Criteria research

Frequently Asked Questions: Distressed Debt Exchanges

Scope

This Frequently Asked Questions ("FAQ") publication on Distressed Debt Exchanges ("DDEs") applies to all issue and issuer ratings assigned by GCR. The FAQ publication is not separate criteria and should be read in conjunction with Criteria for the GCR Rating Framework, Criteria for Rating Structured Finance Transactions, and GCR's Rating Scales, Symbols and Definitions.

Preamble

The research piece provides clarification of GCR's assessment of debt exchanges, refinancing and other changes to an entity's debt structure or terms. It also outlines parameters typically used to distinguish between proactive refinancing by entities with strong credit risk profiles versus distressed restructuring.

GCR typically considers debt exchanges or other early restructuring agreements that meet the following two conditions to be DDEs or distressed restructuring, which GCR views to be similar to a default, even when creditors do not observe the default:

- a debt exchange or restructuring agreement made in order to avoid selected or generalised default, the forced liquidation of assets, business rescue, or other insolvency processes; and
- creditors or debt investors incur some form of loss as the restructuring would not provide commensurate compensation for the investment return they would have to forfeit due to the debt exchange.

It is important to note that the critical factor to identifying a DDE is evidence that an entity is in financial distress. As such, when such an entity reaches an agreement to restructure debt where creditors have to carry some form of financial loss, GCR typically observes the debt offer/restructuring as a default. As most such debt exchanges provide some financial relief to the issuer, observation of the default is usually followed by an upgrade once the DDE is finalised.

Frequently Asked Questions

What is a debt exchange offer?

An offer for debt exchange is typically a pre-emptive offer to change the contractual form of settlement from cash to payment in kind ('PIK', including equity or hybrid securities), new notes, or a combination of PIK and cash. Due to the inherently pre-emptive nature of debt exchange offers, they usually result in bond investors realising a pro-rata value on the securities. If this loss is not adequately compensated, the offer could be classified as a DDE, unless GCR is of the view that the issuer is not distressed.

Issuers may also make a cash offer for debt securities trading at a discount before their scheduled maturity. By offering investors the discounted value upfront in exchange for early realisation of investment proceeds, such a cash offer is not considered to be distressed.

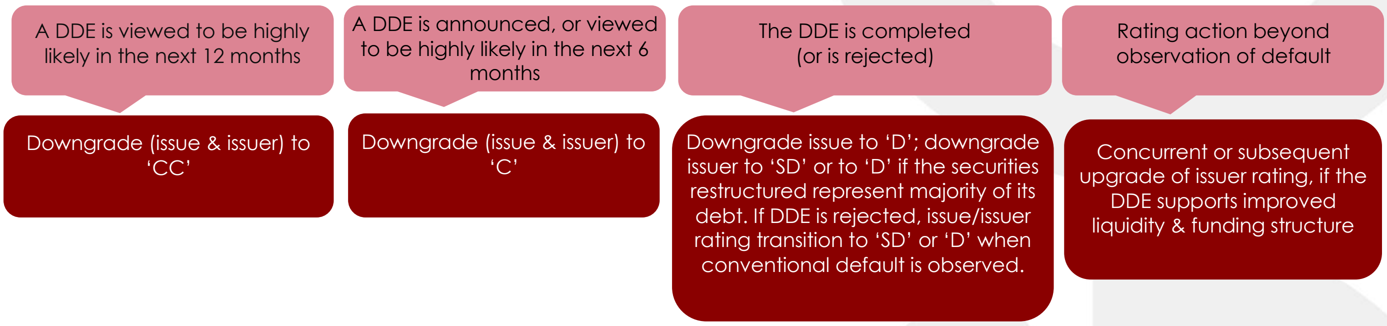
In highly liquid capital markets with long debt instrument tenors, such proactive debt exchanges typically occur when positive market conditions, including changes in the interest rate term structure, facilitate the settlement of debt securities, while also allowing noteholders to release capital early, for (re)investment in higher-yielding opportunities that may arise from the evolution in the investment climate. In such instances, a debt exchange offer is considered proactive, as it benefits both the issuer and investors.

Proposals to refinance bank facilities early are typically motivated by the same reasons as capital market debt exchanges. They are therefore also usually colloquially referred to as exchange offers, as any pre-emptive restructuring effectively 1) exchanges terms of existing facilities (including tenors, interest, fees, or covenants) with new conditions and amendments or 2) constitutes a discounted settlement of term debt using internal cash resources or new facilities drawn from other counterparties.

