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S&P Global

China Ratings

Commentary:

Understanding S&P Global (China) Ratings General Considerations on Rating Modifiers and Relative Ranking Methodology

June 29, 2020

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(Editor's note: This article supersedes the commentary "Understanding S&P Global (China) Ratings General Considerations on Rating Modifiers and Relative Ranking Methodology" published June 19, 2019. It is being republished to provide readers with more details on our approach to applying General Considerations on our Rating Modifiers and Relative Ranking Methodology.)

Introduction

The S&P Global (China) Ratings General Considerations on Rating Modifiers and Relative Ranking Methodology is constructed to describe our approach to considering the impact of common rating modifiers that may influence the ultimate issuer credit rating (ICR) or issue credit rating (issue rating) that we may assign. We may also consider the analysis of relative ranking of different securities and the associated impact on any rating that we may assign.

Where relevant, we may consider external factors, such as group relationships, government support, counterparty financial support and guarantees, amongst others, and see how these factors may influence either an underlying view of creditworthiness or the ultimate rating that we may assign.

When applicable, we would also consider the relative ranking of a given security and the implications of the ranking or nature of that security for any rating that we may assign. Examples where relative ranking may be applicable include areas such as senior secured debt, senior unsecured debt, subordinated debt, hybrid securities, tranched securitization structures, amongst others.

Rating Modifiers

Influence of a Group

When assessing an entity's credit quality, we usually consider its credit profile on a stand-alone basis. However, many issuers have complex entity structures and may have different relationships with their relevant groups.

These relationships could be credit positive or negative. In most cases, the effect on credit quality is positive because the group normally has greater resources and therefore stronger credit quality.

We typically consider the factors below when determining the impact of these relationships.

- The credit quality of the group;
- Any expectations of support from the group;
- Any expectations of negative influence such as cross default or financial demands on the issuer.

For more information on our approach to analyzing the influence of a group, please refer to our commentary "*Understanding S&P Global (China) Ratings Approach To Support*" published May 8, 2019. This commentary may also be republished from time to time.

Influence of a Government

When assessing an entity's credit quality, we usually consider its credit profile on a stand-alone basis. Where relevant, we also consider its relationship with a government.

When assessing a government's credit quality, we may consider its relationship with the higher-level government and determine any impact on its rating.

These relationships could be credit positive or negative. In most cases, the effect on credit quality is positive because the relevant government or higher-level government normally has greater resources and therefore stronger credit quality.

We typically consider the factors below when determining the impact of these relationships.

- The credit quality of the relevant government or higher-level government;
- Nature of the expected support;
- Nature of the expected intervention.

For more information on our approach to analyzing the influence of a government, please refer to our commentary "*Understanding S&P Global (China) Ratings Approach To Support*" published May 8, 2019. This commentary may also be republished from time to time.

Systemic Considerations

Some issuers or issues may benefit from intangible support as a result of its deemed relative importance to maintaining ongoing operations, particularly where an entity plays an important role in terms of services, economy, and employment, etc.

There can be many varied factors that we may consider when assessing the systemic importance of an issuer, for instance: the relationship between its operations and social stability; whether it is a champion of a strategic or pillar industry; whether its default could cause economic instability; its employment size, amongst others.

Support to systemically important issuers can manifest itself in different ways, such as preferential treatment; forcing mergers to consolidate industry leaders; tax cuts; or encouraging certain government-related entities or government bodies to provide support, etc. Such support may be ongoing or extraordinary, and may be reflected in SACP or ICR or both, as we deem appropriate.

Counterparty

Counterparties may be involved in cash management, bank accounts, derivatives, and providing liquidity support, amongst others. A counterparty's failure to perform its obligations may have implications for the performance of a security, notwithstanding the performance of the underlying assets backing the security.

For structured finance transactions we typically consider the maximum achievable rating for a securitization based on the credit enhancement levels provided and also the credit quality and replacement provisions of any financial counterparty supporting the transaction, particularly where the notes are rated above the credit quality of any counterparty.

