cases that make it to court. The use of credit ratings has thereby attracted more attention because its use is

underlined in the public discussion draft (discussion draft) released by the OECD on July 3 2018 on financial transactions.

Given this uncertainty, a series of three articles written for TP Week aim to provide practical guidance on the relevant steps to determine the credit profile of non-rated entities that are part of a multinational enterprise group (MNE group).

This first article discusses OECD guidance and how the business risk profile and financial risk profile form the “anchor rating” of an entity. Subsequently, the second article provides the next part of the framework, which can be used to determine an entity’s stand-alone credit profile (SACP). The final article in this series describes the impact of passive association with an MNE group and the effect it may have on the creditworthiness of an entity based on the S&P group rating methodology.

The OECD’s discussion draft

The OECD’s 2018 discussion draft on financial transactions deals with the mandated follow-up work in relation to Actions 8-10 of the OECD/G20 BEPS project. Under that mandate, the discussion draft, which does not yet represent a consensus position of the committee on fiscal affairs or its subsidiary bodies, aims to clarify the application of the principles included in the 2017 edition of the TP Guidelines.

Until the discussion draft was published, only very little guidance was available on the determination of credit ratings (or the TP aspects of financial transactions for that matter) – apart from the notion that group membership on the credit rating of an entity should not be overlooked. Therefore, although the discussion draft does not yet present a consensus position and is subject to commentary, it is worth noting the OECD’s view on determining credit ratings.

On June 4, Thomas Balco, Head of the Transfer Pricing Unit at the OECD Centre for Tax Policy and Administration, stated: “Countries working on new OECD transfer pricing guidelines for financial transactions have reached agreement on virtually all issues associated with the project”. However, up to the publish date of this article no further information was provided of the agreement. It is anticipated that additional information regarding the agreement is published before year end 2019.

As described in the discussion draft, a credit rating can serve as a useful measure of creditworthiness and as such help to identify potential comparables. A lower credit rating indicates a greater risk of default and thus the arm’s-length compensation should be higher. Because not all entities have a formal credit rating, commercial tools are widely used to determine the credit rating when determining the credit rating in an inter-company situation. These commercial tools, such as the S&P Credit Model or Moody’s RiskCalc, use proprietary data and a specific industry factor to produce estimated credit scores of a borrower.

The credit rating methodology used in commercial tools significantly differs from the credit methodology applied by a credit agency when providing a formal credit rating. Formal credit ratings published by the rating agencies use a more rigorous analysis based on:

- A quantitative analysis of the historic and forecasted performance of a company; and
- A qualitative analysis of a company’s management and business performance.

The OECD, therefore, believes it is questionable whether merely performing a quantitative analysis is sufficient to determine an accurate credit score of a non-rated entity.
The discussion draft thereby states that, when assessing the credit rating of an entity, it is important to note that the financial statements of a specific entity might be influenced by the specific controlled transaction (e.g. an inter-company loan). To account for this, a comparability adjustment should be made in the financial statements (e.g. the loan amount, but also the arm's-length interest rate).

Credit methodology

As described in the discussion draft, commercial tools are widely used by TP practitioners for the determination of an entity's SACP. The benefit of this approach is that it is primarily based on a quantitative analysis and thus less impacted by subjective arguments and can easily be recreated and reviewed by tax authorities. However, it can be argued that only using a quantitative approach does not result in the full picture of the creditworthiness of an entity.

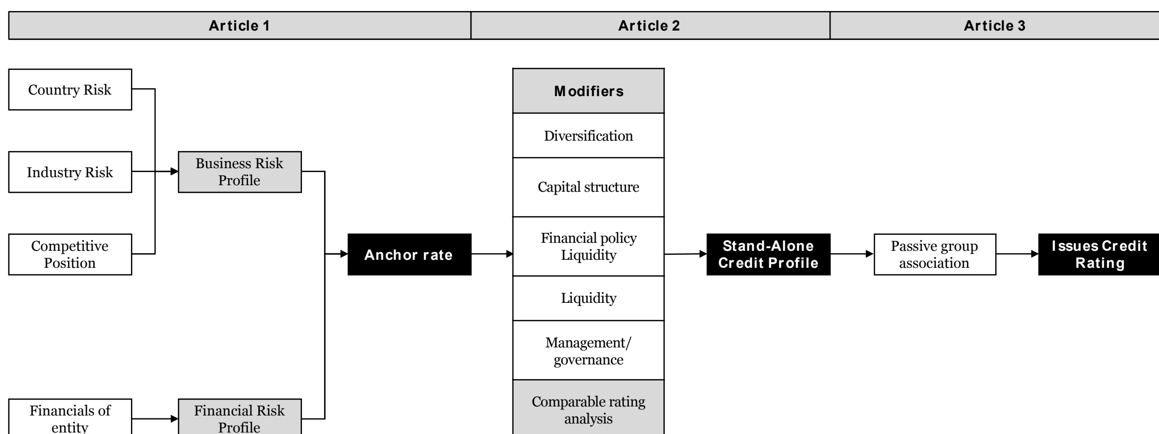
S&P developed a corporate analytical methodology, which can be used as a common framework to better analyse and assess the SACP of an entity. This framework starts with:

1. Analysing the business risk profile;
2. Analysing the financial risk profile; and
3. Combining the two above to determine an anchor rate.

