

# ARCHIVE: Understanding Taiwan Ratings' Rating Definitions

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*(Editor's Note: The criteria article is no longer in use. For related rating definitions please refer to Taiwan Ratings' Ratings Definitions.)*

**PRIMARY CREDIT ANALYST**

**Eunice Fan**  
Taipei  
+886-2-8722-5818  
eunice.fan  
@taiwanratings.com.tw  
eunice.fan  
@spglobal.com

## SCOPE OF THE CRITERIA

1. Taiwan Ratings Corp. (TRC) is refining the criteria it uses in ratings assignment, primarily to promote greater understanding of TRC's rating definitions.

## IMPACT ON OUTSTANDING RATINGS

2. This criteria refinement will not result in rating actions of current outstanding ratings.

## EFFECTIVE DATE AND TRANSITION

3. The criteria are effective immediately.

## METHODOLOGY

4. This publication intends to promote greater understanding of TRC's rating definitions and help local investors attribute clearer meanings to different rating categories.

## Key Attributes Of TRC's Credit Ratings

### Rank ordering of creditworthiness

5. TRC's credit ratings express forward-looking opinions about the creditworthiness of issuers and obligations on a nationwide basis. More specifically, TRC's credit ratings express a relative ranking of creditworthiness. Issuers and obligations with higher ratings are judged by us to be more creditworthy than issuers and obligations with lower credit ratings (see Appendix I for a relevant excerpt from the rating definitions).
6. Creditworthiness is a multi-faceted phenomenon. Although there is no "formula" for combining the various facets, our credit ratings attempt to condense their combined effects into rating symbols along a simple, one-dimensional scale. Indeed, as discussed below, the relative importance of the various factors may change in different situations.

## Understanding Taiwan Ratings' Rating Definitions

7. The term creditworthiness refers to the question of whether a bond or other financial instrument will be paid according to its contractual terms. At first thought, the idea of creditworthiness seems entirely straightforward. However, delving beneath the outward simplicity reveals the true multi-dimensional nature.

### Primary factor -- likelihood of default

8. In our view, the likelihood of default is the centerpiece of creditworthiness. That means the likelihood of default--encompassing both capacity and willingness to pay--is the single most important factor in our assessment of the creditworthiness of an issuer or an obligation. Therefore, consistent with our goal of achieving a rank ordering of creditworthiness, higher ratings on issuers and obligations reflect our expectation that the rated issuer or obligation should default less frequently than issuers and obligations with lower ratings, all other things being equal.
9. Although we emphasize the rank ordering of default likelihood, we do not view the rating categories solely in relative terms. We associate each successively higher rating category with the ability to withstand successively more stressful economic environments, which we view as less likely to occur. Conversely, we associate issuers and obligations rated in lower categories with vulnerability to mild or modest stress.
10. Looking to stress levels is part of how we try to achieve comparability of ratings across different types of securities, different times, and different sectors. That is, we strive to make our rating symbols correspond to the same approximate level of creditworthiness wherever they appear. Thus, when we use a given rating symbol, we intend to connote roughly the same level of creditworthiness to the widely disparate issuers on a nation-wide basis.
11. Still, we do not attach specific probabilities to particular types of potential economic environments. Therefore, we do not ascribe a specific "default probability" to each rating category. On the contrary, we recognize that the observed default rates for all rating categories rise and fall as the economic environment progresses through periods of expansion and contraction (see note 1). Moreover, any given economic cycle generally does not produce the same degree of stress in all sectors and regions. Accordingly, only over the very long term (e.g., covering multiple economic cycles), would we expect to be able to observe whether similarly rated issuers from different market segments actually experience similar long-term default frequencies. These observations inform future changes to our criteria and analytics.

