GCR RATINGS

# CRITERIA FOR SECURED BOND EXPECTED LOSS CREDIT RATINGS

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## Scope of the Criteria

1. The criteria titled 'Criteria for Secured Bond Expected Loss Credit Ratings' is exclusively applied when assigning an Expected Loss ('EL') rating to particular listed or unlisted debt obligations, specifically when distinguishable security or collateral has been pledged to the holders of the debt, which improves their recovery prospects after an event of default (relative to unsecured senior claims).

2. The 'Criteria for Secured Bond Expected Loss Credit Ratings' can therefore only be applied to issue/programme credit ratings. However, unlike other issue credit ratings, 'Secured bond' or 'EL' ratings also factor in expectations of post default recoverability from a specific collateral pool, along with the issuer's creditworthiness.

3. GCR will typically assign 'EL' ratings to specific debt instruments that benefit from security coverage in the event of an issuer default. However, where a secured debt programme has adequate provisions limiting the nature of issued debt to only senior secured obligations, that rank pari passu and share equally in the security pool, GCR may provide a programme rating.

4. The rating scale and symbols used when assigning 'EL' ratings are the same as those for issuer ratings (albeit secured bonds carry an additional 'EL' suffix), but the two are not comparable.

5. Importantly, the criteria below only refers to the recovery criteria element of a 'Secured bond' rating. To see how GCR will accord an issuer credit rating, please visit the specific sector at https://gcrratings.com/criteria/.

## Summary of the Criteria Changes

6. Changes to the criteria include specification of additional asset classes that may be used as security and the establishing of haircuts for the collateral pool. Furthermore, the notching approach based on the estimated recovery prospects relies on the national rating scale, as opposed to the international scale previously.

## Introduction

7. When rating secured debt instruments the 'EL' rating can be applied to reflect both the issuer credit rating and our expectations of recoverability (from the assigned collateral) on 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.

8. The ratings of secured bonds are derived by applying a notching approach, starting from the long-term national scale issuer credit rating of the intended issuer of such bonds (see paragraph 20 for the approach to international scale ratings). In determining the appropriate number of rating notches to be applied, GCR compares the estimated overall recovery rate after a potential default of the issuer with the assumed

average corporate senior unsecured debt obligation recovery rate. If overall estimated recoveries are higher than the assumed average recovery rate, a notching uplift may be applicable in line with the recoveries notching table detailed below (Table 2). However, where relevant, the credit quality of the transaction parties facilitating structural enhancements (e.g., partial guarantee providers) relating to the transaction is also taken into account.

9. Typically, secured bond ratings will change in line with changes to the issuer credit rating, assuming there are no changes in the recovery assumptions. 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 typically 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.

## Assumed Average Recovery Rate

10. International credit rating agency transition and default or recovery studies indicate that the long-term average recovery rate on defaulted senior unsecured debt obligations is approximately 40%. Note must be taken that the data supporting these studies is mainly derived from observations in the US market and other developed markets where rated debt issuance typically takes place. For other jurisdictions different average recovery rates on senior unsecured debt may be expected. Therefore, assumed recovery rates may be changed from the assumed 40% on a case-by-case basis by GCR's rating committee, if there is ample statistical evidence over time, within that market. Such assumptions will be published in a jurisdictional supplement.

## Calculating the Recovery Rate

11. The notching uplift is a function of the expected (stressed) recovery proceeds from the security or other enhancements, relative to the aggregate exposure of the bondholders in a default scenario.

12. The aggregate bondholders' exposure is determined by adding the principal amount outstanding, expected legal and recovery costs, as well as the aggregate assumed missed interest payments (incl. any penalty/default interest). The missed interest is calculated using the relevant benchmark rate(s) for the jurisdiction plus the applicable margin, aggregated over the period assumed until the realisation of recoveries.

13. Security pools can be a mixture of assets, or just one type of specific asset. When assessing the security/enhancements, GCR will apply haircuts depending on the assets and typically within a 2-year liquidation window.

