Proposed Criteria: Reflecting Subordination Risk In Issue Ratings of Corporate Issuers

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S&P Global Ratings is requesting comments on proposed changes to its methodology for rating the debt of investment-grade corporate issuers and some speculative-grade corporate issuers.

Who Would This Affect?

- The methodology would be used to rate the debt issues of corporate and some non-bank financial institution investment-grade issuers. It would also apply to some speculative grade issuers in certain jurisdictions.

Why Now?

The purpose of the changes are to:

- Increase the transparency of our methodology;
- Help market participants better understand our approach to issue ratings; and
- Enhance the comparability of issue credit ratings across regions and sectors.
What Stays the Same?

- The criteria identifies and **signals** significant subordination risk, which could eventually materialize into relatively lower post-default recovery prospects, compared to other issues of the same borrower.

- We **signal** subordination risk by notching the rating down from the issuer credit rating (ICR).

- Three types of subordination are recognized:
  - **Contractual subordination** – relative disadvantage explicitly defined in the loan documentation
  - **Structural subordination** – lenders to an opco are closer to assets than lenders to a holdco
  - **Subordination resulting from a significant amount of secured debt** - collateral coverage gives advantage to secured debt versus unsecured debt
# What Changes?

<table>
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<tr>
<th>REI</th>
<th>Proposed Criteria</th>
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<tbody>
<tr>
<td>Subordination determined by comparing priority claims to assets</td>
<td>Subordination determined by comparing relative rank of classes of debt</td>
</tr>
<tr>
<td>Include non-debt claims (e.g., unfunded pension liabilities)</td>
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<tr>
<td>Debt can be rated the same, higher, or up to two notches lower than the ICR.</td>
<td>Debt can be rated the same as the ICR or one notch lower*</td>
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<td>Broadly defined characteristics can mitigate subordination</td>
<td>Mitigating characteristics more clearly defined</td>
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* We will continue to notch up in certain industries which are out of scope of this proposed criteria (e.g. aircraft-backed equipment trust certificates, secured debt of real estate companies and regulated utilities; see appendix 7 in RFC).
How Many Ratings Could Change?

We expect up to 10% of in-scope issuers to see a ratings change in one or more of their rated debt issuances. Of the issue credit ratings that could change, we expect roughly twice as many downgrades as upgrades.
Proposed Criteria Framework at a Glance

Chart 1
Reflecting Subordination Risk in Issue Ratings

1. Is debt to be rated contractually subordinated?
   - Yes
   - No

2. Is debt to be rated secured? Issued by a qualifying utility? Or issued by an entity located in a qualifying C-ranked jurisdiction?
   - Yes
   - No

3. Is the FRP of the issuer or its parent minimal or modest?
   - Yes
   - No

4. Is the proportion of secured debt to the issuer’s total debt (Secured Debt Ratio) greater than 50%?
   - Yes
   - No

5. Is the proportion of secured debt plus subsidiaries’ unsecured debt to the issuer’s total debt (Priority Debt Ratio) greater than 50%?*
   - Yes
   - No

Preliminary notching outcome: Rate debt one notch below ICR

Preliminary notching outcome: Rate debt same as ICR

Step 6: Determine if a notching adjustment applies

Final notching outcome

*See Step 5 in Methodology section and Appendix 5 for conditions that mitigate subordination risk.
FRP—Financial risk profile. ICR—Issuer credit rating.
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Is debt to be rated contractually subordinated?

- Yes - rate 1 notch below ICR, subject to application of notching adjustment
- No – continue to step 2

Contractually subordinated debt ranks below other debt with regards to claims against the issuer’s assets, due to provisions in the debt instrument’s documentation. When creditors explicitly agree to rank junior to other creditors, they have accepted a relatively higher risk of loss on their investment.
Proposed Methodology: Step 2

Is debt to be rated **secured**?

