Article Title: ARCHIVE | General Criteria: Rating Implications Of Exchange Offers And Similar Restructurings Data: Editor's Note: This criteria article is no longer current. It has been superseded by the article titled, "Rating Implications Of Exchange Offers And Similar Restructurings, Update," published May 12, 2009. Entities in distress often restructure their obligations, offering less than the original promise. The alternative of a general default, in which the investor or counterparty stands to fare even worse, motivates (at least partially) their acceptance of such an offer. We treat such offers analytically as equivalent to a default on the part of the issuer. Therefore, upon completion of an exchange which we view as distressed, Standard & Poor's rates the affected issues 'D', and the issuer credit rating is usually reduced to 'SD' (selective default), assuming the issuer continues to honor its other obligations. This is the case even though the investors, technically, may accept the offer voluntarily and no legal default occurs. Our approach to such transactions pertains equally to the restructuring of any financial obligation of the entity--debt security, loan, or derivatives contract. The restructuring may take the form of an exchange offer or renegotiation. (We focus here on exchange offers.) This article updates and supersedes "Distressed Exchange Offers: Tantamount to Default," published Nov. 2, 2001. The methodology explained in this report is substantially similar; however, we have widened the scope to include: Methodology for considering whether the renegotiation of a derivative contract is equivalent to a distressed exchange and, therefore, tantamount to default for the issuer rating and, if the derivative is a rated obligation, a default for the issue-level rating; Specific discussion on how we apply the methodology to equity hybrid instruments, such as preferred stock; Specific discussion on how we apply the methodology to structured finance transactions; and Additional discussion on when we consider an exchange or tender offer as "distressed," including reference to the current rating of the issuer and/or instrument. The criteria discussed in this article reflect our principle-based methodology, as discussed in "Principles Of Corporate And Government Ratings ," published June 26, 2007, and "Principles-Based Rating Methodology For Global Structured Finance Securities," published May 29, 2007. (See also the related article: "Rating Policies And Procedures: Distress And Default," published March 5, 2001.) This article also partially supersedes the article, "How the Expansion Of The ‘C’ Rating Definition Affects Its use For Hybrid Capital and Payment-In-Kind Instruments ," published Aug. 1, 2008. We expect a limited number of rating downgrades following the release of this criteria update as a result of our now more explicit explanation that a distressed renegotiation of a derivative contract will be considered a default at the issuer rating level. Frequently Asked Questions Are all exchange offers equally problematic? No. We distinguish between distressed offers and those that are merely opportunistic. In a distressed exchange, holders accept less than the original promise because they doubt the issuer will fulfill its original obligations. By way of contrast, an entity that is a strong credit may offer to exchange bonds for below par where changes in market interest rates, other technicalities, or market developments have caused its bonds to trade at a discount. Such an offer is opportunistic, leaving investors with a really free choice to accept or continue to receive all due payments with a fairly high probability--and would have no rating implications other than the resulting beneficial impact on future financial measures. Upon completion of a distressed offer, the entity ordinarily will benefit financially, helping it to avoid a conventional insolvency and reduce risk going forward. This may ultimately lead to higher ratings than before the offer was announced. However, this positive change would be the result of restructuring the obligation (i.e., not meeting its financial obligations in accordance with its terms). In our view, it is analogous to a bankruptcy--a process that also benefits an entity by relieving it of the financial burdens that it undertook previously. Accordingly, our rating takes into account this failure to pay in accordance with the terms of the obligation, and any subsequent benefit would be reflected only afterwards. Exchange offers are sometimes referred to as "coercive." Is this appellation the same as a "distressed offer"? No. An offer may be deemed coercive, if, for example, the entity employs tactics that pit holders of one series against holders of another series or imperils holdouts with the threat of stripping covenants once 51% of the bonds are bought in. But the coercive aspect of an offer is largely irrelevant from a credit perspective. While it may reflect on management style and financial policy, incorporating coercive tactics into an offer would not cause us to view that offer as a