14. The assumed nominal value of funds recovered from the underlying security may be adjusted for the impact of inflation, subject to the time provided to realise liquidation proceeds.

15. In addition to the expected recoveries from different types of securities that are haircut according to the guidance provided in Table 1, GCR will only incorporate cash flows from income generating assets in the recovery calculation where provisions to cede the relevant cash flows and associated bank accounts are included in the transaction documentation.

Table 1: Security Haircuts

| Type of Security | Description | Haircut |
|---|---|---|
| Cash in Hand/Short-Term Liquid Assets | Cash in hand, reserve account (with higher rated counterparty) or overnight deposits in banks/MMFs | 0% |
| Listed Equities | Local or international exchange equities | See Criteria for Rating Investment Holding Companies for stress |
| Local Currency Government Bonds | Local currency bonds of the country of the issuer's jurisdiction | 5% |
| Other Interest-Bearing Securities | All interest-bearing securities, in local or hard currency. | From 5% (AAA) to 100% (CCC). With potential additional haircuts for subordinated or hybrid debts or related party debts. Additional haircuts may be used for exotics or if markets have poor secondary market liquidity for those notes. |
| Unlisted Equity | Private equity, joint-venture or mezzanine positions in related entities | See Criteria for Rating Investment Holding Companies for stress |
| Loan Book Receivables | Self-originated or loan book purchases | Either a fire sale value or stressed credit losses, depending on the term, tenor and characteristics of the loan book. |
| Residential Real Estate (RRE) | Tenanted residential real estate. | Jurisdiction specific10-year peak to trough independent estimate of residential real estate over the maturity horizon of the debt. In the absence of market data, a minimum haircut of 37.5% is applied |
| Income Producing Commercial Real Estate | Commercial real estate with ring-fenced cash flows | See above. In the absence of market data, a minimum haircut of 37.5% is applied |
| High Volatile Commercial Real Estate/Land | Empty buildings, land, or construction | See above or 2x RRE in absence of data |
| Machinery and Equipment | Moveable | Jurisdiction specific stresses will be decided based on secondary market pricing |

16. Where possible and applicable, GCR will only rely on independent asset valuations or audit opinions for the base values to which haircuts are applied. In the absence of such independent opinions, additional haircuts may be applied.

17. The rating committee may use its discretion to apply additional haircuts to certain types of assets where recoverability is considered to be inherently reduced, such as related party or cross jurisdictional loans. In specific cases, the proposed security may not be given any recovery credit due to complexity, illiquidity, or a combination of both (e.g., patents).

18. After calculating stressed recoveries from the security pool as a proportion of the aggregate bondholders' exposure, GCR relies on Table 2 to provide guidance on the appropriate number of notches to uplift the issue rating from the starting point of the issuer credit rating.

19. GCR's rating committee may use its discretion to decide the appropriate number of notches to uplift the issue rating when recovery prospects are within a range of 2.5% from the turning point. Furthermore, if recoveries are considerably below 50%, negative notching may be deemed to be appropriate for the 'EL' rating of the issue/programme.

Table 2: Recovery Prospects and Associated National Scale Notching

| Recovery Prospects | National Scale Notching |
|---|---|
| 95% to100% | +4 |
| 80% to <95% | +3 |
| 70% to <80% | +2 |
| 60% to <70% | +1 |
| 50% to <60% | |
| <50%* | Equal to Issuer Credit Rating/Senior Unsecured Issue Ratings |

*If recoveries are considerably below 50%, negative notching may be applied for the 'EL' rating of the issue/programme.*

## International Scale Ratings

20. When assigning international scale ratings, GCR will map across from the national scale to the international scale using the anchor credit evaluator. See the Criteria for the GCR Ratings Framework for more details on the anchor credit evaluator. Consequently, all secured bonds must be supported by a national scale issuer credit rating, even if the secured bond is accorded on an international scale.