After this, six factors (i.e. diversification, capital structure, financial policy, liquidity, management and governance (M&G) and a comparable ratings analysis) are analysed that can potentially modify the anchor rate. The anchor rate, including the modifiers, leads to the SACP. This process is described in the second article of this series.

Taking the impact of passive group association into account, we will arrive at the issuer credit rating (ICR). This process is described in the last article of the series.

An overview of the entire framework is provided in Figure 1.



Using the framework in Figure 1 as the main methodology to prepare a practical framework is pragmatic, but it also counters the suggestion by the OECD that SACPs derived by commercial tools are less extensive (e.g. primarily based on quantitative parameters) in comparison to formal ratings.

The actual methodology used by credit rating agencies is more extensive and time consuming, but we believe the Figure 1 framework is sufficiently objective and thorough while remaining practical. Details of each step leading up to the anchor rate are detailed below.

Financial risk profile
To determine the anchor rate, the financial risk profile and the business risk profile should be determined.

In practice, this would be determined by means of a commercial tool that, generally, uses the financial statements, geographic location and industry of an entity. Through the Figure 1 framework, a financial profile is established by using certain ratios or margins (e.g. debt to equity, debt to asset, current ratio, return of equity, return on investment, profit and loss (P&L), earnings before interest and tax (EBIT), etc.) and offsetting these ratios against industry averages in certain countries.

Most of the commercial tools have user guides in which all of the ratios, and their uses, are explained;

- Business risk profile - After determining an anchor rate through a commercial tool, the next step would be to assess the competitive position of an entity and to make possible adjustments to the initial anchor rate:
  a) Country and industry risk – In most commercial tools, the country and industry are taken into consideration when determining the anchor rate. However, if the initial anchor rate – determined by means of the commercial tool – does not account for country or industry risk, additional adjustments may be necessary.

     An assessment that should always be made in relation to the country of the entity is whether the final ICR is higher than the sovereign rating of the country in which it is located. This is because, in general, the ICR of an entity is limited to the sovereign rating of the country in which the entity is located because country risks, such as economic, institutional and governance effectiveness, financial system and payment culture/rule of law risks, influence the credit profile of an entity.

  b) Competitive position – In this analysis, there are four factors that should be considered:
     (i) competitive advantage, i.e. the strategic positioning and sustainability of a business model;
     (ii) scale, scope and diversity, i.e. the concentration or diversification of the business activities;
     (iii) operating efficiency, i.e. the quality and flexibility of the asset base; and
     (iv) profitability.

To assess the competitive advantage of an entity, the following questions should be considered:

- Whether the business strategy is consistent and adaptable to trends;
- Whether the entity develops well-differentiated products;
- Whether there is a track-record of customer satisfaction;
- Whether there is a clear premium to brand equity, technological leadership or quality of service;
- Whether there are entry barriers that reduce the threat of competition, or
- Whether there is a demonstrated reinvestment or redevelopment plan in its own asset base.

To assess the scale, scope and diversity of an entity, the following questions should be considered:

- Whether the products or services are diversified, i.e. is one customer responsible for more than 20% of the revenue?
- Whether the customers are diversified based on industry and location;
- Whether the customers have a high credit quality and whether their demand is sustainable and stable;
- Whether the business is dependable on a particular supplier which is difficult to replace; or
- Whether the entity holds a strategic investment that diversifies the business.

To assess the operating efficiency of an entity, benchmarking certain working capital ratios (e.g. inventory/revenue, payables or receivable/revenue) with publicly available industry averages can help. Through such a benchmark, it is possible to determine whether there is superior working capital management.

In addition, profitability should be seen as the materialisation or result of the competitive position of an entity's business activities. Profitability may be an indicator if an entity has an above average competitive position or a below average competitive position. The profitability should therefore be in line with the assessment of other factors in the 'competitive position assessment'. If it is not in line with these factors (i.e. entity is assessed as competitive but is not profitable) there should be a clear argument why the competitive position is assessed as strong when the entity is, for example, loss making.

After having considered all these factors, an assessment should be made of the competitive position (positive, neutral or negative). A positive assessment would lead to an 'up-notch' of one notch and a negative assessment would lead to a down notch of one notch.

Table 1 provides a short overview of the possible impact of the business risk profile on the SACP.

Business risk profile	Impact on SACP
Country and industry risk	Cap at sovereign rating
Competitive position	One notch up or down

In summary, this article describes the process of determining the anchor rate. The anchor rate derived from a commercial tool is in practice often used as the SACP (or even the ICR) of an entity. However, there are adjustments that can (and possibly should) be made, to arrive at a reliable anchor rate – and subsequently a reliable SACP and ICR.

This article was written by Joris Steunenberg and Mick Willemsen, transfer pricing and valuations specialists at Atlas Tax Lawyers and T/A Economics. It is the first in a mini-series on the use of credit ratings in transfer pricing.