

General Criteria:

Principles For Rating Debt Issues Based On Imputed Promises

December 19, 2014

(Editor's Note: This article is no longer effective after Aug. 7, 2020, except in Uruguay. Its contents were moved in their entirety into "S&P Global Ratings Definitions" (see "What Kind Of Promise Do Our Ratings Address?" in "Appendix") without any change in substance. These contents are primarily definitional in nature and characterized as either fundamental attributes of our rating products, clarifications of the meanings of our ratings, or specific applications of our rating definitions.)

1. S&P Global Ratings is updating its principles for rating securities that do not have plainly stated promises with respect to repayment of principal, interest, or both within a specific time period. The principles provide guidance regarding debt instruments that S&P Global Ratings will and will not rate and how we will arrive at those rating decisions when the terms of an instrument, in our opinion, are not credit-based or measurable. This article fully supersedes "Principles For Rating Debt Issues Based on Imputed Promises," published Oct. 24, 2013.
2. These criteria clarify that S&P Global Ratings does not merely rate to the terms of a transaction. Rather, in order to rate a transaction, we require a "ratable promise," which is, in our view, a promise that is both credit-based and measurable. Where a ratable promise does not exist, we will impute such a promise, add a qualifying subscript, or not rate the transaction. In this way, we expect our ratings to continue to provide market participants with meaningful, credit-based opinions. These principles also represent a continuation of our initiative to enhance ratings comparability among structured finance, corporate, financial services, and government instruments by providing globally consistent principles for "imputing" a promise to form the basis of the rating, when needed.
3. The criteria clarify the types of market, or non-credit risks, that would cause S&P Global Ratings to add a subscript to a rating or not assign a rating. These criteria provide general principles for rating debt issues based on imputed promises and are complemented by sector-specific criteria as needed, such as "Use of 'C' And 'D' Issue Credit Ratings For Hybrid Capital And Payment-In-Kind Instruments," published Oct. 24, 2013. This article is related to "Principles Of Credit Ratings," published Feb. 16, 2011. These criteria should be read in conjunction with the related guidance (see the "Related Publications" section).

SCOPE OF THE CRITERIA

4. These criteria apply to all issue credit ratings globally. This includes ratings on instruments that corporate and government entities and structured finance vehicles issue. These criteria do not apply to issuer credit ratings or insurer financial strength ratings.

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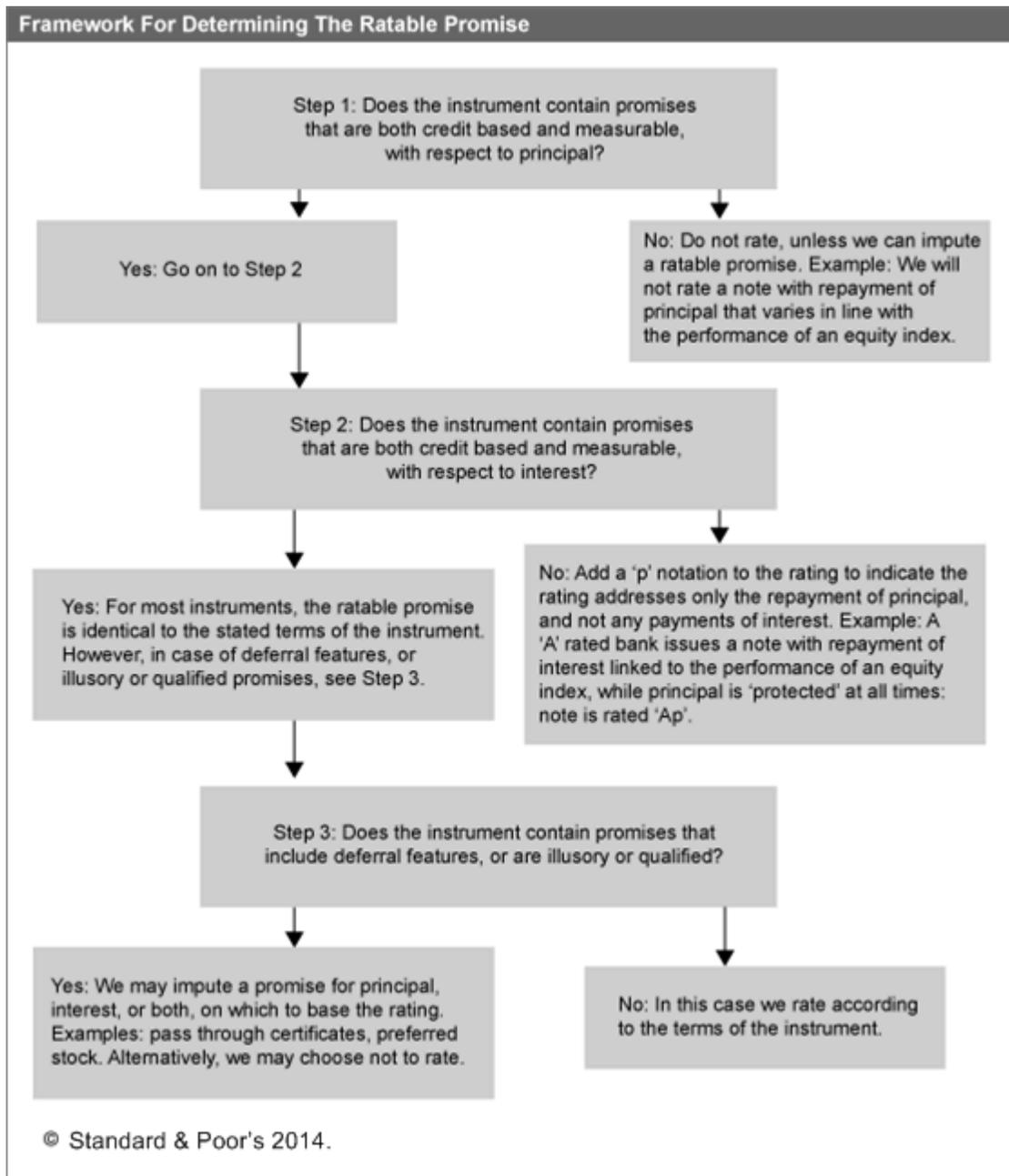
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SUMMARY OF THE CRITERIA