default, just as the absence of such tactics would not prevent an offer from being characterized as a distressed offer. Whether coercive tactics are most often involved or not, exchange offers are entirely voluntary: investors can elect not to participate. Indeed, if an offer failed, there may not be rating implications related to that offer, unless the offer itself and/or the events leading to the offer suggest a change in financial policy or willingness of an issuer to service its debt. However, the voluntary acceptance of a distressed offer implies that there is little expectation that the original obligation will be fulfilled. The entity's offer acknowledges this reality. Holders may be very pleased with an offer that is above market prices, especially if they account for the investment on a mark-to-market basis. Moreover, holders that bought their securities at distressed prices may be elated to make a quick and high return. In fact, holders often are the ones to initiate such transactions. But such considerations do not detract from the credit perspective: The original obligation is not being fulfilled in accordance with its terms. What constitutes "less than the original promise"? The investor may receive less value than the promise of the original securities if one or more of the following happens without adequate offsetting compensation: The combination of any cash amount and principal amount of new securities offered is less than the original par amount; The interest rate is lower than the original yield; The new securities' maturities extend beyond the original; The timing of payments is slowed (e.g., zero-coupon from quarterly paying, or bullet from amortizing); or The ranking is altered to more junior. Whether the discrepancy between the offer and the original promise is large or small, if we deem the offer distressed, we may view it as a default. However, we may not be concerned about an offer with a value so close to the original value that it is hard to discern that there is any shortfall. On the other hand, we look to substance over form: Our focus in such cases is on the value of what is being offered. It does not matter if the entity is offering cash, securities, or common equity, as long as the market value of the offer can reasonably be shown to equate to the accreted value of the original securities (par and any accrued interest). How do you determine whether an offer is distressed or opportunistic? In order for an exchange offer to be viewed as distressed, Standard & Poor's must decide that there is a realistic possibility that the issuer would file for bankruptcy, become insolvent (or the equivalent), or fall into payment default on the instrument subject to the exchange, absent the exchange offer taking place. In the case of sovereigns, for example, we would focus on whether the government would likely fall into payment default in the absence of the exchange offer, or whether the exchange offer is connected to a Paris Club rescheduling. The extant issuer credit ratings, as well as rating outlooks or CreditWatch listings, can often serve as proxies for that assessment. What matters is the type of trajectory we expect the credit to follow over the near term. Trading prices of the securities under offer and/or the offering prices can also provide some insight. Under these circumstances, Standard & Poor's believes that the investor, or counterparty to the exchange offer, is accepting terms that they would be comparing to what they expect to receive when a default has occurred. Alternatively, exchange offers for which we believe the issuer does not face insolvency or bankruptcy if the offer was not accepted will be viewed as opportunistic exchanges and not distressed exchanges. For example, an exchange offer conducted several quarters in advance of maturities, where investors are asked to extend the tenor, with compensation in the form of amendment fees or increased interest rates, would typically be considered proactive treasury management, rather than a default. Our issuer credit ratings, in conjunction with trading prices of the securities subject to an exchange offer, provide insight regarding how to characterize that offer. For example, we consider the following guidelines, in addition to other information: If the issuer credit rating is 'B-' or lower, the exchange would ordinarily be viewed as distressed and, hence, as a default. If the issuer credit rating is 'BB-' or higher, the exchange would ordinarily not be characterized as a default. If the issuer credit rating is 'B+' or 'B', market prices or other cues would be used to make the call. The structure of the transaction may also have a bearing on how we treat that transaction. For instance, if an entity buys in its debt securities on the open market as opposed to making an exchange offer, that purchase would not be considered a de facto default. The scope of the offer may be a relevant factor. If an issuer is making an offer for most of its liabilities, it would suggest a distressed situation. How do you treat loan modifications? We view loan modifications as