Typically, a counterparty would be of high credit quality to take on certain counterparty risks in a transaction such as that of a bank account, or liquidity support, or a derivative. For example, we generally expect the minimum eligible counterparty's credit quality (i.e., the level below which a counterparty typically commits to implementing remedies) to be equivalent to a high bbb_{spc} level or above to be able to support an AAA_{spc} rating on the securities. In addition, we typically review the terms and conditions of any counterparty support being provided, including the replacement provisions and replacement timeframes in the event the counterparty's credit quality ceased to be eligible.

Guarantees

Some issuers or issues may source a guarantor to provide a guarantee for an obligation(s). We typically would review the terms and conditions of any guarantee provided and also consider the credit quality of the guarantor, and may adjust a rating as a result.

When assessing whether a guarantee is a form of credit enhancement, we may consider the payment conditions associated with the guarantee, restrictions on the guarantor's right to terminate the guarantee, and the stated beneficiaries of the guarantee (whether holders of the rated notes are the beneficiaries).

If the obligor's unguaranteed credit quality is superior to the guarantor's, the rating will typically reflect the obligor's credit quality.

In cases of several guarantees where each guarantor only guarantees a proportional amount of the obligation, we typically refer to the lowest guarantor credit quality to rate the obligation, though not below that of our rating on the transaction if it were unenhanced by guarantees.

Relative Ranking

ICR As A Foundation for Determining Issue Ratings

ICR is our forward-looking opinion about an issuer's overall credit worthiness. It focuses on the issuer's capacity and willingness to meet its financial commitments as they come due. ICR does not specifically link to any specific financial obligation. It reflects the issuer's all-in financial profile and is the starting point for assessing issue ratings. We usually consider the issue's relative ranking when determining issue ratings.

Typically, an ICR would coincide with our opinion of the creditworthiness of the senior unsecured debt of an issuer. However, in some instances, the rating on the senior unsecured debt can differ from the ICR.

Subordinated Debt

Subordinated debt, which has a relatively weaker position in an issuer's capital structure, may be assigned a rating below the ICR, depending on the credit characteristics of the issuer and the terms of the issue.

Typically, senior unsecured debt is rated at the same level as the ICR and subordinated debt is rated at least one notch below the ICR. However, if more than 50% of the issuer's debt is secured, for example, we may treat any senior unsecured debt as subordinated and notch it down once from the ICR. We may use the same approach when senior unsecured debt is issued by a parent company that operates largely as a shell to operating subsidiaries. If those operating subsidiaries issue debt that is more than 50% of the entire group's debt, for example, we may notch down the senior unsecured debt issued by the parent because we view it as structurally subordinated to the operating companies' debt.

We may notch down an issuer's contractually subordinated debt from the SACP when we do not expect support from a group or government to be extended to the subordinated debt holders.

Tranching In Securitized Structures

Typically, different tranches have different ranking and payment priority, and typically have differing levels of credit enhancement reflected in their different rating levels.

Different tranches may also reflect different stress scenarios at different rating levels, indicating different degrees of credit risk and having different default and/or loss scenarios. Lower tranches typically have more restrictive default and acceleration provisions, and their rights to cash flows from the underlying securitized assets are typically subordinated to more senior tranches of debt.

Hybrid Instruments

Some issuers may issue debt in the form of a hybrid security. These instruments can have features that are both debt and equity-like in nature. We typically consider an instrument to be a hybrid capital instrument if, without causing a legal default or liquidation of the issuer, it can absorb losses or conserve cash. Examples of such loss absorption or cash conservation include: (1) deferral of the coupon; (2) write-down of principal; or (3) conversion into common equity or another hybrid capital instrument.

Our assessment on the equity content of hybrid instruments initially focuses on the terms and conditions of the security, rather than the nomenclature alone. It also incorporates our view of issuer intent. An instrument may be considered to have high, intermediate, or no equity content, depending on the degree to which a hybrid instrument has equity-like features. The key principles underpinning our view of a hybrid instrument's equity content are: (1) its ability to absorb losses or conserve cash, if and when needed; and (2) its availability to absorb losses or conserve cash, based on the hybrid instrument or its replacement remaining outstanding for a sufficiently long period.