5. The criteria provide principles for determining whether a rating may be assigned, based on whether the principal and interest components of an instrument individually contain promises that are credit-based and measurable. By "credit-based," we mean that the likelihood of payment must be primarily linked to an obligor's willingness and ability to pay. By "measurable," we generally mean that the promise to pay relates to a specific amount due on a specific date. Because our issue credit ratings are primarily an assessment of relative default risk, defining what constitutes a default is critical. Where terms of an instrument do not define a default event, or where we deem that the promise stated in the terms of the instrument is not credit-based and measurable, or the promise carves out credit risk, we will do one of three things:
 - Impute a promise that we consider credit-based and measurable, and use this promise as the basis for assigning a rating;
 - Add a qualifying subscript ('p', denoting that the rating addresses only the repayment of principal and not any payments of interest); or
 - Not rate the instrument.
6. Where promises in instruments are meaningless, illusory, difficult to measure, or contain qualifications, the criteria explain how we may impute a ratable promise--that is a promise on which to base the rating. To impute individual promises for payment of principal and interest, the criteria explain how we apply the terms of an instrument along with those of the underlying asset or assets. The criteria also describe how the imputed promise addresses payment deferrals and interest shortfalls, payment accelerations, puts and calls, and payment qualifications based on the terms and nature of the instrument.
7. Generally, when an instrument breaches the rated promise--whether based on an imputed promise or the instrument's terms--the rating will fall to 'D', absent de-minimis exceptions with regard to the duration and amount of the breach. In addition, when a deferral occurs where deferred amounts are permitted by the terms of the instrument, and we believe virtual certainty exists that repayment of such deferrals will not be made in full at or before maturity, the rating would be lowered to 'D'. Where the issue rating is lowered to 'D' based on an imputed promise, the issuer rating would not necessarily fall all the way to 'D' or 'SD' (selective default). For example, we typically would not lower a company's issuer credit rating to 'D' or 'SD' upon a failure to make a dividend payment on a non-cumulative preferred stock issue, even though the issue rating would fall to 'D'.



8. This paragraph has been deleted.

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METHODOLOGY

A. Attributes Of A Ratable Promise

10. First, a ratable promise must primarily depend on some credit-based element to link the likelihood of repayment to an obligor's willingness and ability to pay. In other words, the investor's likelihood of receiving payment is based on the likelihood of an obligor honoring a promise to pay principal and interest, or the likelihood of a securitization vehicle having sufficient cash flow to honor a promise to pay. Examples of non-credit-based elements include instruments where the investor's payment largely depends on commodity or equity price risk. In other words, if principal varies due to equity price movements, this is not a change related to the ability and willingness of the obligor to pay, and is considered non-credit-based, unless there is a floor in the principal repayment amount where such floor is equal to the original par amount.
11. When the likelihood of receiving a payment is linked to non-credit events, the instrument may transform a non-credit type of risk into a credit risk. An instrument that, in our view, effects such a transformation satisfies the credit-based element condition and, accordingly, has a ratable promise under the criteria. For example, we will continue to rate catastrophe bonds, where our rating methodology focuses on sizing the likelihood that a specified event occurs that would cause non-payment of principal in full, and where non-payment results in a 'D' rating on the instrument. On the other hand, where the payment amount of principal is linked to non-credit events, those securities would not qualify as having a sufficient credit-based element under these criteria. For example, if a bank issues a note where the amount of principal an investor receives varies with the value of an equity index, such as the S&P 500, we would not rate the instrument, unless it is "principal protected," i.e., has a floor on the principal amount equal to the par amount. On the other hand, we would rate a market-value instrument, such as a market-value collateralized debt obligation (CDO). In this case, we rate to a fixed amount of principal due, which does not vary with any index. The rating addresses the likelihood of the investor receiving a fixed amount, based on our assessment of the worst observed historical price declines for the supporting assets.
12. Second, a ratable promise must be measurable. Otherwise, no way exists to determine whether the promise has been broken. For example, a specific amount due on a specified maturity date is measurable. On the other hand, the promise to pay for residual instruments--the debtholder receives all remaining cash flows once other obligations have been paid--is not measurable because one cannot determine whether the promise was honored by observing the amount paid. The ratable promise should be one that is not considered illusory (i.e., misleading).
13. A standard fixed-rate instrument satisfies the conditions for a ratable promise because it contains a plainly stated promise to pay specified amounts at specified times. The actual terms describe the promise, which S&P Global Ratings bases its rating on, even though other provisions in the instrument might blur the meaning of timeliness, loss, or other elements. For example, the rating reflects the likelihood of repayment on the specified date, or within our imputed grace period (see paragraph 51), even though the instrument might provide for a longer grace period. Likewise, an investor may receive the right to compensation for the missed payment in the form of a higher, penalty rate of interest, though that does not negate that an event of non-payment has occurred.
14. To meet the "measurable" standard, the promise can either be expressed as a specified nominal amount or rate, paid on a certain date, or it can be linked to a variable index, subject to certain limitations. The promise to pay interest can also be based on a rate that is periodically determined by an independent third party according to an established market-based process, such as the promised interest rates in auction-rate securities and some variable-rate demand obligations. When a promise is linked to a variable index, the variable index must meet certain minimum standards, regardless of whether it relates to the promise to pay principal or interest:

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- Generally, the index must have an established track record or be considered by S&P Global Ratings as a successor for a long-standing index;
 - The index must be readily accessible, such as posted on a public website;
 - The index must be independent, for example, calculated by a third party independent of the issuer; and
 - The index must be calculated in a transparent, consistent, and verifiable manner.
15. For principal, only inflation, inflation-related (such as a minimum wage index), or currency indices are acceptable. When principal is linked to other types of market indices (such as an equity index, commodity index, fixed-income [bond price] index, CDS index, etc.), a rating will only be assigned if principal is "protected." That is if the issuer or transaction guarantees that principal, equivalent to the original par value, will be repaid in full by the maturity date. Under our criteria, protected principal means that the par amount of principal is protected at all times during the life of the instrument, i.e., repaid at least at par value. For interest, the minimum standards listed above apply to traditional floating-rate interest references (such as interbank rates, inflation, inflation related, and currency). The minimum standards for the variable index for interest (per paragraph 14) do not apply where we are rating an instrument using the subscript 'p'. We will use the subscript 'p' where the interest rate is tied to other types of market indices (such as equity index, commodity index, fixed-income [bond price] index, CDS index, etc.). We may also use the subscript 'p' where most of the promised investment return is linked to one of these market indices, even if such return is not called interest (see paragraph 29).

B. Conditions For Assigning A Rating

16. When the principal and interest components of an instrument satisfy both conditions (credit-based and measurable) for assigning a rating, we will assign a rating without subscripts reflecting the credit risk contained in both components. A single, standard rating will be assigned even if principal and interest have substantially different risk levels. This may occur, for example, due to differences in timing or credit risk profiles. In these cases, sector-specific criteria, usually reflecting a weak-link approach, would determine the rating.
17. For some instruments, the principal component may contain a ratable promise, but not the interest component, and vice versa. When the principal, but not the interest, component of an instrument satisfies the two conditions for a ratable promise, the criteria adds a 'p' subscript to the rating to distinguish the instrument from those that contain ratable promises for both principal and interest. An example is a senior note issued by a 'A' rated obligor with an interest rate that varies based on the value of a commodity or equity index. The criteria consider precious metals, such as gold and silver, to be commodities rather than currencies. Such a note would be rated 'Ap', denoting that the interest component does not sufficiently satisfy the credit-based element condition.
18. The ratings on instruments with payments that fluctuate based on a floating interest rate index (such as LIBOR), inflation (or an inflation-related index), or currency exchange rates would not have subscripts because interest rate, inflation, and currency risk are viewed as ordinary risks in the fixed-income landscape. For example, our ratings do not address the potential losses an investor could incur if the currency in which the instrument is denominated depreciates relative to the investor's home market currency.
19. Under these criteria, S&P Global Ratings will not rate an instrument when the principal component does not satisfy both of the necessary conditions, even if the interest component does.
- 20.

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For structured finance interest-only (IO) securities, we rate based on the referenced notional principal balance (see "Global Methodology For Rating Interest-Only Securities," published April 15, 2010). We impute a credit-based promise in order to rate these securities, as stated in that criteria: "ratings on new IO securities will be based on both the IO's payment priority as well as the rating that we attribute to the credit quality of the underlying assets on which the IO's notional amount is based."

C. Using Imputed Promises To Rate Debt Instruments

21. Some instruments have less traditional promises, for which S&P Global Ratings can often impute a ratable promise. Such promises typically represent illusory or qualified promises. Noncumulative preferred stock and pass-through securities both contain illusory promises, in that the promise to pay is meaningless, or difficult to measure. Neither embodies a ratable promise in its actual terms. However, it is possible to impute a ratable promise to both preferred stock and to pass-through securities in most cases.
22. A qualified promise is a promise that changes if one or more specific events occur; for example, the terms in an instrument allow for shortfalls or late payments under specific circumstances. The inclusion of qualifications may make a promise difficult to measure. Multiple qualifications compound the challenge. In the extreme, broadly stated qualifications may make a promise illusory. As with illusory promises, when the presence of qualifications renders an instrument's actual terms unratable, it is often possible to impute a ratable promise.
23. The deficiencies in certain less traditional promises require S&P Global Ratings to impute a promise with the necessary attributes to assign a rating. An imputed promise may embody deferral features and provide for various caps on what might otherwise seem to be straightforward basis for calculating interest. Once the instrument fails to honor the imputed promise, however, we would generally lower the issue rating to 'D'.
24. Another key difference between an imputed promise and the actual terms of an instrument relates to the impact that a breach of the promise would have on the issuer rating. An issuer's breach of an actual promise to pay on a rated instrument constitutes a default, and as a result, S&P Global Ratings would lower its rating on the issuer to 'D' or 'SD'. However, if an issuer were to breach an imputed promise, we would lower the issue rating to 'D', but the issuer rating would not necessarily fall all the way to 'D' or 'SD'. For example, the lowering of an issue credit rating assigned to a hybrid capital instrument to 'D', such as upon a failure to make a dividend payment on non-cumulative preferred stock, does not in and of itself result in a lowering of the issuer credit rating 'SD' if the non-payment is in accordance with the instrument's terms and conditions, or if the instrument is classified as regulatory capital for a prudentially regulated issuer.