similar to exchange offers. Whether we consider them as defaults depends on the circumstances. If a bank loan is rescheduled such that the lender receives less value than the original value of the loan--for example, if tenor is extended without some form of compensation (e.g., an amendment fee or increased interest rate), or interest or principal is reduced, we may consider it a default, especially if conducted by a distressed issuer. The context and timing of an extension may offer insights into the nature of the change, although sometimes it is difficult to tell. The extension of bank loan maturities for a bilateral bank loan (between a bank and its customer, as opposed to a syndicated loan) considered in the normal course of business (rather than an extension for a distressed issuer) would not be considered a default. Does it matter whether the entity itself, as opposed to a majority shareholder or one of its affiliates, launches the offer? No. We focus on the original promise made to investors. A related party offering clearly less than par would be seen in the same light as the entity itself making the same offer. This situation is obviously separate from a loan originally extended by shareholders to bolster their investee's credit standing, which is somewhat equivalent to the infusion of equity. What are the specific rating actions that Standard & Poor's takes in the case of a distressed exchange offer? The consummation of a distressed exchange offer is viewed as a de facto default with respect to the security involved, resulting in a 'D' rating on that security, even if only a portion of it is subject to the exchange. The issuer credit rating is downgraded to 'SD' (selective default) to reflect the default on some of its obligations. We lower it to 'SD' rather than 'D' if the entity continues to honor all its other obligations, and there is no general default as there would be in the case of a bankruptcy. For sovereigns, once the distressed exchange offer has been confirmed (albeit with a future effective date) we would also lower the issuer rating to 'SD' and the affected issue rating to 'D'. Once a distressed offer is announced or otherwise anticipated, we lower the issuer and issue ratings to reflect the risk of the related default. The issuer credit rating is generally lowered to 'CC' and ordinarily carries a negative rating outlook. The issue that is subject to the exchange offer is cut to 'CC' or lower to reflect recovery levels. Estimated recovery is a function of the value of what is being offered. An offer of less than 30% of the original par value is deemed relatively poor, and we would rate the issue at only 'C'. For any part of the original issue that remains outstanding after the exchange is completed, we would revert to our customary analysis of post-default recovery. If the offer is rejected and there is no expectation of another offer being made, the issuer and issue ratings will ordinarily be restored to their previous levels (unless credit quality has evolved in the meantime for other reasons, including the increased risk of additional distressed exchange offers). After an exchange offer is completed, the entity is no longer in default--similar to an entity that has exited from bankruptcy. The 'SD' issuer credit rating is no longer applicable--and we change it as expeditiously as possible (that is, once we complete a forward-looking review that takes into account whatever benefits were realized from the restructuring, as well as any other interim developments). If the exchange offer applies to only part of an issue--either because the offer was limited or because some holders declined it--we could raise the rating on the portion of the original securities that remain outstanding if the issuer continues full debt service as originally contracted. The rating could also remain at 'D' if payments are not made on time and in full on that portion. What about the entity's other rated obligations? A distressed exchange offer for specific securities may have no direct bearing on the entity's other securities and/or loans, so the ratings on these may not be immediately affected. However, as mentioned earlier, in the aftermath of an exchange offer, the entity may be in a better financial position than before--and that potential could affect all its rated obligations. Accordingly, these issue ratings could be placed on CreditWatch with positive (or developing) implications when an exchange offer is announced if there is a reasonable likelihood that the post-completion issuer rating could be higher than the rating at the date of the announcement. Such a CreditWatch listing would be resolved once we know the offer will be consummated as proposed and can assess its implications for ongoing credit quality. An opportunistic offer rarely affects our ratings on the issuer's other obligations. How do you apply this methodology to ratings of equity hybrid instruments? We view exchange offers on equity hybrids, or perpetual debt with deferrable coupons, in line with the above guidelines. In order for an exchange offer on an equity hybrid