### Secondary credit factors

12. Beyond likelihood of default, there are other factors that may be relevant. For example, one such factor is the payment priority of an obligation following default. Our ratings reflect the impact of payment priority in a very visible way: When a corporation issues both senior and subordinated debt, we usually assign a lower rating to the subordinate debt. For most issuers, the likelihood of default is exactly the same for both senior and subordinated debt because both default at the same time when an issuer goes into bankruptcy. A further example is the "structural subordination" of a holding company's debt to the debt of its operating subsidiaries.
13. Another secondary factor is the projected recovery that an investor would expect to receive if an obligation defaults. For example, our ratings on certain financial institution obligations and on lower rated corporate obligations reflect adjustments for the expected recovery following default (see note 2).
14. A third secondary factor is credit stability. Some types of issuers and obligations are prone to displaying a period of gradual decay before they default. Others may be more vulnerable to sudden deterioration or default. In essence, some types of credits tend to give a warning before they default, while others do not. In addition, the likelihood of default for some types of credits may suddenly change because of changes in key aspects of the economic or business environment. For other credits, the likelihood of default may be less sensitive to changing conditions.
15. Creditworthiness is complex and while there is no formula for combining the different factors into an overall assessment, the criteria does provide a guide in considering these factors. Payment priority and recovery apply more often in the context of rating specific obligations than in rating issuers. Also, payment priority and recovery have increasing significance as likelihood of default increases (i.e., at lower rating levels). In contrast, credit stability has increasing significance as likelihood of default decreases (i.e., at higher rating levels). In addition, the relative

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importance of the several factors may wax or wane with changes in market conditions and the economic environment. The rating criteria for different types of credits detail the specifics of how payment priority, recovery, and stability factor into our analysis.

16. TRC's credit ratings are forward looking. That is, they express opinions about the future. Indeed, the issue that they address -- credit quality -- is at its core future oriented. Ratings at the lower end of the rating scale reflect our view as to the rated entity's vulnerability to cyclical fluctuations and, accordingly, generally address shorter time horizons and may reflect specific economic forecasts and projections. Conversely, ratings at the higher end of the rating scale generally address longer time horizons and are usually less reflective of forecasts or projections of what is likely to occur in the near term. Instead, they reflect greater emphasis of our view as to what might occur in unlikely (or highly unlikely) future scenarios.
17. Given the movement in economic and credit cycles, we expect ratings to change over time as the creditworthiness of rated issuers and obligations rises and falls. To address the inherent variability of creditworthiness, we maintain surveillance on our ratings. Our approach to changes in creditworthiness is to take prompt rating actions when we believe, based on our surveillance, that an upgrade, downgrade, or an affirmation is appropriate. Along with the ratings themselves, we strive to explain the basis for our analysis by publishing a clear rationale for the ratings we issue. In many cases, we not only describe our reason for assigning a particular rating, but also discuss future developments that could cause us to change it.

## Linking TRC's Scale to S&P Global Ratings' Global Scale

18. TRC's scale ratings provide a finer demarcation of credit risk among local obligors than is possible with S&P Global Ratings' scale. Therefore, 'tw' symbols as a prefix are used to highlight TRC's rating scale.
19. TRC's scale credit ratings provide a forward-looking opinion of an obligor's creditworthiness (that is, issuer, corporate, or counterparty credit ratings) or overall capacity to meet specific financial obligations (that is, issue credit ratings), relative to that of other entities and specific obligations in Taiwan. In contrast to S&P Global Ratings' scale ratings, TRC's scale rating opinions focus on a comparative credit risk analysis of active obligors within Taiwan.
20. TRC's scale credit ratings have the following major attributes:
  - TRC generally adopts, on a mutatis mutandis basis, the Ratings Criteria used by S&P Global Ratings'. TRC acknowledges, however, that some circumstances may exist or arise where the applicability of S&P Global Ratings' criteria may not be appropriate, in its entirety, either because of TRC's range of credit rating services or the operating or legal environment in Taiwan. Where TRC deems that the circumstances are sufficiently material to warrant it, TRC will publish separate Criteria articles to clarify its position.
  - TRC's scale ratings highlight the relative creditworthiness of obligors and obligations in Taiwan, and focus on a comparative analysis of Taiwan's active obligors (this is in contrast to the all-encompassing international comparative context of S&P global Ratings' global scale ratings).
21. We have developed a broad mapping guideline between the rating categories of TRC's scale and the rating categories of S&P Global Ratings' scale (see Appendix II for the mapping of two scales). The mapping guideline has two major objectives, including to ensure ranking consistency between the ratings on the two scales, while allowing TRC's scale the scope to provide meaningful differentiation of credit risk among obligors active in the local financial markets; and to anchor TRC's scale to S&P Global Ratings' scale measure of relative creditworthiness.
22. Reflecting the increased scope for differentiation of credit risk, TRC's scale ratings are more sensitive to changes in credit risk and, in turn, are likely to change more frequently and to a larger degree than S&P Global Ratings' scale ratings. That is, a given change in the business or financial profile may affect an issuer's TRC's scale rating but not its S&P Global Ratings' scale rating. Accordingly, ratings stability of TRC's scale ratings such as 'twAAA' would not be comparable with that of S&P Global Ratings' 'AAA'.