1. Interest

25. If the terms of an instrument indicate a specific rate (with or without qualifications), our imputed promise for the instrument typically uses the stated rate. If the instrument omits a specific rate, the imputed promise uses a rate based on the underlying assets.
26. An imputed promise of interest generally bases the amount due on the outstanding face amount (i.e., unamortized par amount) and the imputed interest rate.
27. The imputed timing of the interest payment is either the dates associated with the rated obligation, or if none are stated, the payment dates associated with the underlying assets.
28. If the instrument specifies a higher coupon payment upon the occurrence of certain events, the imputed promise usually considers the potential step-up in coupon as part of the ratable promise.

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Examples could include higher interest rates resulting from failed remarketings, deferred payments, or credit deterioration.

29. An instrument may contain provisions by which investors may receive additional amounts over and above the stated coupon. Such payments may come in the way of special distributions, fees, or other supplemental payments. Generally, the rated promise does not consider the likelihood that these additional payments will be made unless the coupon payment itself is de minimis or illusory. If the stated coupon (or the effective yield, when there is no stated coupon) is de minimis or illusory and the additional payments are both credit-based and measurable, then we would generally include the additional payments in the rated promise, and a single, standard rating would apply (see paragraph 16). However, if the stated coupon is de minimis or illusory but the additional payments are not credit-based or not measurable, we would either not assign a rating, or we would assign a rating that indicates the interest is not rated, as in 'XXp'. When there is no stated coupon and the additional payments are not credit-based or not measurable, the instrument would generally receive the 'p' subscript unless we make a case-specific determination that the effective yield of the credit-based and measurable component of the promise to pay is not de minimis. To be clear, we do not consider a traditional market-base rate as de minimis, such as an instrument linked to LIBOR flat. However, the base rate must meet the minimum standards set out in paragraph 14. In general, to evaluate whether a promised coupon payment is de minimis, we would consider factors including:
- Whether the promised coupon exceeds the relevant sovereign government borrowing rate at the time of issuance for an instrument with the same tenor and currency of the rated issue; and
 - On a judgmental basis, whether the promised coupon constitutes only a small fraction of the overall return offered, above the return of original invested principal, for the instrument.

2. Principal

30. If the terms of an instrument specify a final maturity date, as well as an earlier, projected principal repayment schedule--sometimes referred to as the expected maturity date or the target amortization schedule--the imputed promise is principal due at final maturity (or "legal maturity date") in cash. Although more typically found in securitizations, this treatment applies to all rated instruments with such features, including project finance instruments and traditional corporate bonds. If the terms of a securitization do not specify a final maturity (such as those for certain pass-through securitizations), the imputed promise is to pay principal by the latest original maturity of the underlying assets, plus a period to allow for liquidation of the collateral, if needed. In the cases of non-securitizations with terms that do not specify a final maturity (for example, perpetual bonds or preferred stock), the imputed promise is that the instrument will maintain its rank in the capital structure (such as senior or subordinated) and will pay principal in full at a specified call date, an optional refinancing date, or the time of liquidation.

3. Temporary interest deferrals and payment delays

31. The manner in which an imputed promise allows for temporary deferrals depends on our view of the cause for the deferral and whether the missed payment can be repaid by maturity.
32. **Instruments that capitalize interest from issuance.** Examples of instruments that capitalize interest beginning at issuance include zero-coupon bonds and accrual or accretion bonds that accrue interest from inception. Such instruments capitalize interest from inception for reasons other than credit stress. For these instruments, the ratable promise is identical to the actual

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terms--the deferral feature (from inception) would not affect the rating. However, once the deferral period ends and the instrument begins paying interest in cash, any subsequent deferral (even in accordance with terms) is evaluated as below.

