Article Title: ARCHIVE | General Criteria: Credit FAQ: How The Expansion Of The 'C' Rating Definition Affects Its Use For Hybrid Capital And Payment-In-Kind Instruments Data: (EDITOR'S NOTE: — We originally published this criteria article on Aug. 1, 2008. We are republishing this article following our periodic review completed on Aug. 6, 2012. This article is no longer current. It has been superseded by the article titled, "Methodology: Use Of 'C' And 'D' Issue Credit Ratings For Hybrid Capital And Payment-In-Kind Instruments," published Oct. 24, 2013.) On July 23, 2008, Standard & Poor's Ratings Services announced that it has expanded the definition of its 'C' long-term issue credit rating to include issues on which cash coupon payments have been deferred, eliminated, or, in some cases, paid in kind (PIK), as permitted under the terms of the issue. As a result, we revised our ratings on six hybrid capital issues to 'C' from 'D'. This change did not affect any issuer credit ratings. We will generally continue to assign a 'D' rating to issues that are in payment default, to issues that have been subject to a distressed exchange, or when the issuer has filed for bankruptcy or taken similar action. This FAQ, which is applicable to global Corporate and Government Services ratings, discusses this criteria change and provides more detailed information. Different criteria are applied to structured finance ratings. Frequently Asked Questions How does the definition expansion change our approach to assigning ratings to hybrid capital instruments? The definition expansion only affects the rating that we assign to a hybrid capital issue in the event that the cash coupon on the instrument is no longer being paid but the issuer is not bankrupt or insolvent. As a result of the definition expansion, we would now use the 'C' rating if the coupon is not paid because of a coupon deferral or suspension that is in line with the terms of the instrument, but the issuer's credit rating (ICR) is not 'D', 'SD', or 'R'. Hybrid capital instruments typically have clauses that allow or force the issuer to defer or eliminate the cash coupon in particular circumstances. For example, the issuer may be able to defer the coupon at any time or maybe only in the event that its capital or earnings position falls below a set level. The deferral may be at the management's discretion or it may be required by the terms of the hybrid capital issue or by the terms of another agreement. In the event that the issuer does not pay a coupon, and this is in accordance with the conditions expressed in the instrument documentation, then we will assign a rating of 'C' to the hybrid capital instrument. The definition expansion does not alter our rating approach to hybrid capital instruments that are paying their coupons: that is, our ratings on these instruments still address the likelihood of nonpayment. What was our previous treatment and why have we changed it? Our previous treatment was to use the 'D' rating in most cases when an issuer did not pay a coupon on a hybrid capital or PIK instrument (see the discussion of PIK debt below). This may have created some confusion because we were using the 'D' rating in some situations where there was no event of default and where the issuer was still complying with the terms and conditions of the instrument. We will now use the 'C' rating for types of nonpayment that are permitted under the terms of the instrument to more clearly distinguish these from cases that do constitute events of default, for which holders have specified remedies. How does the change affect PIK debt? PIK debt can pay interest in cash or in kind in certain circumstances. (These obligations are typically issued by speculative-grade corporates.) PIK means that the investor, in lieu of cash, receives more of the same note, or that the note's principal is increased. There are several forms of PIK debt. In their simplest form, PIK notes pay interest in kind from the outset, and for the life of the instrument. Some PIK debt initially requires cash interest payments, but gives the issuer the option of paying in kind later. In other cases, payments are initially PIK, but then must be made in cash after a prespecified period. Toggle notes are a specific form of PIK debt designed to facilitate switching back and forth between cash payments and PIK distributions, at the issuer's discretion. The issuer increases remuneration for those periods when the PIK option is utilized. With appropriate disclosure at the time of issuance, the investor should expect a toggling cash/PIK payment pattern. When we are satisfied that disclosures are sufficient to give investors the expectation of receiving PIK at various stages of the security's life, including occasions when the company is not under stress and where the issuer is speculative grade at the time of issuance, we will not treat utilization of the PIK as mandating the assignment of a 'C' rating. For toggle notes and PIK debt that initially pays in kind, we have been assigning ratings higher than 'C' during the PIK period (unless the issuer was bankrupt or insolvent). We will continue to follow this approach. Specifically, we do not apply any gap between the ICR and the rating assigned to a toggle note, except to reflect recovery expectations following a default. For other forms of PIK debt, we believe that a shift from paying cash to paying in kind is indicative of severe financial distress and warrants a 'C' rating. Previously, we assigned a 'D' to the issue in these situations. Does this change apply to all corporate and financial institution hybrid capital and PIK instruments? The only exceptions, as noted above, are PIK debt that has always paid in kind, or toggle notes when we believe the issuer is not in distress. In these cases, a rating above 'C' may be maintained. Our new approach is applicable regardless of whether the issuer is regulated or not. What about cases where the issuer is still paying a coupon on the hybrid capital instrument, but the coupon has been reduced in amount? Sometimes the terms and conditions of a hybrid capital instrument will allow the issuer to reduce the amount paid on a particular coupon date if the issuer is facing financial difficulties. Examples include "pay if you can" debt; or issues where the coupon includes both a nondeferrable and a deferrable element. In other cases, the issuer may only be permitted to pay a portion of the coupon because it has limited distributable reserves. If the investors are still receiving a coupon payment, but the payment has been reduced in amount, we would use the 'C' rating--assuming that the terms of the instrument allowed for the coupon to be reduced. In this case, the investor will be receiving a lower coupon than he or she expected, but the issuer will still be complying with the terms of the instrument. We would assign a rating of 'D' if the reduction in the coupon does not comply