What is a DDE or distressed restructuring, and what are the rating implications?

GCR typically considers a DDE to be an early refinancing of debt by a distressed entity that unduly prejudices investors or creditors. Investors usually accept these agreements if a normal post-enforcement workout process is expected to result in even lower recoveries, or a long recovery process.

Figure 1: Typical rating transition in respect of distressed debt securities*



* The transition applies to both national scale and international scale ratings.

As GCR considers DDEs to be akin to a selective default, issue and issuer ratings would be downgraded to a 'CC' as soon as it considers the potential for a distressed restructuring to be elevated. This is typically followed by a further downgrade to a 'C' rating once the DDE or other distressed restructuring is announced, even if the terms are still to be agreed with funders.

Thereafter, the rating is typically downgraded to a 'D' rating on the specific issue when the debt exchange is finalised. An 'SD' rating is assigned to the issuer, if the DDE is restricted to one series/tranche of notes, or the majority of debt is still being serviced. The issuer may also be downgraded to a 'D' rating if it is restructures all or most its debt under a DDE agreement.

It may be possible for an issuer to be downgraded to a 'D' rating, and immediately upgraded to a higher credit rating. Such concurrent rating action(s) would typically apply if GCR is of the view that the DDE would enhance the liquidity and capital structure of the restructured issuer.

In cases where the DDE is not expected to support sustainable improvement in the financial profile on its own, GCR may only upgrade the issuer ratings in subsequent reviews when it is satisfied 1) that the credit risk profile has been adequately stabilised by the DDE and normalised operating activity, or 2) that the DDE has allowed for other remedial actions to be taken to avert successive default(s) in the short-term. This may include adoption of negative pledges or other interventions to manage the entity out of its distressed financial position.

DDEs usually rise sharply ahead of, or during a recession, significantly outstripping conventional defaults during periods of severe economic strain or deep market shocks. Accordingly, even in cases where a debt restructuring agreement is not classified as a default by creditors, GCR would typically downgrade the issue and issuer to 'C' ratings when a debt exchange it views to be distressed is announced. Thereafter, a selective or generalised default rating is assigned to the issuer when the DDE or other debt restructuring is completed. Any securities that are specifically subject to the DDE would be also be assigned a 'D' rating at this stage.

What is the difference between DDEs and proactive restructuring?

The key to identifying a DDE is to determine if an issuer is indeed in distress, and is therefore offering debt investors discounted recoveries or amended terms in order to avoid business rescue proceedings, or the winding up of its operations as creditors assert their rights to proceeds from an asset fire-sale.

As such, restructuring that meets the following conditions is typically deemed to be a DDE, allowing for a default to be observed, even if the issuer or its creditors may not define the exchange or restructuring as distressed:

- the debt exchange or restructure, in GCR's view, implies lower recoveries or otherwise prejudices creditors in terms of term, interest rate, pricing or any other condition, and
- if the proposed refinancing does not materialise, the issuer is highly likely to register some form of conventional default in the short-term.

Information asymmetry may make it difficult to establish if a default would result if investors/creditors do not take up an exchange offer. This could impede rating agencies' ability to progressively transition the debt or issuer ratings to a default in a timely manner. In these cases, additional considerations that could help GCR to identify a distressed entity may include any of the following:

- materially constrained liquidity (in local or foreign currency) at the time when an exchange offer, or other proposed restructuring is announced;
- deeply negative cash flows, increasing the likelihood that interest or scheduled principal repayments may be missed in the short-term;
- refinancing risk is significantly elevated by high or concentrated short-term debt maturities;
- unsustainably high leverage, especially if GCR considers recapitalisation to be unlikely, due to limited shareholder support or a weak shareholder base;

- an entity is viewed to be so distressed that the proposed refinancing would not materially reduce the potential for a conventional default over the next 12 months;
- The entity could breach regulatory minima or meaningful covenants.

In the absence of sufficient information to support the view that creditors would be unduly prejudiced by a proposed restructuring, GCR could still progressively downgrade the issue and issuer ratings from 'CC' to 'C' ratings if it considers a default to be imminent in 12 or six months respectively. This would usually be followed by downgrades to a 'D' and 'SD' respectively, when the restructure it considers to have been undertaken to avoid immediate or imminent default is finalised.