## Measuring Ratings Performance

## Understanding Taiwan Ratings' Rating Definitions

23. As noted earlier, the key objective of TRC's ratings is rank ordering the relative creditworthiness of issuers and obligations. Accordingly, a key measure that we use for assessing the performance of our ratings is how well they have rank-ordered observed default frequencies during a given test period. That is, when our ratings perform as intended, securities with higher ratings should display lower observed default frequencies than securities with lower ratings during a given test period.
24. Our issuer performance studies have shown mostly strong rank ordering of default frequencies. (See Appendix III for TRC's ratings performance.) However, as noted above, economic cycles do not produce the same degree of stress in all market segments at any point in time. Accordingly, although we strive for comparability in our ratings, we expect to observe less consistency in rank ordering of observed default frequencies among market segments. Only over very long periods -- covering multiple economic cycles -- would we expect to be able to observe whether similarly rated credits from different market segments actually experience similar long-term default frequencies.
25. Small sample sizes also sometimes affect measurements of actual default frequencies. Comparisons of default rates between sub-sectors that contain small numbers of credits can be distorted by small sample sizes and by idiosyncratic factors.
26. Beyond the primary measure of rank ordering, we secondarily consider whether ratings have effectively incorporated other aspects of creditworthiness. In that vein, we examine whether the observed default rate for each rating category during a given test period is higher or lower than has been historically observed during past periods of similar economic and financial conditions. We examine rating transitions and sudden defaults to consider the degree to which ratings have captured credit stability.

## Conclusion

27. TRC's ratings express forward-looking opinions about relative creditworthiness of issuers and obligations. Creditworthiness is a multi-dimensional phenomenon. We view likelihood of default as the single most important dimension of creditworthiness. We place the greatest emphasis on rank ordering default likelihood in applying our rating definitions, in developing rating criteria, and in rating specific issuers and obligations.
28. In addition, we place secondary emphasis on likelihoods of default as part of how we strive for comparability of ratings. In an indirect way, our consideration of default likelihood can be viewed as associating "stress tests" or "scenarios" of varying severity with the different rating categories. We do not expect to observe constant default frequencies over time; we expect observed default frequencies for all rating categories to rise and fall with changes in economic conditions.
29. Beyond likelihood of default, we also consider secondary dimensions of creditworthiness: payment priority, recovery, and credit stability. Those can become critical elements of how we apply our rating definitions in developing criteria for particular situations.
30. However, when we conduct studies to measure the performance of our ratings, we return to the touchstone of relative ranking of observed default frequency. We may measure and report on absolute default frequencies or on secondary factors, but our primary emphasis for performance measurement always remains the relative ranking of default frequency during any given study period.

## Notes

31. (1) We generally apply longer time horizons for our analysis of issuers/issues at higher rating levels. Even so, this does not fully neutralize the effect of economic cycles.
32. (2) Although, as set forth in our published criteria, recoveries can be a factor in some of our ratings, our credit ratings are not intended to be indicators of expected loss.