## Partial Guarantees

21. When there is a partial guarantee, we look at the counterparty strength of the guarantor (which could act as a cap to the rating), the level of security provided, and the terms of the partial guarantee.

22. Like the GCR guarantee guidelines, to receive credit, partial guarantees should be unconditional and irrevocable. However, unlike general obligation or full value guarantees, they may have slightly more room on timeliness.

## Legal Opinions

23. Credit is only given to structural enhancements if a satisfactory transaction-specific legal opinion is analysed. As a minimum, GCR expects the legal opinion to include capacity language in respect of transaction parties, a description of the security and an opinion that transaction documentation is legal, valid, binding, and enforceable against the relevant transaction parties.

24. In the event that the security is shared with other creditors (e.g., senior or pari passu ranking parties, or parties that have subrogation rights), GCR expects this to be described in the legal opinion as this may influence the calculation of the estimated overall recoveries. GCR also expects confirmation from the issuer in writing that the underlying security is not dual ceded to another party.

## GLOSSARY OF TERMS/ACRONYMS

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|---|---|
| Advance | A lending term, to transfer funds from the creditor to the debtor. |
| Asset | A resource with economic value that a company owns or controls with the expectation that it will provide future benefit. |
| Beneficiary | Nominated person or institution in the policy document that is entitled to receive the proceeds stated in the policy. |
| Benefits | Financial reimbursement and other services provided to insureds by insurers under the terms of an insurance contract. |
| Bond | A long term debt instrument issued by either a company, institution or the government to raise funds. |
| Budget | Financial plan that serves as an estimate of future cost, revenues or both. |
| Callable | A provision that allows an Issuer the right, not the obligation, to repurchase a security before its maturity at an agreed price. The seller has the obligation to sell the security if the call option holder exercises the option. |
| Capacity | The largest amount of insurance available from a company. In a broader sense, it can refer to the largest amount of insurance available in the marketplace. |
| Capital Markets | The part of a financial system concerned with raising capital by dealing in shares, bonds, and other long-term debt securities. |
| 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. |
| Cedent | The party that transfers it's right in a cession. |
| 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). |
| Conditions | Provisions inserted in an insurance contract that qualify or place limitations on the insurer’s promise to perform. |
| 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. |
| Country Risk | The range of risks emerging from the political, legal, economic and social conditions of a country that have adverse consequences affecting investors and creditors with exposure to the country, and may also include negative effects on financial institutions and borrowers in the country. |
| 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. |
| Coverage | The scope of the protection provided under a contract of insurance. |
| Credit Assessment | See GCR Rating Scales, Symbols and Definitions. |
| 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 |
| 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. |
| Diversification | Spreading risk by constructing a portfolio that contains different exposures whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in. |
| Enforcement | To make sure people do what is required by a law or rule et cetera. |
| Equity Investment | An instrument that signifies an ownership position of shares of stock in a company that is either listed or traded on a stock exchange (also known as a counter) or are unlisted. |