33. **Instruments that lack deferral provisions, or the deferral is expressed as a "temporary shock absorber."** Pass-through certificates are an example of instruments that lack specific provisions for deferral, even though deferrals or interest shortfalls may occur and be repaid prior to maturity. Examples of instruments that provide for deferral as a temporary shock absorber include payment-in-kind (PIK) notes, PIK toggle notes, subordinate tranches of CDOs, and cumulative preferred stock. These instruments defer or capitalize interest at times of stress. However, payments are not foregone. Rather the cash flow timing is delayed. Temporary shock absorbers may also include instruments with temporary write-downs to principal, as long as the terms of the instrument allow for full reinstatement of the principal along with reinstatement, deferral, or capitalization of the related interest shortfall (i.e., the interest that would have accrued on the portion of principal subject to the temporary write-down).
34. For all instruments similar to those above, sector-specific criteria or analyses will typically provide more detail as to how, and whether, we will consider a deferred payment as leading to a lower rating or a default. (For example, see "Structured Finance Temporary Interest Shortfall Methodology," published on Dec. 15, 2015, and for corporate and government ratings, see "Use Of 'C' And 'D' Issue Credit Ratings For Hybrid Capital And Payment-In-Kind Instruments," published on Oct. 24, 2013.) This sector-specific approach is necessary to appropriately capture differing amounts of credit and non-credit factors that could lead to a deferral and differing instrument terms across asset classes and jurisdictions.
35. In addition, for all sectors and asset classes, when we believe virtual certainty exists that repayment of deferred amounts due under the terms of the documentation will not be made in full at or before maturity--whether because of the asset composition, structural mechanics of the transaction, or other factors--this certainty overrides any imputed allowed deferral periods. At the time of, or following, a deferral event, when, in our view, such virtual certainty exists, the rating would be lowered to 'D'. For purposes of this paragraph, amounts due under the terms of the documentation include principal, interest, interest step-up, and compounding of deferred interest at the rate set in the documentation.
36. **Instruments with a deferral expressed as a "permanent shock absorber."** These include many hybrid capital instruments, including contingent-convertible bonds and non-cumulative preferred stock. As opposed to temporary shock absorbers, when instruments with permanent shock absorbers defer interest, write down principal, or convert to equity, unpaid amounts are not repaid in the future. As a result, investors suffer a permanent loss.
37. In the case of permanent shock absorbers, although the terms of the instrument may permit non-payment of interest, conversion to equity, or write-down of principal, the terms of the imputed promise are to pay cash on a timely basis. Therefore, use of this type of permanent shock absorber would constitute a breach of the imputed promise. For example, a write-down of principal, in accordance with the terms of a bank hybrid security, would result in a 'D' rating. Similarly, the conversion of a debt instrument into common equity as a result of a credit-related trigger, in accordance with the terms of the instrument, would result in a 'D' rating unless the current market value of the shares received upon conversion was equal to or exceeded the original principal amount.
38. However, the exercise of an equity conversion feature in an instrument that includes one does not constitute a breach of the ratable promise if the conversion does not occur as a result of credit stress.

4. Acceleration or early amortization

39. For non-securitization instruments, such as corporate bonds, acceleration (where all principal amounts become immediately due and payable) is typically due to an event of default, and the expectation of additional ongoing payments may not exist. The purpose of the acceleration is to position creditors to better enforce their claims in bankruptcy or other restructuring proceedings. Although the triggering event may have been a covenant default rather than a payment default, once payments are accelerated, the imputed promise is breached unless accelerated amounts are paid per the terms of the acceleration clause.
40. For securitization instruments, our criteria call for different treatment of payment accelerations that result from events of default or other early amortization events. In a tranching securitization, the acceleration alters the payment waterfall for senior creditors while payments continue. To the extent that a structured finance security is not credit tranching (e.g., a repackaged security), we follow the methodology used to rate the underlying securities.
41. For securitizations, the lack of immediate payment of principal in full following such an event would not be a breach of the ratable promise. In these cases, the criteria focus on the fact that the acceleration could result in a higher likelihood of full payment of obligated amounts in a shorter period of time relative to the original promise. Therefore, the ratable promise for principal remains principal due at original final maturity.
42. With regard to interest for securitizations with a tranching structure--when the purpose of the change in the transaction waterfall is to divert all cash flow to senior noteholders--the ratable promise after the credit stress event follows the sector-specific approach for addressing interest shortfalls and payment delays.

5. Puts and calls

43. When an instrument specifies the ability for investors to demand principal repayment before maturity (with a corresponding obligation of the issuer to honor it) or when an instrument allows the issuer to call the obligation at an earlier date, the specified promise to pay under these events (if it exists) should meet the conditions necessary to assign a rating. If it does not, then the instrument as a whole does not contain a ratable promise.
44. For an instrument with a call option, when the obligation requires full repayment of the outstanding par amount upon the exercise of the call, a payment of less than 100% of the related par amount results in the breach of the ratable promise.
45. However, the criteria would not consider a call at less than par a breach of the ratable promise in certain infrequent circumstances. If, in the view of S&P Global Ratings, the call option price is below par, but: a) is not credit-risk sensitive, b) is reflected in the price of the security, and c) there is a high level of transparency and a low likelihood that the call provisions could be misunderstood when the securities are sold, we would not necessarily consider exercise of the call as a breach of the ratable promise. For example, a zero-coupon note with an annual call provision at accreted value, where such accreted value provides for payment of the original invested amount plus a return in line with the original effective yield of the instrument, would not represent a breach of the imputed promise. On the other hand, an instrument with a call provision at present value of the instrument, based on then current market yields, would not be ratable. (See also "Methodology For Rating Structured Finance Securities With Call Provisions At Less Than Par," published May 14, 2009.)
46. For an instrument with a put option, the ratable promise is equivalent to the stated promise. An

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issuer's failure to honor the put would constitute a breach of the promise. However, when instruments contain provisions that allow investors to indicate their desire to put back an obligation, but do not obligate the issuer to honor the desire, an issuer's decision not to repay the amount does not represent a breach of the imputed (rated) promise.

6. Treatment of other qualifications

47. In general, an instrument's imputed promise incorporates most non-credit-related qualifications that are in the instrument's actual terms. Examples of what we consider non-credit-related qualifications include allowances for lower payments due to activated military reservists (Servicemembers Civil Relief Act provisions); lower payments due to lost interest from prepayments; qualifications that cap a promise to pay interest at the lower of an interest index (such as LIBOR) plus a spread or the weighted-average coupon (WAC) of the underlying assets; and allowances for lower payments due to negative amortization. Lower payments resulting solely from these factors, if the terms of the instrument permitted them, would not represent a breach of the imputed promise and would not cause the rating to fall to 'D'.
48. By contrast, lower payments resulting from credit-related qualifications that reflect credit deterioration would likely be a breach of the imputed promise. Examples include non-payments on certain U.S. public finance appropriation obligations because of a decision not to appropriate funds.
49. Where a securitization instrument's interest obligation is constrained by referencing the WAC of the underlying assets in the pool, a severe deterioration in the WAC resulting from credit events (such as loan modifications) would be a breach of the imputed promise. The guidance (see "Related Publications") provides details on how "severe deterioration in the WAC" for U.S. RMBS is determined.