- Yes - rate debt same as ICR, subject to application of notching adjustment
- No - continue to step 3

Secured debt is better positioned than unsecured debt because of the additional protection that the security may provide (see definition of secured debt in Appendix 8 of the RFC). We reflect the secured lenders’ priority relative to other lenders by rating the secured debt at the same level as the ICR.
Is issuer’s financial risk profile ‘minimal’ or ‘modest’?

- Yes - rate debt same as ICR, subject to application of notching adjustment
- No - continue to step 4

*If an issuer has relatively low leverage, it is less likely that the debt to be rated would be significantly disadvantaged to more senior debt.*
Is the secured debt ratio (proportion of secured debt to the issuer’s total consolidated debt) > 50%?

- Yes - rate 1 notch below ICR, subject to notching adjustment
- No - continue to step 5

If there is a significant proportion (>50%) of secured debt in an issuer’s consolidated capital structure—we consider that the unsecured debt is disadvantaged because secured lenders have priority over unsecured lenders.
Is the priority debt ratio (proportion of secured debt plus unsecured debt issued by subsidiaries, to the issuer’s total consolidated debt) > 50%?

- No - rate debt same as ICR, subject to application of notching adjustment
- Yes, and mitigants do not apply – rate 1 notch below ICR, subject to notching adjustment
- Yes, but mitigants apply – rate debt same as ICR, subject to notching adjustment

*If unsecured subsidiary debt + total secured debt is significant, then lenders to the holdco issuer could be meaningfully structurally subordinated.*
Proposed Methodology: Mitigants to Structural Subord.

Operating assets at the holdco

- Issuer owns operating assets that generate 30% or more of the issuer’s and its subsidiaries’ consolidated earnings, cash flow, or a similar financial metric.

- Meaningful direct holding level income mitigates the risk that stems from the distance of holdco creditors from the group’s other main cash generating assets.
Proposed Methodology: Mitigants to Structural Subord.

Upstream guarantees

• Guarantors that provide upstream guarantees of the rated debt generate at least 30% of the issuer’s and its subsidiaries’ consolidated earnings, cash flow, or a similar financial metric.

• Upstream guarantees bring unsecured holdco debt to parity (in standing) with unsecured subsidiary debt.
Diversification

- If the issuer is a ‘well-diversified’ company (as detailed in Appendix 3 of RFC), we will generally not notch if Priority Debt Ratio (Step 5) is <75%

- An issuer's business or geographic diversity may improve the prospect of the residual value remaining for creditors because the company's individual subsidiaries could retain value differently based on their distinct businesses, some with shortfalls and others with surpluses.
Does the notching adjustment apply?

- In rare situations, we may adjust the preliminary notching outcome if we believe that such an outcome does not fully capture the debt's relative subordination or, alternatively, priority ranking.

- We expect to apply this adjustment only in cases where we strongly believe that conditions support a final notching outcome that is different than the preliminary outcome.

- The use of the notching adjustment would result in the following final notching outcomes:

<table>
<thead>
<tr>
<th>Preliminary Notching</th>
<th>Notching Adjustment Used?</th>
<th>Final Notching</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>Yes</td>
<td>-1</td>
</tr>
<tr>
<td>-1</td>
<td>Yes</td>
<td>0</td>
</tr>
</tbody>
</table>
Proposed Methodology: Other Considerations

- Certain government-related entities with “almost certain” or “extremely high” assumed level of support
- Companies in certain Group C-ranked jurisdictions
- Unsecured debt issued by regulated utilities
- Japanese bank loan waivers
Specific Questions On Which We Request Your Feedback

• Is the proposed methodology sufficiently clear and transparent?

• What is your view about the proposed exclusion of non-debt claims?

• What is your view about the 50% threshold for notching for subordination risk?

• What is your view about the treatment of debt issued in Group C jurisdictions?

• What is your view about the proposed treatment of certain Govt Related Entities?

• What is your view about the mitigating factors?

RFC Response Deadline:

• We invite you to submit comments by June 6, 2017.

• Submit comments to: http://www.standardandpoors.com/en_US/web/guest/ratings/rfc
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