## Appendix

### Appendix I- Excerpts from Taiwan Ratings' Ratings Definitions

#### Long-term Issuer Credit Ratings

Category	Definition
twAAA	An obligor rated 'twAAA' has an extremely strong capacity to meet its financial commitments relative to that of other Taiwanese obligors. 'twAAA' is the highest issuer credit rating assigned according to Taiwan Ratings national scale.
twAA	An obligor rated 'twAA' differs from the highest-rated obligors only to a small degree and has a very strong capacity to meet its financial commitments relative to that of other Taiwanese obligors.
twA	An obligor rated 'twA' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than higher-rated obligors. Still, the obligor has a strong capacity to meet its financial commitments relative to that of other Taiwanese obligors.
twBBB	An obligor rated 'twBBB' has an adequate capacity to meet its financial commitments relative to that of other Taiwanese obligors. However, adverse economic conditions or changing circumstances are more likely to weaken the obligor's capacity to meet its financial commitments.
twBB, twB, twCCC, and twCC	Obligors rated 'twBB', 'twB', 'twCCC', and 'twCC' on the Taiwan Ratings credit rating scale are regarded as having high risk relative to other Taiwanese obligors. While such obligors will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposure to adverse conditions relative to other Taiwanese obligors.
twBB	An obligor rated 'twBB' denotes somewhat weak capacity to meet its financial commitments, although it is less vulnerable than other lower-rated Taiwanese obligors. However, it faces ongoing uncertainties or exposure to adverse business, financial, or economic conditions, that could result in an inadequate capacity on the part of the obligor to meet its financial commitments.
twB	An obligor rated 'twB' is more vulnerable than obligors rated 'twBB'. The obligor currently has a weak capacity to meet its financial commitments relative to other Taiwanese obligors. Adverse business, financial, or economic conditions would likely impair the obligor's capacity or willingness to meet its financial commitments.
twCCC	An obligor rated 'twCCC' is currently vulnerable relative to other Taiwanese obligors and is dependent upon favorable business and financial conditions to meet its financial commitments.
twCC	An obligor rated 'twCC' is currently highly vulnerable to defaulting on its financial commitments relative to other Taiwanese obligors. The 'twCC' rating is used when a default has not yet occurred but Taiwan Ratings expects default to be a virtual certainty, regardless of the anticipated time to default.
SD and D	An obligor is rated 'SD' (selective default) or 'D' if Taiwan Ratings considers there to be a default on one or more of its financial obligations, whether long- or short-term, including rated and unrated obligations but excluding hybrid instruments classified as regulatory capital or in nonpayment according to terms. A 'D' rating is assigned when Taiwan Ratings believes that the default will be a general default and that the obligor will fail to pay all or substantially all of its obligations as they come due. An 'SD' rating is assigned when Taiwan Ratings believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner. A rating on an obligor is lowered to 'D' or 'SD' if it is conducting a distressed exchange offer.
*Ratings from 'twAA' to 'twCCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the rating categories.	

### Short-term Issuer Credit Ratings

Category	Definition
twA-1	An obligor with a 'twA-1' short-term credit rating has a strong capacity to meet financial commitments relative to that of other Taiwanese obligors. Within this category, certain obligors are designated with a plus sign (+). This indicates that the obligor's capacity to meet its financial commitment on these obligations relative to that of other obligors in the Taiwanese market is extremely strong.
twA-2	An obligor with a 'twA-2' short-term credit rating has a satisfactory capacity to meet financial obligations relative to that of other Taiwanese obligors.
twA-3	An obligor with a 'twA-3' short-term credit rating has an adequate capacity to meet financial commitments relative to that of other Taiwanese obligors. However, the obligor is more vulnerable to adverse changes in business circumstances or economic conditions than higher-rated obligors.
twB	An obligor with a 'twB' short-term credit rating has a weak capacity to meet financial commitments relative to that of other Taiwanese obligors and is vulnerable to adverse business, financial, or economic conditions.
twC	An obligor with a 'twC' short-term credit rating has a doubtful capacity to meet financial commitments.
SD and D	An obligor is rated 'SD' (selective default) or 'D' if Taiwan Ratings considers there to be a default on one or more of its financial obligations, whether long- or short-term, including rated and unrated obligations but excluding hybrid instruments classified as regulatory capital or that are in nonpayment according to terms. A 'D' credit rating is assigned when Taiwan Ratings believes that the default will be a general default and that the obligor will fail to pay all or substantially all of its obligations as they come due. An 'SD' credit rating is assigned when Taiwan Ratings believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner. A rating on an obligor is lowered to 'D' or 'SD' if it is conducting a distressed exchange offer.

\*Apply to an obligor's capacity to meet financial commitments over a time horizon of less than one year.

## Appendix II- Mapping of TRC's Ratings Scale to S&P Global Ratings' Global Scale

Taiwan Ratings Corp. "tw" Scale Rating		S&P Global Ratings' Global Scale Rating
Short-term rating	Long-term rating	
twA-1+	twAAA	A & above
twA-1+	twAA+	A- to A
twA-1+	twAA	BBB+ to A-
twA-1+	twAA-	BBB to BBB+
twA-1	twA+	BBB- to BBB
twA-1	twA	BB+ to BBB-
twA-2	twA-	BB+
twA-2	twBBB+	BB to BB+
twA-2	twBBB	BB- to BB
twA-3	twBBB-	B+ to BB-
twB	twBB+	B+
twB	twBB	B to B+
twB	twBB-	B
twB	twB+	B- to B
twB	twB	B-
twB	twB-	B-
twC	twCCC+	CCC+
twC	twCCC	CCC
twC	twCCC-	CCC-
twC	twCC	CC
twC	twC	C
SD	SD	SD
D	D	D

