MOODY'S
INVESTORS SERVICE

CROSS-SECTOR
METHODOLOGY

Methodology for Credit-Linked Notes and Instruments Whose Rating-Relevant Terms May Change Due to Specified Events

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This rating methodology replaces the *Rating Obligations with Variable Promises* methodology published in April 2016. The methodology has been renamed, as we have narrowed the focus to credit-linked notes and instruments whose terms may change due to specified events. We have added greater detail on our approach to rating credit-linked notes and on the types of alternate security provisions that are relevant to ratings and how we consider these alternate security provisions. We have also streamlined the document by removing non-methodological information.

Introduction and Scope of This Methodology

In this cross-sector rating methodology, we outline broad principles for rating credit-linked notes whose payment terms are dependent upon the credit performance of another entity in addition to the issuer.

Separately, this methodology also provides guidance on the rating implications of certain material terms (e.g., a change in seniority) that are subject to change based upon events specified in the issuance documents, and may result in changes to a security's rating-relevant terms (as defined below).

Guidance in this cross-sector methodology supplements other methodologies and applies to instruments issued in all fundamental rated sectors globally.[1,2]

1 In this report, we use the term fundamental to describe issuers and transactions other than structured finance, i.e., nonfinancial corporates, financial institutions, project finance issuers, sovereigns, sub-sovereigns and US public finance entities.

2 The additional guidance in this cross-sector methodology applies unless specified otherwise in sector-specific methodologies. A link to an index of our sector and cross-sector rating methodologies can be found in the "Moody's Related Publications" section.

Credit-Linked Notes: Obligations Linked to the Credit Performance of a Separate Entity[3]

Payments under a two-party credit-linked note typically depend upon the credit performance of the issuer as well as another specified entity. When rating such credit-linked obligations, we incorporate the credit risk of the referenced third party in addition to the credit risk of the primary obligor, and we rate to the lower of the two, absent any support mechanisms. For example, a bank might issue a note under which the bank agrees to pay interest and principal only if a particular country meets its sovereign debt obligations, and the instrument doesn't benefit from any external support or meaningful collateral. In this example, we would rate the instrument at the lower of the applicable sovereign bond rating and the applicable rating of the bank.

Securities with Rating-Relevant Terms That May Change Upon Changes in Regulation, Legislation or Other Events Anticipated in the Transaction Documents at the Time of Issuance[4]

To avoid the cost and administrative burden of retiring or amending securities, issuers may include certain alternate contractual provisions (the alternate provisions) that give them the right to replace an existing obligation or to change rating-relevant terms in response to changes in laws, regulations or other specified events. This guidance is limited to instruments for which changes in regulation, legislation or other specified events could change terms that are material to our assessment of the probability of default and financial loss in the event of default or impairment. Terms that are in the scope of this guidance are limited to changes in the following: the obligor(s); the guarantor(s), including the removal of a guarantor; the instrument's seniority; or the triggering events that permit write-down of the debt or that require its conversion to a more junior class of security (collectively, rating-relevant terms).[5]

For example, in some sectors, the seniority of an instrument may be altered to maintain compliance with capital regulations if new regulatory requirements make the instrument non-compliant, or the triggering events for conversion or write-down of contingent capital securities may change if new regulations would eliminate favorable capital treatment available at issuance. Transaction documents may contain alternate provisions that change the instrument's seniority based on: specified changes in tax, resolution, insolvency or other laws, accounting treatment, or a credit rating agency's methodology; or the cessation of an index or reference rate. Furthermore, some issuers seek to accommodate potential future corporate reorganizations through the transfer of the obligation to another issuer, the release of a guarantor or a change in the guarantor.

Our rating may be affected by the presence of such provisions when there is a significant likelihood that any of the specified events will occur. If the consequences of an event are contingent upon an issuer's decision to exercise its rights to invoke the alternate provisions, we also assess the likelihood that such rights will be exercised. If we consider the likelihood of the specified events leading to a change in terms to be low, we generally base our analysis on the security terms and conditions absent any such event. Where there is a multi-notch gap between how the security would be rated under its original terms and the alternate provisions and we consider there to be a meaningful or increasing likelihood that the specified events will occur, we may assign a rating at a lower level than the one that would be assigned absent the alternate provision reflecting our view of the likelihood of the specified events. In cases where there is a significant

[3] This section applies to fundamental issuers and transactions. For structured finance credit-linked transactions please see our sector-specific methodologies, including those that discuss our approach to rating corporate synthetic obligations and repackaged securities.

[4] This section applies to fundamental issuers and transactions. For structured finance, where relevant, please see our sector-specific methodologies, which describe how the modeling of scenarios is complemented by qualitative analysis, which generally includes a review of transaction structure and pertinent legal risks.

[5] Please see Rating Symbols and Definitions, which describes what Moody's ratings do and do not address. For a link to Rating Symbols and Definitions, please see the "Moody's Related Publications" section.

likelihood that a specified event will occur and the alternate provisions will be invoked, the rating would typically be based on the alternate provisions.

In cases where transaction documents contain alternate provisions, we also consider the effect of other mitigating provisions in our rating analysis. Bond indentures and related documentation often include limitations that prevent issuers from substituting or amending the terms in a way that would have a material negative impact on investors. In some cases, an opinion from an independent third party to this effect is required. Depending on their terms and enforceability, these third-party safeguards are typically favorable for creditors, because they increase the certainty that investors will not receive an instrument with materially higher credit risk relative to the obligation created at the date of issuance. For instruments with contingent provisions that lack such third-party safeguards, we consider whether and how any other provisions within the agreement might limit the risk to investors.

Moody's Related Publications

Credit ratings are primarily determined by sector credit rating methodologies. Certain broad methodological considerations (described in one or more cross-sector rating methodologies) may also be relevant to the determination of credit ratings of issuers and instruments. An index of sector and cross-sector credit rating methodologies can be found here.

For data summarizing the historical robustness and predictive power of credit ratings, please click here.

For further information, please refer to *Rating Symbols and Definitions*, which is available here.

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