with the terms of the instrument. If the terms of the instrument specify that the coupon payment varies in line with another financial indicator (such as net profits or the common dividend amount), the coupon could decline in some periods, but we would not consider this to be a partial payment of the coupon. As long as the coupon adjustment is in accordance with the issue terms, we would not move the issue rating to 'C'. Investors in such instruments can rationally expect fluctuations in the coupon amount. What about situations when the principal of the hybrid capital instrument is written down to absorb losses? We will assign a rating of 'C' when the principal has been written down in compliance with the terms of the instrument. This type of loss absorption clause is not a standard feature globally, but we see it fairly frequently in European hybrid capital instruments. These clauses typically allow for a permanent or temporary write-down of the principal if the issuer suffers specific financial difficulties. For example, some European bank hybrid capital instruments have clauses that require the principal to be written down if the issuer reports a loss over a particular period, or if it breaches a specified regulatory trigger. By contrast, we would not use the 'C' rating if the principal is written down as a result of a bankruptcy filing or a general default on debt by the issuer--these are cases where we would use the 'D' rating. What rating is assigned when the issuer is now making cash coupon payments, but an arrearage exists? We will continue to use a 'C' rating for obligations that have payment arrearages allowed by the terms of the documents. Instruments such as cumulative preferred stock allow for the accumulation of unpaid dividends, which may be subsequently paid. Noncumulative preferred instruments by definition cannot have an arrearage position, because investors lose all rights to any eliminated coupon. Does the new approach change how we respond to situations where the issuer does not make a scheduled principal repayment on a hybrid capital instrument? Yes--we would also use the 'C' rating when a "scheduled" hybrid capital principal payment is not made because of the issuer's financial distress. If the failure to make a scheduled principal repayment is due to a bankruptcy filing or general default on debt, we use the 'D' rating. Please note that a different approach is applied to scheduled maturities of structured finance issues. How do we identify a "scheduled" principal repayment? Is it the call date? A "scheduled" principal repayment date is the date when the issuer is obliged to redeem the instrument and repay the principal, unless it is in financial difficulty. Please note that an optional redemption (call) date does not constitute a scheduled principal repayment--the date is only "scheduled" if there is a formal undertaking to redeem the instrument at that date. Some instruments have conditional call dates, where the issuer has undertaken to call or redeem the instrument if certain conditions have been met at the call date. We would use the 'C' rating if, due to financial distress, the issuer does not call the instrument on this date. But what if all the principal repayment dates are optional? Many hybrid capital instruments only have optional redemption dates, and some regulators do not allow issuers to provide any assurance to investors that they will redeem an instrument at a specified date. If the issuer does not redeem the instrument on an optional call date, then we would not change the issue rating to 'C'. This applies whether or not there is a coupon step-up associated with the optional call date, and even if the market had been expecting the call to be exercised. A decision not to call an issue at an optional redemption date rarely leads to a change in the rating assigned to the issue, or the ICR assigned to the issuer. What about situations where the issuer uses an alternative coupon satisfaction mechanism (ACSM) to pay the hybrid coupon? These types of clauses typically allow the issuer to pay a coupon out of the proceeds of selling new shares or new hybrid instruments. If the issuer complies with the terms of the instrument, and the investor receives the resulting cash (in an amount equal to the coupon), then this is a compliant servicing of the coupon (even though it may be a signal of potential future stress) and we would not change the instrument's rating to 'C'. Concerns about the company's overall credit quality and future payments on this issue could result in a downgrade, but not to 'C' (unless the ICR is lowered to such a low level that notching for deferability and subordination so requires). If the issuer is unable to sell new shares or new hybrid instruments to raise cash to pay the coupon, and instead hands the shares/new hybrids to the hybrid investors to satisfy a coupon payment, then we will assign a rating of 'C' in cases where this is allowable according to the instrument terms, or a 'D' rating if this contravenes the terms of the instrument. These decisions are independent from the actual market value of the shares or new hybrids, at time of delivery to the hybrid holder. When would we still use the 'D' rating for a hybrid capital or PIK instrument? We will generally continue to assign a 'D' rating to issues that are in payment default, to issues that have been subject to a distressed exchange offer, or in cases when the issuer has filed for bankruptcy or taken similar action. For example, we use the 'D' rating if the issuer was actually obliged to pay a particular coupon on a specific date under the terms of the hybrid capital instrument, but in fact failed to do so. We also use the 'D' rating when the issuer effects an exchange of the instrument as part of a distressed exchange offer. We consider such an exchange as tantamount to a default, notwithstanding the willingness of the investor to forego their originally-promised interest and/or principal. Ultimately, it is the perceived inability or unwillingness of the issuer to fulfil the original terms that drives such exchanges. Additionally, we use the 'D' rating if the investor had to hand the instrument to the government as part of the nationalization of the issuer--assuming that the investor is not fully compensated. If the 'D' rating generally is not used for permitted payment deferral, do ratings still recognize deferral risk? Absolutely--the changes noted above do not affect our guidelines for "notching," that is, the number of notches that an issue is rated below the ICR based on our analysis of the deferral risk and/or subordination features associated with the issue. All deferrable instruments are rated at least one notch below the ICR because of their deferral risk. As deferral becomes an increasingly likely prospect, the gap between the ICR and the rating on a hybrid capital instrument should widen to reflect the heightened risk of deferral.