## Appendix III- TRC's Ratings Performance

### Taiwan Cumulative Average Default Rates, 1999-2018

--Time horizon (years)--

(%)	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10
twAAA	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
twAA	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
twA	0.13	0.27	0.41	0.57	0.74	0.93	1.13	1.13	1.13	1.13
twBBB	1.09	2.49	3.34	3.93	3.93	4.24	4.87	5.54	6.24	6.24
twBB	2.7	4.86	6.49	7.03	8.65	10.27	11.89	12.99	13.55	13.55
twB	2.56	7.69	10.26	10.26	12.82	15.38	20.51	25.64	28.3	28.3
twCCC/C	0.00	0.00	9.09	45.45	72.73	90.91	100	N/A	N/A	N/A
Investment grade	0.23	0.52	0.73	0.89	0.95	1.09	1.3	1.46	1.64	1.64
Speculative grade	2.55	5.11	7.23	9.36	12.34	14.89	17.45	19.18	20.05	20.05
All rated	0.45	0.97	1.39	1.79	2.21	2.67	3.22	3.63	3.92	3.92

N/A--Not applicable. Source: S&P Global Fixed Income Research. Copyright © by Taiwan Ratings Corp. All rights reserved.

### Average One-Year Transition Rates (1999-2018)

(%)									
From/to	twAAA	twAA	twA	twBBB	twBB	twB	twCCC/CC	D	NR
twAAA	88.30	7.02	0.00	0.00	0.00	0.00	0.00	0.00	4.68
	(15.10)	(13.77)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(6.48)
twAA	1.46	94.96	1.01	0.00	0.00	0.00	0.00	0.00	2.58
	(2.05)	(3.47)	(1.51)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(2.32)
twA	0.00	6.09	87.95	1.68	0.13	0.00	0.00	0.13	4.02
	(0.00)	(6.51)	(7.40)	(3.13)	(0.51)	(0.00)	(0.00)	(0.54)	(4.12)
twBBB	0.00	0.27	9.26	75.75	1.36	0.00	0.00	1.09	12.26
	(0.00)	(1.10)	(20.86)	(22.82)	(2.01)	(0.00)	(0.00)	(3.22)	(10.91)
twBB	0.00	0.00	0.54	12.43	59.46	0.54	0.54	2.70	23.78
	(0.00)	(0.00)	(1.36)	(17.32)	(27.35)	(2.83)	(1.18)	(6.81)	(17.17)
twB	0.00	0.00	0.00	0.00	7.69	46.15	7.69	2.56	35.90
	(0.00)	(0.00)	(0.00)	(0.00)	(9.78)	(31.77)	(17.04)	(9.36)	(35.84)
twCCC/CC	0.00	0.00	0.00	0.00	36.36	0.00	63.64	0.00	0.00
	(0.00)	(0.00)	(0.00)	(0.00)	(45.17)	(0.00)	(45.17)	(0.00)	(0.00)

Note: Parenthetical numbers are standard deviations. D--Default. NR--Not rated Source: S&P Global Fixed Income Research. Copyright © by Taiwan Ratings Corp. All rights reserved.



## Revisions And Updates

This article was originally published on June 26, 2018, under the title “Understanding Taiwan Ratings' Rating Definitions.” These criteria became effective on June 26, 2018.

Changes introduced after original publication:

- Following the update of Taiwan Ratings' Ratings Definitions on July 5, 2019, we updated Appendix I and II to remove the 'R' rating symbols. We also updated the Taiwan Ratings' Cumulative Average Default Rates as well as the Average One Year Transition Rates in Appendix III to cover the period 1999 to 2018.

## Related Criteria And Research

### Related Criteria

- Taiwan Ratings' Ratings Definitions, [www.taiwanratings.com](http://www.taiwanratings.com) – July 5, 2019
- Methodology For National And Regional Scale Credit Ratings – June 25, 2018

### Related Research

- Guidance | General Criteria: S&P Global Ratings' National And Regional Scale Mapping Specifications– June 25, 2018

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