GCR RATINGS

Research

Credit Spotlight: Issuer Credit Ratings, Issue Credit Ratings and Expected Loss ('EL') Ratings

Report Scope

The purpose of this report is to outline the difference between Issue(r) Credit Ratings ('ICR') and Expected Loss Ratings ('EL'), enabling investors and issuers to have a clear understanding of these ratings and the relationship between them. We also explain the potential contrary nature of asset encumbrance for Expected Loss and Issuer Credit Ratings.

Overview

GCR's issuer credit ratings rank the ability of an entity to meet its contractual financial obligations as they fall due, relative to other legal entities either on a national or international basis. Typically, issuer credit ratings are pari passu to the senior unsecured ratings in the rated entity's credit hierarchy.

Issue ratings reflect both the underlying creditworthiness of the issuing obligor, as well as the specific characteristics of the notes being rated. As a result, it is possible that different obligations, issued by a single issuer could be accorded different ratings. For example, factors such as contractual subordination, or the increased default characteristic attributable to loss bearing capital instruments could attract lower ratings relative to senior unsecured issuances. Conversely, an issue could have higher ratings when specific liabilities are, for example, statutorily preferred or when a guarantee is in place. With the exception of a structured finance transaction, GCR typically will not rate an issue without rating the issuer.

Expected Loss ('EL') ratings also only apply to specific debt issues, but exclusively when security or collateral has been pledged to the holders of the debt, which improves their recovery prospects after an event of default (relative to senior unsecured claims). Therefore, unlike other issue credit ratings, 'EL' ratings also factor in expectations of post default recoverability from a specific collateral pool, as well as the issuer's creditworthiness. Presuming there are no changes in the recovery assumptions, typically secured bond ratings, such as the 'EL' rating, would move in line with issuer credit rating changes. However, we could widen the gap in specific default scenarios. Lastly, although atypical, it is possible that the same instrument could explicitly simultaneously have an issue credit rating and a 'EL' rating, upon the request of the issuer.

Whilst pledging collateral, for a secured bond, can lead to a higher 'EL' rating, it could also lead to a lower issue(r) credit rating. For example, in the case where cash flows generated by encumbered assets have a restricted scope of use (typically associated with securitisation) and diverts cash away from other senior liabilities.

Understanding Issuer Credit Ratings

GCR can assign an issuer credit rating to any legal entity that is capable of incurring debt obligations as the primary borrower. Issuer credit ratings measure the relative ability of an entity to meet its contractual financial obligations as they fall due. This indicates the ability of the entity to make timeous payments of its outstanding senior unsecured debt obligations, while maintaining the status of a going concern.

Issuer credit ratings are not an explicit predictor of the likelihood for an entity to default over a given time horizon. However, it is intuitive to conclude that an entity with a higher issuer credit rating is considered to be less likely to default than an entity with a lower rating, assuming that the ratings are on the same scale (i.e. national vs international).

GCR's issuer ratings are assigned in a manner consistent with the Criteria for the GCR Ratings Framework, together with the relevant sector specific criteria applicable to the individual group or entity that forms the subject of the rating analysis.

Understanding Issue Credit Ratings

An issue rating may be assigned to a specific financial instrument, typically in the form of a debt instrument. An issue rating incorporates all of the underlying credit risks of the issuing obligor (or potentially guarantor), as well as the characteristics of the particular obligation being rated. GCR can assign issue ratings against unsecured and secured debt instruments.

GCR assigns unsecured issue ratings according to the relevant criteria and the instruments' hierarchy in the issuer's capital structure. Unsecured issue ratings are inextricably linked to the respective issuer's creditworthiness and as such, senior unsecured issue ratings typically reflect the issuer's credit rating. An issuer's subordinated instruments (including senior subordinated, junior subordinated and other hybrids) are always notched down from (even hypothetical) senior unsecured instrument ratings. This is to reflect the increased proximity to default and / or the lower relative recoverability of these instrument(s) relative to senior unsecured instruments and each other.

Although less common, issue ratings could also be higher than the issuer rating, if there is any external support for the issue or a specific statutory preference that improves the credit quality of the notes versus the senior unsecured liabilities of that specific issuer.

Issue ratings may be assigned on the long-term or short-term scale, as well as on the national or international rating scale. For a public issue credit rating to be assigned, a public issuer credit rating must also be assigned.

Understanding Structured Bond / Expected Loss 'EL' ratings

When rating secured debt instruments the Expected Loss ('EL') rating can be applied. The 'EL' rating reflects both the issuer credit rating and our expectations of recoverability (from the assigned collateral) from that specific issue.