D. The Effects Of Breaching A Ratable Promise

50. Generally, when an instrument breaches a ratable promise--whether based on an imputed promise or the instrument's terms--the rating on the instrument would be lowered to 'D'. However, there are two exceptions, one relating to grace periods and one relating to de-minimis shortfalls.

Grace periods

51. In accordance with our criteria "Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings," the long-term rating on a past due security may not be lowered to 'D' if we expect full payment will be made within the earlier of the stated grace period or 30 calendar days after the due date. If there is no stated grace period, or a stated grace period of one to five business days, we impute a promise of timely payment to mean no later than five business days after the due date for payment. For short-term ratings, 'D' is used when payments on a financial obligation are not made on the date due even if the applicable grace period has not expired, unless S&P Global Ratings believes that such payments will be made during such grace period. However, any stated grace period longer than five business days will be treated as five business days (see "Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings," published Oct. 24, 2013).

De-minimis shortfalls

52. De-minimis shortfalls of the amount due will not have a rating impact, regardless of whether we expect recovery of the shortfall amount, where such shortfalls do not exceed 1 basis point of original principal on a cumulative basis.

APPENDIX

Frequently Asked Questions

Step-Ups And Step-Downs

53. **What are the key implications of the imputed promises criteria for transactions with "step-up" or "step-down" coupons?** For step-up coupons, the imputed promise usually includes the step-up rate (i.e., a failure to pay the step-up would be considered a default [see paragraph 28]). However, if the step-up differential is subordinated in priority of payment, we do not consider the differential to be part of the imputed promise unless (1) the initial coupon is de minimis, or (2) the failure to pay such step-up leads to an event of default (EOD). If either condition is met, the imputed promise would also incorporate the subordinated step-up differential, in which case the rating on the instrument would reflect our credit opinion of the subordinated step-up. Consider these examples:
- A corporate security has terms that require a step-up of 100 basis points (bps) in the interest rate in case of credit deterioration, for example if debt to EBITDA worsens significantly, to a certain defined level, from the ratio at origination. Such a step-up is part of the ratable promise--in other words, if the step-up is triggered and the issuer fails to pay the new rate (including the step-up) on time and in full, we would lower the note rating to 'D'.
 - A commercial mortgage-backed security (CMBS) transaction has terms that require a step-up of 100 bps on the interest rate payable on all classes in the event that the underlying loans are not refinanced by a specific date. The step-up differential is paid sequentially but is subordinated to both the base interest (i.e., "pre-step-up" amounts) and principal. If there is no event of default associated with a failure to pay such a step-up, we do not include the step-up in the ratable promise, i.e., the failure to pay the step-up would not result in a rating of 'D'. In such cases, we treat such a step-up as a "bonus" payment (as long as the pre-step-up rate is not de minimis) and accordingly is not part of the ratable promise.
 - A residential mortgage-backed security (RMBS) has terms that require a "subordinated" step-up of 100 bps on all classes in case any "early amortization event" occurs. As in the first example, such a step-up is subordinated in that it would be paid (sequentially) only if there is sufficient cash flow in the waterfall after the pre-step-up rates are paid to all classes. However, in this example, the failure to pay the stepped-up interest rate is an EOD. The presence of the EOD signals that such a step-up is not simply a "bonus" payment: It is a required payment to compensate investors for increased risk in the transaction. In this case, we would lower the instrument rating to 'D' if a trigger event occurs that results in the stepped-up interest rate and such additional interest is not paid on time and in full according to the terms of the notes. Therefore, our ratings on each class would reflect the likelihood that stepped-up interest payments are made.
54. For step-down coupons, if they are a result of credit deterioration, we usually consider the

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step-down equivalent to a default. However, if the step-down coupons are a result of credit improvement, they have no effect on the rating. Consider these examples:

- A corporate note has the provision that if debt to EBITDA improves to a certain level above the level at origination, the rate on the note will decline by 200 bps. Such a provision rewards the issuer for credit improvement via a lower interest rate. Therefore, payments made at the lower rate, in accordance with the terms, would have no effect on the rating (although a significant enough improvement in debt measures, among other factors, may result in an improved issuer credit rating).
- A bank note has the provision that if capital ratios deteriorate below a certain level, the rate on the note will decline by 200 bps. Such a provision is a type of step-down coupon as a result of credit deterioration: It provides relief to a distressed issuer. If the provision were triggered and payments were made at the lower rate, we would lower the rating on the note to 'D', despite the note terms. We consider such a step-down as akin to a distressed exchange, which, similarly, is a default under our criteria.

55. **An issuer rated 'A' issues a principal-protected, equity-linked medium-term note (MTN) that pays a de-minimis stated coupon. But, the interest rate steps up to a rate that is not de minimis after a specific period of time. Is the promise to pay interest ratable?** Yes, as long as the weighted-average yield of the credit-based and measurable component of the promise to pay interest is not de minimis (i.e., in most cases, higher than yield on sovereign securities with an equivalent tenor). For example, say the interest rate is .25 bps for year 1 (plus a variable return based on the S&P 500 Index) and steps up to a fixed rate of 5% for years 2 through 10. In this case, the rating on the instrument would be 'A' because the weighted average of the promised fixed rates is clearly not de minimis. On the other hand, the promise would not be ratable if the weighted-average yield of the credit-based and measurable component of the promise were de minimis. As another example, say the interest rate is .25 bps for years 1 through 9 (plus a variable return based on the S&P 500 Index) and steps up to a fixed rate of 5% for the final interest payment in year 10. In this case, the rating on the instrument would be 'Ap' (i.e., if, at the time we initially assigned the rating, we concluded that the weighted-average rate of interest was de minimis [see paragraph 29]).