instrument to be viewed as distressed, Standard & Poor's believes that there is a realistic possibility that, absent the exchange offer taking place, the issuer would either exercise the coupon deferral option or restructure the terms of the instrument. The instrument's deferral risk may serve as a guide for determining whether the offer is distressed. For the instrument rating trajectory, distressed exchange offers in reference to equity hybrids would usually result in an instrument rating of 'C', rather than the 'D' rating used for non-hybrids. This is because, in the case of a deferral event on a hybrid in accordance with its terms (outside of a distressed offer scenario), we would lower the rating to 'C'; therefore, a distressed exchange offer should not result in a lower rating. We would lower an equity hybrid rating to 'D' when there is a simultaneous general default on all classes of debt (e.g., in a bankruptcy filing, insolvency, or the equivalent) or if a permanent loss of principal and future coupons occurs when the issue is nationalized. In the case of a hybrid distressed exchange offer (as opposed to a non-hybrid exchange offer), the issuer rating would not be lowered to 'SD' unless there are more senior classes of debt also subject to distressed exchange offers. The offer would not automatically lead to a change in the issuer rating. What about exchange offers for unrated obligations? Where Standard & Poor's determines that a rated issuer's offer in reference to unrated financial contracts constitutes a distressed exchange, the issuer credit rating will be lowered to 'SD'. Such offers in reference to unrated financial obligations may include: bank loan modifications (see the "How do you treat loan modifications?" section of this article), offers in reference to the commutation of credit default swaps, or offers in reference to the restructuring of other derivatives. We review these offers using the same factors we review for rated obligations, in order to determine whether we consider such exchanges distressed, which would result in an issuer rating of 'SD'. Exchange offers for unrated obligations that are not considered financial obligations or do not provide credit enhancement for financial obligations, such as commutation offers on traditional insurance policy claims or a settlement offer for a commercial dispute, would not be considered a distressed exchange offer for the purpose of these criteria. We also do not consider modifications to pension plans, other retirement benefit plans, other labor obligations, or operating leases a default event for the purpose of these criteria. How do you apply this methodology to structured finance ratings? Many issuers of structured finance obligations are incorporated with a very limited purpose; thus, we refer to them as special purpose vehicles (SPVs) or special purpose corporations (SPCs). We generally do not assign issuer credit ratings to these entities, so the 'SD' treatment would not be relevant. The most frequent request reviewed by Standard & Poor's in our Structured Finance group does not typically concern a distressed exchange of notes, but rather an amendment of existing debt document terms and conditions. The most frequent type of amendment, in this context, concerns credit derivative swap amendments, such that the floating-rate payer (the protection buyer--most typically a swap broker-dealer counterparty) agrees to a higher or more remote threshold amount or attachment point in exchange for paying a far lower insurance premium or fixed-rate swap payment leg. The impact of such an amendment is often to lower the coupon on a note issued by the trust or special purpose vehicle that has entered into the credit default swap as a seller of protection. In contrast with a distressed exchange offer, these amendments for swaps and notes typically reference vehicles that currently have 'AAA' or other investment-grade ratings. Thus, such amendment requests are not typically being made to avoid a payment default or insolvency of the SPV. Nevertheless, the same principles will apply as described in the previous paragraphs, with the proviso that we will publish supporting information that details the amendment request and rationale for the rating decision. When we believe an amendment was not requested in order to avoid an issue payment default or an SPV insolvency or bankruptcy if the offer was not accepted, Standard & Poor's will view the amendment as opportunistic and not distressed, and we would not lower the rating to 'D'. Recently, we have also seen proposals for exchange offers involving traditional securitization structures, such as student loan asset-backed securities. To date, such offers have been opportunistic and, therefore, would not affect outstanding ratings. However, if we believe that the issuer would face insolvency, bankruptcy, or imminent payment default if the exchange or amendment were not executed, then we would view it as commensurate with a distressed exchange and lower the issue rating to 'D' before raising it to a level that reflects the then current credit quality.