Recoveries are made possible by the advantage of having distinct security ceded for the benefit of the secured lender. Contractual arrangements that enable the cession of security give rise to structural enhancements which improve the expected recovery post default, relative to unsecured debt. GCR generally relies on independent market valuations of the ceded collateral in its analysis.

By its very nature, the 'EL' rating of the structured bond is more relevant in a post default scenario. It provides a relative scale of the severity of the expected loss that may be incurred on a specific instrument, should the issuer default on its obligations. Although the rating scale and symbols used when assigning 'EL' ratings are the same as those for issuer ratings (albeit structured bonds carry an additional 'EL' suffix), the two are not comparable.

An EL rating may be assigned to listed or unlisted debt obligations issued by a rated entity and secured by distinguishable assets of the issuer or from external support, such as a partial guarantee.

For more information on how GCR analyse secured bonds, see the GCR Secured Bond methodology, on the GCR website.

Ratings migration relationships

Presuming there are no changes in the recovery assumptions, typically secured bond ratings would move in line with issuer credit rating changes. However, this may change in two scenarios. Firstly, if the issuer credit rating moves to very low or near default levels and we still consider the recovery assumptions to be strong. Secondly, if the issuer defaults but we expect the entity to carry on as a going concern post restructuring or exchange. In this case, the revised 'EL' rating would reflect an expected post default issuer credit rating alongside the recovery expectations of the issue. If the recovery assumptions change then the notching between the issuer credit ratings and expected loss ratings will typically also change.

Understanding Asset Encumbrance

The relationship between pledged collateral and EL ratings has been established above. However, when an issuer pledges collateral for secured debt it can also affect the issuer credit rating. In this context, GCR call the pledging of collateral, asset encumbrance.

Asset encumbrance arises when there is an existing claim against an asset by a party other than the owner of the asset. Typically, a borrower will encumber assets that it owns by giving security interests over those assets, such as a pledge or cession of the assets, to a lender. This arrangement may restrict the owner of the asset from exercising certain rights such as the transfer of the encumbered asset or the utilisation of cash flows generated by the asset.

In most cases, the full benefit of having secured notes as opposed to unsecured, is realised following the default of the issuer. Therefore, in this case, asset encumbrance doesn't impact the issuer credit rating, and this is because typically prior to the occurrence of an event of default, secured and senior unsecured creditors rank *pari passu* in the credit hierarchy. However, should the cash flows generated by encumbered assets have a restricted scope of use (typically associated with securitisation), we may factor this into the liquidity assessments of issuers because it diverts cash away from other senior liabilities.

The level of asset encumbrance can also be assessed to determine whether or not an entity has the ability to raise additional liquidity by leveraging its assets, especially for entities that depend on secured funding.

Disclaimer

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Glossary of Terms/Acronyms

Asset	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Assets	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Bond	A long-term debt instrument issued by either a company, institution or the government to raise funds.
Bondholder	Investor of capital market securities.
Borrower	The party indebted or the person making repayments for its borrowings.
Capital	The sum of money that is invested to generate proceeds.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Cash	Funds that can be readily spent or used to meet current obligations.
Cede	To transfer all or part of a risk written by an insurer (the cedant or primary company) to a reinsurer.
Cession	Amount of the insurance ceded to a reinsurer by the original insuring company (cedant) in a reinsurance transaction.
Claim	1. A request for payment of a loss, which may come under the terms of an insurance contract (insurance). 2. A formal request or demand (corporate finance).
Collateral	Asset provided to a creditor as security for a loan or performance.
Contract	An agreement by which an insurer agrees, for a consideration, to provide benefits, reimburse losses or provide services for an insured. A 'policy' is the written statement of the terms of the contract.
Covenant	A provision that is indicative of performance. Covenants are either positive or negative. Positive covenants are activities that the borrower commits to, typically in its normal course of business. Negative covenants are certain limits and restrictions on the borrowers' activities.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Credit Risk	The possibility that a bond issuer or any other borrowers (including debtors/creditors) will default and fail to pay the principal and interest when due.
Credit	A contractual agreement in which a borrower receives something of value now, and agrees to repay the lender at some date in the future, generally with interest. The term also refers to the borrowing capacity of an individual or company
Creditor	A credit provider that is owed debt obligations by a debtor.
Creditworthiness	An assessment of a debtor's ability to meet debt obligations.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Default	A default occurs when: 1.) The Borrower is unable to repay its debt obligations in full; 2.) A credit-loss event such as charge-off, specific provision or distressed restructuring involving the forgiveness or postponement of obligations; 3.) The borrower is past due more than X days on any debt obligations as defined in the transaction documents; 4.) The obligor has filed for bankruptcy or similar protection from creditors.
Downgrade	The rating has been lowered on its specific scale.
Enforcement	To make sure people do what is required by a law or rule et cetera.
Environment	The surroundings or conditions in which an entity operates (Economic, Financial, Natural).
Equity	Equity is the holding or stake that shareholders have in a company. Equity capital is raised by the issue of new shares or by retaining profit.
Expected Loss	Losses that a bank expects to bear over a certain period (generally a year). These losses are a consequence of doing business, namely the bank's role as financial intermediary.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with as a consequence of holding the security or asset. For a company, its exposure may relate to a particular product class or customer grouping. Exposure may also arise from an overreliance on one source of funding. In insurance, it refers to an individual or company's vulnerability to various risks
Going Concern	An accounting convention that assumes a company will continue to exist and trade normally for the foreseeable future. In practice this is likely to mean at least for the next 12 months.
Hybrid	A form of security that has characteristics of various types of transaction or product.

