Distressed Debt Exchange

Criteria Report

This report updates and replaces *Rating Criteria for Distressed Debt Exchanges*, dated 11 February 2013.

Scope and Limitations

This report describes India Rating and Research's (Ind-Ra) criteria for rating the issuers that use Distressed Debt Exchanges (DDEs). These criteria apply to the following sectors: corporates, financial institutions, insurers, subnationals, and infrastructure & project finance. These criteria do not apply to Structured Finance ratings.

These criteria apply to the issuers that have instruments and other financial obligations owned by third-party investors who would usually be expected to exercise all remedies available to them. Instruments issued to affiliated investors (e.g., parent companies to optimise tax efficiency, central banks or government bodies) may be treated differently.

Summary

Key DDE Rating Drivers: When considering whether a debt restructuring should be classified as a DDE, Ind-Ra generally expects both of the following to apply: 1) The restructuring imposes a material reduction in terms vis-à-vis the original contractual terms; 2) The restructuring or exchange is conducted in order to avoid bankruptcy, similar insolvency or intervention proceedings or a traditional payment default. Additional nuances for banks are covered elsewhere in this report.

Options When Under Distress: Issuers with untenable capital structures, either insolvent or illiquid (for example, due to excessive debt, high coupon rates, or substantial near-term maturities), generally have three options for restructuring their obligations: a) bankruptcy or similar insolvency or intervention proceedings; b) refinancing — generally available where an issuer's problem is liquidity- rather than solvency-related; or c) a DDE.

How Ind-Ra Records DDEs: When an exchange or tender offer that Ind-Ra considers to be distressed is announced, an issuer's Long-term Issuer Rating (IR) is downgraded to 'IND C'. Completion of DDE typically results in the IR being downgraded to 'Default' ('IND D'). Shortly after DDE is completed, the IR will be rated again and upgraded to a performing level, usually still a low speculative grade.

Considerations for Sovereigns and Subnationals: Bankruptcy is not an option for state governments or subnational and municipal issuers.

Considerations for Banks: Banks often have tranched liability structures that include junior securities which are designed, in various ways, to be loss-absorbing. When a bank undertakes a DDE of junior (e.g., regulatory capital) securities, Ind-Ra is unlikely to lower its IR to 'C'. The securities subject to DDE will be downgraded to a level consistent with their non-performance. A DDE of a senior obligation will result in a bank's IR being downgraded to 'C'.

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DDE Criteria for Bonds

An exchange offer will be considered a DDE and recorded as a 'D' if there is a material reduction in terms in relation to the original contractual terms, and the exchange is necessary to avoid bankruptcy, similar insolvency or intervention proceedings, or a traditional payment default.

A material reduction in terms could be any one or a combination of the following:

- Reduction in principal amount
- Reduction in interest or fees
- Extension of maturity date
- Change from a cash pay basis to pay-in-kind (PIK), discount basis or other form of non-cash payment
- Swapping of debt for equity, hybrids or other instruments
- Cash tender for less than par if acceptance is conditioned on a minimum aggregate amount being tendered or if combined with a consent solicitation to amend restrictive covenants. If either of these conditions is not evident, then cash tender offers for less than par will not be DDEs, unless other circumstances clearly indicate that failure of a large percentage of creditors to participate in the tender would likely contribute to the entity ultimately failing
- Exchange offers or cash tenders that are accepted only if the tendering bondholder also consents to indenture amendments that materially impair the position of holders that do not tender

Ind-Ra will review the circumstances of any exchange offer and consider the impact of each of the factors above. Theoretically, an exchange could be executed to be at least neutral to existing creditors, but the likelihood is very remote for a distressed issuer.

DDE Criteria for Bank Loans

A material reduction in terms, by itself, is not sufficient for an amendment to a revolving credit or term loan to be classified as a DDE. The flexibility of loans compared to bonds, and the frequency with which loans are amended across the spectrum of credit quality, make it difficult to have a categorical determination of a DDE for a loan.

For example, extending the maturity and reducing the interest on a revolving loan could result either from an improvement or deterioration in credit quality, and non-payment defaults caused by covenant violations are commonly waived or amended. Banks and other investors in term loans are frequently willing to extend maturities for reasons other than avoiding a liquidity crisis.

Therefore, while India Rating's DDE criteria may be applied to bank loan restructurings in a similar fashion to bond DDEs, it will also be necessary to consider the issuer's solvency, liquidity, and access to additional funding.

Indicators that a loan exchange, typically an "amend and extend" transaction, is a DDE include any one or a combination of the following:

- The issuer's declared intention to file for bankruptcy if the loan amendment is not accepted
- A reduction in terms coupled with a concurrent bond exchange considered to be a DDE
- The introduction of PIK interest (but not exercise of a previously agreed PIK option)
- An exchange of debt for equity
- Above-market compensation (e.g., equity in addition to rather than in exchange for debt or interest materially above market)
- A significant reduction in terms coupled with an obvious, significant deterioration in credit quality

Applicable Criteria

Corporate Rating Methodology (March 2016)

Financial Institutions Rating Criteria, (December 2015)

Corporate Debt Restructuring

For issuers with their debt under the CDR mechanism, Ind-Ra apart from the principals enunciated above will consider all outstanding RBI guidelines covering such restructuring.