Convertible Debt

56. **How do you treat convertible debt under the imputed promises criteria?** Convertible debt is generally ratable. In the case of mandatory convertible securities, we rate them based on the credit-based and measurable promise that exists until the time of conversion, at which point we would withdraw the rating. In the case of convertibles that do not have mandatory conversion features, we can rate them if the investor holds the conversion option. The conversion feature by itself has no effect on the rating, although if such an instrument has deferral or subordination features, such features may affect our issue rating, as per the relevant sector criteria. If the conversion is at the issuer's option (as to whether the instrument converts to shares, and the timing of such conversion), and if the value of principal once converted into shares varies with the equity price, paragraph 11 would apply and the instrument would not be ratable, "if the payment amount of principal is linked to non-credit events, those securities would not qualify as having a sufficient credit-based element under these criteria." If the instrument converts to shares based on credit deterioration (i.e., such as a deterioration in a bank capital ratio), the instrument would

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be ratable, but the rating would reflect our view of the likelihood of such an event (and the rating would be lowered to 'D' upon conversion), per related criteria for the sector. (The relevant sector criteria referenced in this FAQ includes "Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions," published on Jan. 29, 2015, and "Hybrid Capital Handbook," published Sept. 15, 2008).

Replacement Index

57. **How do you consider a replacement index? For example, an 'A' rated issuer issues a five-year MTN that pays interest based on a spread to EURIBOR. However, if the index becomes unavailable, the MTN interest rate will be determined by the bank, in good faith, based on relevant market practice. Is the promise to pay interest measurable?** Yes. The ratable promise would be based on the interest index (EURIBOR), regardless of any alternative interest rate determination method, because we generally expect EURIBOR to be available. However, if we believed that EURIBOR may not be available, we would assign a rating of 'Ap', or not rate the instrument, because the alternative method for determining interest is not measurable (see paragraph 14).

Failure To Pay Interest (Effect On Ratings With 'p' Subscripts)

58. **Let's take a principal-protected, equity-linked note rated 'Ap', where the 'p' subscript is added because the promise to pay interest varies with equity prices and, therefore, such promise does not contain enough credit-based content for us to rate it. Furthermore, the terms in the instrument clearly state that a failure to pay interest is an EOD. Would the rating on the instrument fall to 'D' if interest is not paid on time and in full?** No. Because the rating does not address interest, a failure to pay interest would not, by itself, result in a 'D' rating on the instrument. However, if such a failure leads to the acceleration of principal repayment, and the principal is not paid in accordance with the requirements of the acceleration provision, we would lower the rating on the instrument to 'D' (see paragraph 39 in reference to acceleration provisions).
59. **Let's take a principal-protected, commodity-linked, repackaged ("repack") security, where the 'p' subscript is added to the rating because the promise to pay interest varies with commodity prices and, therefore, such promise does not have enough credit-based content for us to rate it. Furthermore, the terms in the instrument clearly state that a failure to pay interest is an EOD that would automatically lead to a liquidation of all assets and a wind-up of the repack issuer. Consequently, if a failure to pay interest occurred and the liquidation proceeds were insufficient, the repack securities would default. Is the promise to pay principal ratable?** Yes, if the credit source supporting payments of interest is rated; no, if the credit source supporting payments of interest is not rated.
60. The EOD and the automatic unwind provision link the ability to pay principal to the ability to pay interest. Accordingly, if a default on the promise to pay interest could also result in a default on the promise to pay principal, the promise to pay principal would be weak-linked to the lower of (1) the credit source supporting repayment of principal, or (2) the credit source supporting interest payments. For example, if the likelihood of receiving both principal and interest is 'AA+' because they are paid from the same credit source and have the same credit risk, the rating on the instrument would be 'AA+p'. However, if the likelihood of receiving principal is 'AA+' but the likelihood of receiving interest is 'A' (because the promise to pay interest reflects a different credit

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risk profile), the rating on the instrument would be 'Ap'. We would add the 'p' subscript to the instrument rating because the promise to pay interest is commodity-linked and does not have enough credit-based content for us to rate it otherwise (see paragraphs 16 and 17).

Bonus/Supplemental Payments; De-Minimis Interest

61. **A corporation rated 'AA-' is about to issue a 10-year convertible bond (convertible at the option of the investor) that promises to pay an interest rate of 1.25% but no additional amounts. The yield on the government's ('AAA') 10-year bonds is 2.60%. Is the fact that the interest rate is below the government yield a factor under this criteria?** No. Because the corporate bond did not promise any bonus/supplemental/additional amounts, the government bond yield is not relevant. The government bond yield would be relevant only when additional amounts are promised. In those cases, the criteria call for applying a de minimis test to the promised interest rate. The de minimis test considers factors including the sovereign government borrowing rate (see paragraphs 25, for when there is no bonus payment, and 29, for when there is a bonus payment).
62. **A repack issuer issues a \$10 million, principal-protected note that matures in 10 years. The note is priced at par and backed by a \$10 million, zero-coupon, sovereign bond (issued by a sovereign rated 'AA+') that also matures in 10 years, and by the residual tranche of a prime RMBS transaction. The repack note has no stated coupon, but it does promise to pay "supplemental amounts" based on cash flows from the underlying RMBS tranche. Is the repack security is ratable? If so, would the rating have a 'p' subscript?** Yes, the repack security is ratable, and would have a 'p' subscript added. Because the instrument does not promise any interest and the additional amounts are not credit-based (they come from a residual tranche), the assigned rating would be 'AA+p'.

