Article Title: ARCHIVE | Criteria | Corporates | General: Evolving Role of Credit Ratings in the Asian Bank Loan Market Data: An important sign of the evolution of the capital markets in Asia has been the emergence of credit ratings. This reflects the increasing sophistication of investors and issuers, and the need for greater transparency, especially in the high yield bond and loan markets. Increasingly, both banks and borrowers are finding value in ratings through increasing transparency, benchmark pricing, and improving secondary market liquidity. The development and operation of capital markets depends crucially on information being made available, without it, markets cannot function effectively. The financial crisis currently afflicting most of Asia, where incomplete information about the financial conditions of many financial institutions and corporations led to contagion, only serves to highlight the critical role played by information flows in today's global economy. Bank Loan Ratings One result of these market developments in Asia has been the introduction of Bank Loan Ratings (BLR). In May 1999, Standard & Poor's assigned its first BLR ratings in Hong Kong, and since then has been investigating the possibility of launching the business into other parts of Asia, such as Singapore and Japan. Globally, Standard & Poor's has assigned over 1,000 ratings, totaling approximately US$580 billion in bank loans. Bank Loan Rating Benefits: Optimizes pricing, Expands potential investor base, Reduces underwriting risk, Improves secondary-market liquidity, Independent credit risk assessment, Validates the worth of collateral, Assists in portfolio monitoring, Facilitates information flows. Designed primarily for the syndicated bank loan market, a BLR goes beyond the general default risk of a borrower, which is captured in the corporate credit rating (CCR). It does this by taking into account the effect of collateral, covenants, and other structural features of the loan that may mitigate the lender's loss in the event of default. A BLR incorporates the likelihood of ultimate repayment of the loan obligations through cash flow generation or realization of the enterprise and asset value. In comparison, a CCR assigned by Standard & Poor's evaluates only the risk that the issuer will default on its obligations, but does not address the matter of recovery. As a result, a company's BLR in some instances may be higher than its CCR, depending on how effective the loan structure is likely to be in protecting lenders in a default scenario. It is possible, for example, that a company whose corporate credit rating is 'BB' might offer its bank lenders sufficient security and other protection that the rating on the bank loan would be higher, perhaps 'BB+' or 'BBB-'. Recent U.S. studies provide evidence that companies benefit from significantly lower interest rate spreads on loans that are structured well enough to earn a rating higher than the default corporate credit rating. Growth Prospects Important factors contributing to the growth of BLRs in the U.S. and Europe have been the emergence of the lead or "agent" banks in loan syndications, the introduction of portfolio theory to the management of bank loan portfolios, and the growth of a large secondary trading market for syndicated bank loans. In Asia, secondary trading in syndicated bank debt has historically been relatively low and most banks have seen themselves as relationship lenders whose major compensation is the interest on the loan. However, there seems to be some evidence that secondary trading has increased in recent years, primarily as a result of the withdrawal of a number of key banks from the market and ongoing portfolio restructuring. It remains to be seen if secondary trading will increase in Asia in the future, but if this were to come about, bank loan ratings would play a key role in facilitating this development. Ultimately, bank loan ratings will help borrowers optimize the pricing they can obtain by assisting banks in their quest for balance sheet flexibility. Bank Loan Criteria Used in Hong Kong The starting point for assigning a bank loan rating is determining the borrower's default risk, based on an analysis of the company's business strength and level of financial risk. The result is expressed as the corporate credit rating. Analysis then turns to aspects pertaining to recovery in a specific bank loan facility. The likelihood of ultimate repayment of loan obligations is affected by the degree of confidence of full recovery in times of default. In Hong Kong, syndicated bank loans primarily provide lenders with security or financial covenants designed to protect against loss in the case of borrower default. Standard & Poor's takes these features into account in determining a loan's recovery prospects. Generally speaking, a well-structured bank loan with greater loan coverage (asset value-to-loan) provides a higher degree of confidence that the value of the assets will actually cover the claim. Accordingly, particular emphasis is placed on the issue's legal structure, the value and the ranking of security, and other structural protections used to support the credit. In estimating the effectiveness of collateral and the length of the potential delay of recovery, analysis focuses on how the legal system resolves bankruptcies and provides access to collateral. In addition, Standard & Poor's also reviews legal opinions on the loan facility to ensure that the security is enforceable and unlikely to face a successful legal challenge. To minimize the timing risk inherent in the enforcement of security, the lender should have a perfected title in security, priority in an event of default, the ability to achieve true control over the security, and the full enforceability of the security. In Hong Kong, secured debt holders can effectively and efficiently take true control of any perfectly pledged assets after default. There is no administrative stay to prevent secured creditors from realizing