It is worth pointing out that any failure to pay interest or principal in a timely matter is always considered to be a default, even when creditors have agreed to a moratorium or debt service. For more types of default, please see our Ratings Definitions, Symbols and Scales criteria on the website.

What are the typical indicators of proactive restructuring?

GCR distinguishes DDEs from cases where 1) debt exchanges or early refinancing benefit both the issuer and its creditors or 2) refinancing is opportunistic, and in certain circumstances, could see creditors incur realise a lower pro-rata value as a result of early debt redemption, although they would be able to capitalise on the early release of capital by reinvesting in new issuances with stronger returns (usually due to a positive shift in interest rates or spreads).

Amongst other factors, corporates or financial institutions with robust financial profiles may make exchange offers or change outstanding debt terms to 1) capitalise on strong liquidity positions or favourable interest rate policy shifts, 2) diversify their debt investor profiles, 3) further term-out outstanding debt obligations or 4) keep capital instruments aligned to regulatory requirements. If an issuer with an otherwise sound credit risk profile proposes a debt exchange due to proactive or conservative treasury risk management protocols, we would typically not consider this to be a DDE.

Specifically, early refinancing that is finalised when an issuer has reasonable covenant headroom and sound liquidity, while also appropriately offsetting potential loss of economic value to creditors, would be viewed as proactive, as it inherently reflects an entity's financial flexibility. In addition, the early settlement of notes trading at a discount would not typically be considered to be a DDE, unless the issuer is also viewed to be distressed.

Is a debt exchange offer automatically classified as distressed if investors are forced to accept it?

Investors may voluntarily take up proactive debt exchanges or be coerced to do so by issuers that are well-positioned to term out or reduce debt through early settlement of notes. This does not automatically mean that the offer is distressed, as issuers that with strong financial profiles may compel investors to accept early note settlements as part of a proactive reprofiling of their capital structure. As coercive exchange offers could alienate investors, such action is typically only undertaken by highly rated issuers with regular, strongly subscribed debt issuances.

Conversely, whether investors are compelled by the issuer or other funders, or voluntarily accept the restructure of a distressed entity's debt, it would still be typically considered to be a DDE. This is because the exchange would still serve as a means of averting an eventual default, or of potentially achieving higher recoveries than would have been realisable from a conventional workout process.

How does GCR determine if creditors have been prejudiced by a debt restructure?

GCR typically considers creditors or debt investors' interests to be prejudiced by a debt exchange offer or restructuring if investors are subject to one or more of the following:

- reduced principal, interest, fees, and longer debt tenors without adequate compensation for the associated economic loss;
- relaxation of pre-existing negative pledges or other restrictions meant to protect investors;
- changes that effectively subordinate other senior creditors' interests;
- an offer of equity, hybridised debt or other PIK in *lieu* of the original cash settlement;
- a cash offer for debt securities trading at a discount together with a request for covenant relief to be applied to the rest of the bond series/programme.

Are changes to loan agreements automatically considered to be signs of distress?

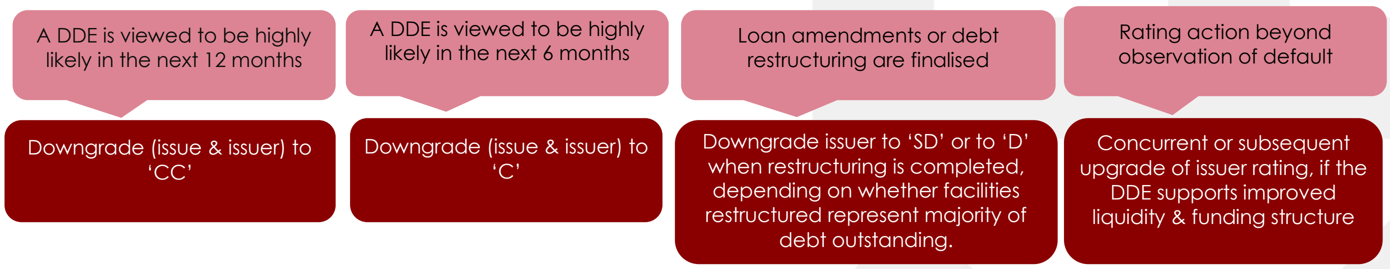
If amendments to existing loans or facilities result in reduced realisable values for creditors, the debt restructuring agreement could be considered to have the same effect as normal default. This could arise if the loan tenor is extended without commensurate repricing or fee adjustments, or if applicable interest rates and the outstanding principal are reduced to give an issuer solvency and liquidity relief. GCR could also downgrade the issuer to a 'CC' (respective national or international scale) rating if the potential for a distressed restructuring has been significantly increased by (*inter alia*) untenable losses, negative cash flows, and high leverage levels.

