Comments on Proposed Criteria – Issue Ratings

On 15 February 2021, TRIS Rating requested comments on proposed revisions to the criteria of notching up/notching down issue ratings from the Issuer Credit Rating (ICR) of an issuer. We would like to thank all market participants who provided feedback. After careful consideration of the market feedback, we have revised our criteria to incorporate some suggestions and to make clarifications on some issues. We have finalized and published our criteria titled "Issue Ratings," published 15 June 2021, on TRIS Rating's website.

The following points are a summary of the comments made by market participants and TRIS Rating's responses to the comments.

1. We don't think there should be any further notching so long as there are cross-default provisions across the issuer's financings, because then the issuer is compelled to make sure all financings are serviced, and is unlikely to make a distinction whether certain financings are at the holdco/opco level.
   Answer: A cross-default provision may have the effect of deterring an issuer when opting for selective defaults in a stress scenario. However, it does not address the issue of structural subordination in a liquidation scenario. If the operating assets are at the opco level, the creditors at the opco level will have a better chance of debt recovery from the proceeds of liquidating the operating assets. In contrast, the creditors of the holdco will have the first claim against the assets at the holdco level, which are likely to be insignificant vis-à-vis the assets at the opco level. The only chance for the holdco creditors to receive an amount from the opco's liquidation is when there is a residual amount from the proceeds of liquidation at the opco level, after satisfying all obligations to the creditors at the opco level.

2. On guaranteed debts, "if two or more guarantors jointly guarantee the issue and those guarantors are not highly correlated, the issue could be assigned a rating higher than the highest rating among the guarantors." What is the definition of 'guarantors that are not highly correlated'?
   Answer: The guarantors should not be in the same industries and/or same countries/regions.

3. On the definition of priority debt and total debt, TRIS Rating excludes operating leases, what about financial lease liabilities?
   Answer: We have revised the paper to exclude both financial lease and operating lease obligations from the calculation of secured debt and priority debt ratios in most businesses, except for some businesses that rely heavily on financial lease as a source of funds, like airline and shipping businesses. For these businesses, we will include financial lease as secured debt in the calculation of both ratios.

4. Are there any differences between the senior unsecured debt rating of issuers that have secured debt to total debt (secured debt ratio) higher than 50% and those that have a secured debt ratio less than 50% but whose priority debt to total debt ratio (priority debt ratio) is higher than 50%?
   Answer: Yes. We have revised the paper to clarify how we assign a rating to senior unsecured debt. Generally, if the issuer has low financial risk, we would assign its senior unsecured debt

rating at the same level as the assigned ICR. If that is not the case, we will then consider the level of secured debt ratio and/or priority debt ratio of the issuer. If the issuer's secured debt ratio is higher than 50%, its senior unsecured debt will be rated one notch below the assigned ICR. If an issuer's secured debt ratio is less than 50% but its priority debt ratio is higher than 50%, we may or may not notch down its senior unsecured debt rating depending on the circumstances of applicable mitigating factors.

5. According to the definition of "Priority Debts", in which the total debts include all of the issuer's interest-bearing debts, convertible debentures and the full principal amount of hybrid securities, is the full amount of hybrid securities being counted in the calculation of the priority debt after the first call date of 5-years (as before 5 years, 50% should be counted as equity, from a credit rating perspective)?
   Answer: Priority debt is related to the recovery prospects of debt obligations in a liquidation scenario. Legally, hybrid securities are debt obligations that rank behind all senior and subordinated debts but before common equity. The full principal amount of hybrid securities should therefore be counted in the calculation of the priority debt ratio. The 50% equity treatment tied to the first call date is for net-debt calculation for the purpose of evaluating the issuer's level of financial leverage, which is a separate concept from priority debt calculation.

6. Are there any other cases in which the issue rating of the parent company is notched down more than one notch under the Priority Debt Concept?
   Answer: For senior unsecured debt ratings, we limit the notch-down to one notch from the ICR.

7. For issue ratings of secured debts, tradable securities that can be pledged as security include only government bonds or investment-grade corporate bonds. Are there any other asset types that can be pledged as security under this new concept of issue rating?
   Answer: We might consider other assets to be used as collateral for debt issuance on a case-by-case basis. However, the proposed collateralized assets and structure would have to satisfy a number of key considerations, such as liquidity of assets; acceptable and periodically updated valuation or a mechanism to keep track of the security value; clear enforcement procedures in a default scenario; and legal and physical protection of collateralized assets for the interest of secured creditors.

8. For hybrid securities, why does TRIS Rating propose to reduce the number of notches down for hybrid securities of non-investment grade issuers from three to two notches?
   Answer: After further consideration, we have revised the guidance for the number of notches down for hybrid securities to focus on the securities' features that affect the debt holders' claims. According to the new criteria, typical hybrid securities seen in the market will be subject to at least two notches down from the assigned ICR: at least one notch for interest payment deferral risk and one notch for subordination risk. In addition, we would focus on the features of hybrid securities and the possibility that the issuer may defer the coupon payment. Hybrid securities that have more equity-like characteristics than the typical hybrid securities that we have seen in the market, could be notched down by more than two notches from the ICR.

9. For REITs, should TRIS Rating focus on the debt to assets ratio rather than the priority debt to total debt ratio?

   Answer: The new criteria take into consideration the potentially subordinated position of an issuer's unsecured creditors vis-à-vis its secured creditors and the creditors of its operating subsidiaries. The 50% priority debt threshold is meant to provide flexibility for the issuer to incur priority debt without resulting in a rating notch-down on its unsecured debt obligations. The criteria also set out specific mitigants to be considered in evaluating the subordination impact. For an issuer that currently has a priority debt slightly above the 50% threshold, an adjustment of its debt structure or capital structure will be necessary to avoid a notch-down on its unsecured debt obligations.

   For REITs and regulated utilities, the applicable leverage thresholds for determining low financial risk are already more relaxed than general corporates. Those that have low financial risk may not be subject to the priority debt notch-down. In addition, for REITs, we may use the level of secured debt to total assets (at fair market value) as a trigger for notching down the senior unsecured debt issues. We may also assign the senior unsecured debt rating at the same level as the ICR if the remaining value of assets after netting off the amount of priority debts can cover the repayment of its senior unsecured debt. However, we may use the forced sale value of the REIT's assets or apply a discount to the market value to derive a reasonable estimate of salvage value in a liquidation scenario.

10. For a holding company, instead of looking only at the priority debt ratio, should TRIS Rating take into account the quality of its investments in other assets/affiliates?

    Answer: Due to the complexity of some holding companies, in addition to the amount of operating assets at the holdco level, we may also take into consideration investments other than shares of subsidiaries at the holdco level. In some instances, we may not notch down the unsecured debt rating of a holdco, if the holdco has substantial investments in other assets and/or affiliates and these investments are assessed to materially improve the recovery prospects. As such, we may consider that the unsecured creditors are not significantly disadvantaged to priority debt holders.

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