Ratings Implications

Issuer Ratings

Pre-Execution

On the announcement of a prospective debt exchange offer that Ind-Ra determines to be a DDE, the IR will likely be lowered to ‘IND C’, indicating very high risk of default. In situations where the completion of the DDE is subject to material uncertainty — for example, because of a minimum acceptance level that the agency believes may not be reached — a Rating Watch Negative classification may be used as an initial alternative to lowering the IR to ‘IND C’.

On Execution

On confirmation of completion of the exchange — sometime after the closing of the offer — the IR will be lowered to ‘IND D’ to record the default event. Ratings for debt issues that are not part of a DDE offer will also likely be lowered to ‘IND C’ after the announcement. In case of structured obligations, the rating of each of the obligations could be different and would take into account any third party support (not impacted by DDE) in the form of guarantees that might be available. However, the ‘IND C’ rating may either be upgraded or affirmed once the IR for the newly restructured company has been determined.

Post-Execution

Shortly after the IR is lowered to ‘IND D’ on completion of the exchange, it will be changed to the appropriate IR for the post-exchange capital structure and the issuer’s future prospects. At the same time the new IR is assigned, all related issue ratings may be adjusted, including those specific issues that were not part of the exchange, to ensure that all ratings are consistent. As these criteria will apply to a broad range of situations across a variety of sectors, it is difficult to define precisely the length of time that the IR will remain at ‘IND D’ before the new post-exchange IR is assigned.

If the DDE does not close, Ind-Ra will review the issuer’s liquidity and solvency prospects and assign the appropriate IR.

Tendered Bond/Loan Issues

The ratings of eligible securities that are subject to a prospective DDE will likely be lowered to very low speculative grade — typically to the ‘C’ category — on announcement of the DDE.

Untendered Bond/Loan Issues

The ratings of eligible securities that are not tendered and continue to be serviced will remain at very low speculative grade — typically in the ‘IND C’ category — until the exchange is completed and will then be rated according to the newly restructured company’s credit and business profile.

New Bond Issues

Any new bond issue or loan package resulting from a DDE will be rated on the issuing entity’s credit profile post-exchange. The fact that the issue was a product of a DDE is not relevant to the rating.

Additional Considerations for Banks

While not always the case, bank DDEs are likely to occur when investors are threatened with regulatory intervention that will lead to a more adverse outcome for an instrument than is contractually possible.

In most situations, Ind-Ra expects a DDE would likely focus on junior, regulatory capital instruments that are designed to be loss-absorbing, where actions such as write-offs, conversion to equity, or deferral/omission of coupons are permitted by terms of the hybrid issues.

Loss-absorption characteristics for such securities will be considerably enhanced by tighter coupon omission and write-down/equity conversion features that will emerge on the back of in-process regulatory and legislative developments.

Where distressed exchange/tender offers are undertaken on such junior instruments, Ind-Ra would usually not expect to lower the IR of the bank to 'C'. A DDE on instruments (e.g., legacy lower tier two securities) that do not have such explicit loss-absorption features would also not automatically cause a bank's IR to be downgraded to 'C', but will be looked at on a case-by-case basis. However, given that the bank was stressed to the point of being at the threat of regulatory intervention, Ind-Ra would normally expect to lower the instrument rating, briefly, to a non-performing level, if the ratings are not already at such levels.

Whether bank or regulator-initiated, key to avoidance of a DDE from the perspective of the IR is that the actions are designed to support the senior obligations and that the senior obligations are not adversely restructured. Senior obligations typically make up the vast majority of claims against a bank and their non-payment best reflects the uncured failure of a bank. To avoid doubt, should a bank complete a DDE for senior obligations, the bank's IR will be downgraded to 'C' or even 'D'.

As the government moves to improve the legislative frameworks for resolving failed banks, it is increasingly likely that regulatory authorities will be given greater powers to unilaterally alter the terms of bank obligations, including bonds, or force losses onto them as part of their bank resolution tools.

Contractual write-down and equity conversion features mean it should become increasingly unnecessary for regulators to alter the specific terms of regulatory capital and similar instruments. Nevertheless, the same approach as outlined above will be taken where the regulator intervenes to change the terms of a security. For most junior obligations, this is unlikely to be recorded as a default at an IR level; for senior obligations it will.

In situations where a bank has already been intervened and is in a state either of fully operational limbo pending a regulator's decision on its fate or of orderly resolution (i.e., wound down but obligations are being serviced according to terms), Ind-Ra will assess tender or exchange offers for obligations on a case-by-case basis. Again, any tender or exchange for junior obligations is unlikely to be recorded as a default at an IR level. Key to determining whether a tender or exchange for unsubordinated obligations will constitute a default at an IR level is likely to be whether Ind-Ra believes failure to tender would clearly lead to a more adverse scenario than is contractually possible (examples could include payment default or enforced squeeze-out).