That said, the proactive extension of facility maturities that is properly constituted between the issuer and funder is typically viewed as part of conservative treasury risk management, and not a DDE. This stance is more likely to be adopted when it comes to bank loan amendments (versus bonds), because of the typically limited information about changes to terms, and when these changes are undertaken.

The shifting of debt exposures across banks, and multifaceted facilities (which may include access features) could also obscure interpretation of loan amendments. Generally, GCR therefore considers debt refinancing by well-capitalised/lowly geared entities with reasonable access to capital and strong liquidity headroom to be proactive. Conversely, proposed refinancing by entities viewed to be distressed could be equated to a near-default (i.e. meeting 'CC' or 'C' definitions), especially in cases where there is no facility headroom, funders are unwilling to provide term facilities, and if creditors increase secured facility coverage requirements, or call for additional collateral to cover existing facilities.

Generally, the timely observation of defaults on bank facilities is difficult, especially when the entity has a complex debt structure, consisting of multiple credit lines and facility uses, or highly structured syndications and derivative exposures. In such cases, if GCR is of the view that some scheduled interest or principal payments have been missed (due to factors such as restrained liquidity coverage and negative cash flows), it could downgrade the issuer rating to an 'SD' or a 'D', depending on the proportion of debt repayments it considers to have been missed or rescheduled to address an untenable financial position.

Figure 2: Typical rating transition in respect of distressed loan restructuring*



* The transition applies to both national scale and international scale ratings.

In summary, material changes in loan terms do not necessarily indicate a DDE, unless GCR is of the view that the issuer required the debt relief to avoid default. Amendment of terms such as covenants, the release of security, and an interest reset that is part of a refinancing agreement could actually improve the liquidity profile and capital structure of the issuer.

This especially applies in cases where an issuer proactively negotiates a revision of terms to manage down its cost of funding due to positive changes in the interest regime, movements in the swap curve or M&A activity that fundamentally changes the nature of covenants that funders typically apply to entities in the same industry.

With so much ambiguity, how can GCR tell if bank loan refinancing is distressed?

Due to the inherent flexibility in most loan agreements, and because banks continuously re-rate their loan exposures, and restructure facilities extended to clients accordingly, GCR has one or more of the following parameters to assess the potential of a DDE:

- funders are not compensated for lower recoveries resulting from the debt restructure, and GCR is of the view that the issuer requires the amended terms to avoid default, liquidation or bankruptcy (depending on the jurisdictional requirements);
- the issuer asks creditors for amendments to both its bond programme and its bank facility terms, implying a high risk of a generalised default;
- liquid securities and other PIKs are offered to settle debt in *lieu* of cash.

In addition, GCR would typically observe a default when creditors are required to adopt loan amendments by regulatory or court intervention(s) in a pre-enforcement scenario. This serves to subordinate other senior creditors, and implies severe financial distress typically associated with distressed restructuring.

Are there any types of loans/debt securities that could be excluded from a DDE?

The conversion of shareholder or sovereign guaranteed debt to equity (whether the option or right sits with the shareholders or the issuer) is not necessarily consistent with a DDE, but it could trigger cross-default clauses that translate to a default. Other the hand, in cases where debt conversion improves the funding profile and liquidity coverage, GCR may consider upgrading the ratings of an issuer with a strong parent This would be especially applicable if shareholder loans form a sizeable proportion of the issuer's debt obligations.

Hybrid debt (i.e. instruments with debt and equity components) would also typically not act in the same way as senior or non-complex subordinated instruments. Although extremely rare, such exchanges would be taken on a case by case basis.

Is a credit standstill agreement the same as a DDE?

A credit standstill is an agreement between creditors and the issuer that allows a temporary halt in scheduled interest and/or principal payments, typically to give the issuer time to restructure its obligations without being forced into bankruptcy by any of its lenders.