Residuals

63. **Do you rate residuals, i.e., securities whose payout is variable and determined according to residual cash flows in a given transaction?** Generally we do not rate residuals, as the promise is typically not measurable. However, in markets where there is a regulatory requirement to rate the whole capital structure in a securitization, we may assign the lowest possible rating to the residual tranche, even if it does not otherwise meet the characteristics of a ratable promise.

Early Redemption Features

64. **In securities where principal is linked to market issues or indices (e.g., equity, commodity, fixed-income [bond price] index, credit default swap index, etc.), do early redemption features affect our determination as to whether principal is "protected" and therefore ratable?** Early redemption features would not cause an issue to be unratable if redemption is at par value. If early redemption may be at less than par--for example, if the redemption is at market or fair value or if certain costs/expenses can be deducted from a par redemption, the issue may be unratable, unless we view the redemption triggering event as remote.
65. Examples of triggering events we generally consider remote*:
- Illegality (change in law);

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- Tax event (such as change in tax law);
- Force majeure; and
- Technical reasons (such as calculation difficulty with or dissolution of the basis indices).

*We generally consider these triggering events to be remote as long as they are not being contemplated when the ratings are assigned. On a case-by-case basis, we may not consider these types of triggering events to be remote for a given transaction, in which case, we would not rate the instrument.

66. An example of a triggering event we do not generally consider remote:

- Increase in hedging costs. If such an increase triggers an early redemption, the issue would not be ratable if hedging costs are passed through or breakage/unwinding charges are deducted from par repayments.

Note: if we believe the triggering event is not remote, but we can assess the likelihood of the triggering event occurring, we may determine the issue is ratable, but capped at a level commensurate with our assessment of the likelihood of the triggering event, since that represents the likelihood that repayment could be less than par.

Negative Interest Rates

67. **Does the potential for a negative interest rate on the issue render it unratable? For example, if the negative interest rate results in a deduction from principal and therefore less than par repayment, would we consider it a default on the instrument?** No, the potential for negative yields on an issue is contemplated in these criteria. It is acceptable and therefore the issue is ratable. For example, an instrument that is linked to a base rate that could be negative would be acceptable under these criteria, even though this may mean redemption at less than par. The intent of paragraph 15 is to include any standard interest rate index.

REVISIONS AND UPDATES

This article was originally published on Dec. 19, 2014. These criteria became effective on Dec. 19, 2014.

Changes introduced after original publication:

- On Nov. 3, 2016, we added two new frequently asked questions in Appendix A, updated our contact information, and added Appendix B.
- Following our periodic review completed on Dec. 19, 2016, we deleted paragraph 8 because it was no longer relevant. The effective date in paragraph 9 was moved to Appendix B, and we added a "Change History" section to Appendix B.
- Following our periodic review completed on Dec. 18, 2017, we updated our contact information and related criteria; deleted text related to the original publication, which was no longer relevant; and replaced Appendix B with the "Revisions And Updates" section.
- On Dec. 13, 2018, we republished this criteria article to make nonmaterial changes. In paragraph 14, we clarified in the first bullet that we generally consider a track record as a characteristic when assessing the measurability of a promise. We deleted a reference to a track record of 10 years, and we clarified that the index could also be a successor to a long-standing

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index. We also updated the contact information.

- On Dec. 21, 2018, we made changes to paragraph 63 to clarify that in markets where there is a regulatory requirement to rate the whole capital structure in a securitization, we may assign the lowest possible rating to the residual tranche, even if it does not otherwise meet the characteristics of a ratable promise.
- On July 29, 2019, we republished this criteria article to make nonmaterial changes as a result of the retirement of the U.S. RMBS Loan Modification criteria ("Methodology For Incorporating Loan Modifications And Extraordinary Expenses Into U.S. RMBS Ratings," April 17, 2015), which was related to these criteria. Specifically, we replaced the Loan Modification criteria references in paragraph 49 with references to the new related guidance ("Guidance: Principles For Rating Debt Issues Based On Imputed Promises," July 26, 2019).

RELATED PUBLICATIONS

Related Criteria

- S&P Global Ratings Definitions, Aug. 18, 2016
- Structured Finance Temporary Interest Shortfall Methodology, Dec. 15, 2015
- Methodology For Incorporating Loan Modifications And Extraordinary Expenses Into U.S. RMBS Ratings, April 17, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Rating Natural Peril Catastrophe Bonds: Methodology And Assumptions, Dec. 18, 2013
- Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings, Oct. 24, 2013
- Use Of 'C' And 'D' Issue Credit Ratings For Hybrid Capital And Payment-in-Kind instruments, Oct. 24, 2013
- Global Methodology For Rating Interest-Only Securities, April 15, 2010
- Methodology For Rating Structured Finance Securities With Call Provisions At Less Than Par, May 14, 2009
- Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009
- Hybrid Capital Handbook, Sept. 15, 2008

Related Guidance

- Guidance: Principles For Rating Debt Issues Based On Imputed Promises, July 26, 2019

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These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks

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