their security, or to prevent unsecured creditors from bringing actions against the company. In the past, the majority of liquidation workouts in Hong Kong were completed within 12 months. Covenants alone, in the absence of collateral seldom result in superior protection. Nonetheless, a strong covenant package is crucial as part of a secured facility. Covenants can play a significant role in protecting creditors of a subsidiary of another, perhaps riskier company. Tight covenants can also help prevent the borrower's assets from being removed by the parent company. This is particularly meaningful in Hong Kong, where many family-controlled companies lack transparency and have relatively complicated group structures. Generally, as the borrower's business and financial position improves, covenants become fewer and less stringent. Significance of Tenor Shorter-term loans are generally viewed as favorable in a BLR. This is because longer-term concerns could constrain the corporate credit rating and might extend beyond the repayment time horizon of a bank loan facility. Meanwhile, since the ability to rely on asset valuations diminishes over a longer time span, the benefit to asset-based recovery potential can be greatest for shorter-term loans. Moreover, the risk of obsolescence or regulatory restrictions increases over time for certain types of assets, such as aircraft. Amortization of debt reduces the amount of debt that has to be covered by the value of the assets and thereby improves the loan-to-value coverage over time. Accordingly, if tranche A of a loan facility amortizes more quickly than tranche B, the former tranche could carry a higher rating. Collateral Analysis Collateral analysis centers on the determination of asset values. If the security consists of the operating assets of a unit that will remain an ongoing concern, an "enterprise value analysis" is performed. Otherwise, a liquidation analysis or "discrete asset value analysis" is conducted to determine the value of the assets that constitute the collateral. For security consisting of discrete assets that may have value independent of the business, a discrete asset value analysis is also performed. Given that corporate rescues are seldom used in Hong Kong and that real estate is the most common form of collateral, the discrete asset value analysis will probably be the most common analytical approach. BLR Notching Criteria ISSUER CREDIT RATING ('BB', 'B') <24 MONTHS <6 MONTHS <60 DAYS 1 times (x) collateral cover (principal) +1 +1 or 2 +2 or 3 1.25x collateral cover (principal) +2 +2 or 3 +3 or 4 1.65x collateral cover (principal and interest) +3 -2 or 3 from guarantor -1 or 2 from guarantor ISSUER CREDIT RATING ('A', 'BBB') <24 MONTHS <6 MONTHS <60 DAYS 1 times (x) collateral cover (principal) +1 plus 1 plus 1 1.25x collateral cover (principal) +1 plus 2 plus 2 1.65x collateral cover (principal and interest) +2 -2 or 3 from guarantor -1 or 2 from guarantor Source: Standard & Poor's Enterprise value is determined using the company's level of earnings before interest, taxes, depreciation, and amortization (EBITDA) at the hypothetical point of default, and a cash flow multiple. EBITDA is projected to reflect the decline in cash flow that would normally accompany a default. For this analytical exercise, the analysis simulates default scenarios, attempting to determine appropriate default scenarios based on company-specific information and industry fundamentals. The multiple employed in the valuation model is derived from the cash flow multiple of the borrower's peer group. The market multiple is adjusted to incorporate the depressing effect that a liquidation scenario can have on asset value. For highly cyclical companies, the valuation is refined to account for cyclical variability. In a default scenario, the ranking of any priority claims, such as mortgage debentures, product liabilities, or environmental liabilities, is deducted from the enterprise value and reduces the amount available for repayment of the bank facility. Similarly, the value of other higher-ranking existing secured debt, such as secured lease finance or secured subsidiary debt, is subtracted from the enterprise value. In some instances, trade creditors have a priority interest in stock or inventory, and hence the secured bank loan lender would have a lower-priority claim on inventory. The analysis also assumes that any revolving portion of a bank facility is fully drawn at the time of default. The analytical starting point for discrete assets, such as real estate, listed securities, plants, and equipment, is the current market value of the assets. Several methods are used to ascertain this market value, including the discounted cash flow model, recent sales of comparable assets, and replacement costs, adjusted to reflect the age and technology of the asset being valued. Independent appraisals are necessary for specialized security, such as real estate, plants, or equipment. Once the market value has been arrived at, it is crucial to ascertain whether the value of the collateral is likely to hold up during various postdefault scenarios. A final assessment of the security value is then determined using factors such as volatility, liquidity, special-purpose nature, and the importance of the asset to the issuer's business. Secured lenders' shortfall on divestment of the security is treated as unsecured in line with other unsecured obligations. Most Hong Kong valuation companies adopt valuation guidelines that generate the maximum open-market value on the valuation date. Accordingly, to achieve a conservative estimate of the collateral value during the postdefault scenarios, it is important to understand the point in the industry cycle at which the valuation is made. Account should also be taken of the assumptions and methodology of the valuation, the potential volatility of the cycle within the loan term, the liquidity of the assets, and the degree of severity of value deterioration in distressed scenarios.