As with a DDE, the announcement of a credit standstill would typically see the issuer ratings downgraded to a 'C' (respective national or international scale rating), because interest payments have to be rescheduled, and the issuer has the risk of defaulting, being placed under receivership or filing for bankruptcy unless the standstill is followed by a sustainable restructuring exercise. As the standstill starts, GCR would typically observe defaults (issuer to 'SD', and issue ratings to 'D'), with an upgrade only typically accorded post the restructuring of debt obligations.

Overall, if a credit standstill was negotiated to avoid insolvency, bankruptcy or other form of default, we would still typically observe a default when it is finalised, unless the refinancing is achieved without unduly prejudicing debt investors/creditors.

Do debt exchanges in anticipation of short-lived credit pressure automatically result in downgrades?

Generally, proactive liquidity management by strong issuers stabilises their financial profiles, and is typically credit enhancing, as it enables scheduled interest or principal obligations to continue to be met during short-lived periods of uncertainty or ahead of major M&A activity. For example, funders may agree to roll maturing obligations for short periods (six or 12 months) until a merger or unbundling is finalised. They may also provide bridge funding to enable an issuer to defer the issue of medium to long-term notes until markets have stabilised. This would allow for appropriately structured facilities to be put in place thereafter.

In cases where adequately capitalised/conservatively geared issuers pre-emptively resolve short-term liquidity pressure through refinancing, GCR would not typically consider such actions to be the same as DDEs. If an issuer secures term facilities to repay notes early, this also bodes positively, as it improves the debt maturity profile and liquidity coverage. That said, where liquidity risk is elevated due to excessive debt or curtailed financial flexibility, GCR would typically consider such early refinancing to be a DDE, especially when the terms of the new debt structure also result in investors having to absorb discounted returns on their investments.

GCR would not typically downgrade an issuer due to the rescheduling of interest and/or principal in respect of shareholder loans. This especially applies where the shareholder guarantees its operationally integral subsidiary's external debt (meaning that the issuer's creditworthiness would be underpinned by its stronger parent's credit risk profile.

Nevertheless, other signals of distress, such has excessive debt or high covenant risk due to weak earnings or poor liquidity management, could result in a downgrade of the issuer by increasing the number of notches between the issuer and its parent. In addition, if the issuer is not essential to its parent, we may downgrade it to a near default rating if the issuer is so distressed that liquidity relief from the rescheduling of shareholder loans to its parent would not materially improve its financial profile.

Are structured securities typically excluded from GCR's assessment of DDEs?

The DDE assessment principles outlined above also apply to structured finance transactions, although they typically have very limited practical application, due to the prescriptive nature of most structured securities.[1] Nonetheless, if GCR considers an exchange offer or amendment is necessary to avoid a payment default on a poorly performing transaction, this may be seen as a DDE, and the rating would be downgraded to a 'C', then to a 'D' when default is observed.

GCR could also consider an exchange offer to be similar to a near default if in its opinion, the issuer would face bankruptcy or default if creditors do not take up the offer. Conversely, exchanges or amendments made to take advantage of favourable market conditions would not affect outstanding issue ratings. In addition, if a securitisation structure reaches a post-enforcement scenario whereby the notes are declared to be immediately due and payable to the noteholders, GCR may move the ratings of the notes to a 'D' rating, depending on the structure of the securitisation vehicle.

Structured finance transactions are typically equipped with several layers of credit enhancement (e.g. excess spread and over-collateralisation) and/or liquidity to allow the SPV to withstand a potential sharp stress in cash flows or increases in delinquencies and defaults. Similarly, conservative stresses are applied to expected loss ratings assigned to secured notes. In addition, ratings that assess ultimate payment of principal and/or interest would not necessarily be assessed under GCR's normal definitions of a DDE or default.

That said, periods of severe economic stress and other Black Swan Events may significantly curtail the performance of underlying assets in structured finance transactions and secured notes. However, we do not believe that this would create material negative rating risk in highly rated structured finance transactions or structurally enhanced instruments, as long as the economic stress is temporary and asset quality recovers quickly thereafter. We may still downgrade some transactions or issues to 'C' if in GCR's view, there is a much

[1] For instruments whose ratings are directly based on the creditworthiness of an underlying entity or obligor, expectations or notification of a planned distressed restructuring of the entity's debt would necessarily also result in the ratings on the notes or similarly structured derivatives being downgraded to 'CC' or 'C' to match the issuer ratings of the underlying entity.

higher likelihood of default due to significant economic disruptions. This would typically be followed by a downgrade of the ratings to a 'D' when the default is observed.

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