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| 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. |
| Exchange Rate | The value of one country's currency expressed in terms of another. |
| 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 indvdual or company's vulnerability to varous 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. |
| Guarantee | An undertaking in writing by one person (the guarantor) given to another, usually a bank (the creditor) to be answerable for the debt of a third person (the debtor) to the creditor, upon default of the debtor. |
| Haircut | The percentage by which the market value of an asset is reduced. The size of the haircut reflects the expected ease of selling the asset and the likely reduction necessary to realised value relative to the fair value. |
| Hybrid | A form of security that has characteristics of various types of transaction or product. |
| Income | Money received, especially on a regular basis, for work or through investments. |
| Insurance | Provides protection against a possible eventuality. |
| Interest Rate | The charge or the return on an asset or debt expressed as a percentage of the price or size of the asset or debt. It is usually expressed on an annual basis. |
| 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. |
| International Scale Rating. | An opinion of creditworthiness relative to a global pool of issuers and issues. |
| Issuer | The party indebted or the person making repayments for its borrowings. |
| Junior | A security that has a lower repayment priority than senior securities. |
| Leverage | With regard to corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt. |
| Liabilities | All financial claims, debts or potential losses incurred by an individual or an organisation. |
| Liability | All financial claims, debts or potential losses incurred by an individual or an organisation. |
| Liquid Assets | Assets, generally of a short term, that can be converted into cash. |
| 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. |
| Loan | A sum of money borrowed by a debtor that is expected to be paid back with interest to the creditor. A debt instrument where immovable property is the collateral for the loan. A mortgage gives the lender a right to take possession of the property if the borrower fails to repay the loan. Registration is a prerequisite for the existence of any mortgage loan. A mortgage can be registered over either a corporeal or incorporeal property, even if it does not belong to the mortgagee. Also called a Mortgage bond. |
| Long-Term Rating | A long term rating reflects an issuer's ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations. |
| Long-Term | Not current; ordinarily more than one year. |
| 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). |
| Mandate | Authorisation or instruction to proceed with an undertaking or to take a course of action. A borrower, for example, might instruct the lead manager of a bond issue to proceed on the terms agreed. |
| Margin | A term whose meaning depends on the context. In the widest sense, it means the difference between two values. |
| Market Risk | Volatility in the value of a security/asset due to movements in share prices, interest rates, currencies, commodities or wider economic factors. |
| Market | An assessment of the property value, with the value being compared to similar properties in the area. |
| Maturity | The length of time between the issue of a bond or other security and the date on which it becomes payable in full. |
| MMF | Money Market Fund |
| Notching | A movement in ratings. |

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| 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. |
| Operational Risk | The risk of loss resulting from inadequate or failed internal processes, people or systems or from external events. This includes legal risk, but excludes strategic risk and reputational risk. |
| Option | An option gives the buyer or holder the right, but not the obligation, to buy or sell an underlying financial asset at a pre-determined price. |
| 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. |
| Performing | An obligation that performs according to its contractual obligations. |
| 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. |
| Portfolio | A collection of investments held by an individual investor or financial institution. They may include stocks, bonds, futures contracts, options, real estate investments or any item that the holder believes will retain its value. |
| Pricing | A process of determining the price of a debt security. |
| Principal | The total amount borrowed or lent, e.g. the face value of a bond, excluding interest. |
| Private | An issuance of securities without market participation, however, with a select few investors. Placed on a private basis and not in the open market. |
| Provision | The amount set aside or deducted from operating income to cover expected or identified loan losses. |
| Real Estate | Property that consists of land and / or buildings. |
| Receivables | Any outstanding debts, current or not, due to be paid to a company in cash. |
| Reserve Requirement | Minimum amount of cash or cash equivalents (computed as a percentage of deposits) that banks are required by law to keep on hand, and which may not be used for lending or investing. Reserve requirements serve as a safeguard against a sudden and inordinate demand for withdrawals, and as a control mechanism for injecting cash (liquidity) into, or withdrawing it from, an economy. |
| Reserve | (1) An amount representing actual or potential liabilities kept by an insurer to cover debts to policyholders. (2) An amount allocated for a special purpose. Note that a reserve is usually a liability and not an extra fund. On occasion a reserve may be an asset, such as a reserve for taxes not yet due. |
| Risk | The chance of future uncertainty (i.e. deviation from expected earnings or an expected outcome) that will have an impact on objectives. |
| Senior | A security that has a higher repayment priority than junior securities. |
| Short Term | Current; ordinarily less than one year. |
| Subordinated Debt | Debt that in the event of a default is repaid only after senior obligations have been repaid. It is higher risk than senior debt. |
| Surveillance | Process of monitoring a transaction according to triggers, covenants and key performance indicators. |
| Valuation | An assessment of the property value, with the value being compared to similar properties in the area. |