"High" equity content hybrids typically have very strong equity-like characteristics. They include features that help protect the issuer's credit quality near the current level, and if they substitute for plain vanilla debt, they improve the overall quality of the issuer's capitalization. Potential issue features may include mandatory convertibility, linkage to commons shares, or mandatory deferability. Investors in "high" issues typically bear equity-like risk, and we would expect the value of such instruments to have a high correlation with the value of equity.

"Intermediate" equity content hybrids typically have substantial equity-like characteristics. These include features that help protect the issuer's credit quality in the event of financial distress. The essential elements we may consider include flexibility of ongoing payment upon stress, subordination, and permanence. If such hybrids substitute for plain vanilla debt, they improve the overall quality of the issuer's capitalization. Nevertheless, an "intermediate" equity content hybrid is also debt-like in some respects, typically due to the relatively fixed nature of the dividend/interest on an ongoing basis, given investor expectations.

We typically assign "no" equity content to hybrid instruments that do not meet the requirements for "high" or "intermediate" equity content, including when issuer intent is lacking, and therefore treat these instruments as akin to debt in our analyses, where applicable. For example, if the likelihood of redeeming a hybrid instrument would increase in response to a worsening of the issuer's credit quality, the hybrid may be assessed as having "no" equity content.

We typically consider the relative ranking of the instrument and its likelihood of repayment according to expected terms, as well as the impact of the hybrid on the credit quality of more senior securities, in terms of providing additional protection.

In addition to evaluating the terms of the instrument, we also assess management's intent for the security to be available for loss absorption or cash conservation, when needed. We may consider factors including, but not limited to, public statements regarding replacement, as well as our view of the issuer's capital strategy, and the issuer's past behavior concerning hybrid issues.

We consider the views of regulators, in so far as they may influence the structure, terms, and payment of the issuance. For prudentially regulated banks and insurers, we typically assign no equity content to the instrument where it is not included in regulatory capital.

Where there is uncertainty about the level of cushion or the time period the instrument will be available, we will generally adopt a conservative view. Our view of a hybrid instrument may change over time.

Hybrid issues with high equity content may be treated as 100% equity and the coupons are typically excluded from interest in financial ratios; hybrid issues with intermediate equity content may be treated as 50% debt and 50% equity, and 50% of the coupons may be treated as interest in financial ratios; hybrid issues with no equity content may be treated as 100% debt and the coupons may be treated as 100% interest in financial ratios.

We generally assign an issue credit rating to a hybrid capital instrument by notching down from the ICR on the issuer. That said, we may exclude any element of support that we do not expect to apply to the hybrid. For example, if the ICR includes any uplift for potential extraordinary group or government support that we do not expect to apply to the hybrid, we may notch down from the SACP instead.

We may notch down once or twice for subordination and adjust down the rating by one more notch to reflect deferral of payment risk. If we consider that payment risk is not adequately captured in one notch, particularly when the issuer has a low ICR/SACP, we may apply wider notching at issuance as deferral risk increases. For example, notching for hybrid instruments issued by corporates may generally combine:1) one or two notches for subordination; and 2) one or more notches to reflect the risk of payment deferral/cancellation. Notching for hybrid instruments issued by financial institutions may generally combine:1) one or two notches for subordination; 2) one or more notches to reflect the risk of coupon deferral/cancellation; and 3) additional notching to reflect the risk of common equity conversion or principal write-down under mandatory contingent capital clause.

A debt instrument that transforms into a hybrid instrument upon a trigger event may be rated based on its hybrid features if we anticipate that the trigger will be activated at or before loss absorption or cash conservation on an equivalent hybrid instrument.

This approach generally applies to hybrid instruments issued by corporates, financial institutions, and insurance entities. Although we generally apply consistent principles across all sectors, the treatment of certain hybrid instruments may reflect sector-specific characteristics in terms of ownership, role of government and regulatory considerations, etc.

This report does not constitute a rating action.

This document is prepared in both English and Chinese. The English translation is for reference only, and the Chinese version will prevail in the event of any inconsistency between the English version and the Chinese version.