Interest	Scheduled payments made to a creditor in return for the use of borrowed money. The size of the payments will be determined by the interest rate, the amount borrowed or principal and the duration of the loan.
Issue Ratings	See GCR Rating Scales, Symbols and Definitions.
Issuer Ratings	See GCR Rating Scales, Symbols and Definitions.
Issuer	The party indebted or the person making repayments for its borrowings.
Junior Debt	A security that has a lower repayment priority than senior securities.
Junior	A security that has a lower repayment priority than senior securities.
Lender	A credit provider that is owed debt obligations by a debtor.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Loss	1. A tangible or intangible, financial or non-financial loss of economic value. 2. The happening of the event for which insurance pays (insurance).
Market	An assessment of the property value, with the value being compared to similar properties in the area.
Notching	A movement in ratings.
Obligation	The title given to the legal relationship that exists between parties to an agreement when they acquire personal rights against each other for entitlement to perform.
Obligor	The party indebted or the person making repayments for its borrowings.
Pari Passu	Side by side; at the same rate or on an equal footing. Securities issued with a pari passu clause have rights and privileges that are equivalent to those of existing securities of the same class.
Pledge	An asset or right delivered as security for the payment of a debt or fulfillment of a promise, and subject to forfeiture on failure to pay or fulfill the promise.
Pool	An organisation of insurers or reinsurers through which particular types of risk are underwritten and premiums, losses and expenses are shared in agreed-upon amounts.
Principal	The total amount borrowed or lent, e.g. the face value of a bond, excluding interest.
Ranking	A priority applied to obligations in order of seniority.
Recovery	The action or process of regaining possession or control of something lost. To recoup losses.
Redemption	The repurchase of a bond at maturity by the issuer.
Repayment	Payment made to honour obligations in regards to a credit agreement in the following credited order: 3.) Satisfy the due or unpaid interest charges; 4.) Satisfy the due or unpaid fees or charges; and 5.) To reduce the amount of the principal debt.
Risk	The chance of future uncertainty (i.e. deviation from expected earnings or an expected outcome) that will have an impact on objectives.
Secured Creditor	A creditor that has specific assets pledged as collateral that will receive the proceeds in the event of default.
Secured Debt	Debt backed with or secured by collateral to reduce lending risk and thus the interest rate charged.
Securitisation	A process of repackaging portfolios of cash-flow producing financial instruments into securities for sale to third parties.
Security	One of various instruments used in the capital market to raise funds.
Senior Unsecured Debt	Securities that have priority ahead of all other unsecured or subordinated debt for payment in the event of default.
Senior	A security that has a higher repayment priority than junior securities.
Short Term	Current; ordinarily less than one year.
Statutory	Required by or having to do with law or statute.
Structural Enhancement	This may be provided as credit enhancement or as various other methods to enhance the security of a transaction such as performance triggers, short revolving periods et cetera.
Structured Bond Ratings	See GCR Rating Scales, Symbols and Definitions.
Timely Payment	The principal debt, interest, fees and expenses being repaid promptly in accordance with the contractual obligation.
Tranche	A portion of an obligation, each of which has different terms.
Ultimate Payment	A measure of the principal debt, interest, fees and expenses being repaid over a period of time determined by recoveries.
Valuation	An assessment of the property value, with the value being compared to similar properties in the area.