Issue Ratings

Overview of the methodical rating assignment
to specific debt claims

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Introduction

The issuer rating reflects a general assessment of a debtor's ability to service its financial liabilities in full and on time. The debtor is regarded as a consolidated legal entity. Analytically, the issuer rating corresponds to the issue rating of a senior unsecured debt.

The credit rating of certain issues should in particular cases differ from the issuer rating due to issue-specific risk characteristics. The two most important issue-specific risk factors with systematic relevance to creditworthiness are covenants as well as seniority and ranking. These two factors are discussed in more detail later. All other risk factors are already fully reflected in the issuer rating. In addition to the usual creditworthiness-related key figures and qualitative creditworthiness factors, the issuer rating also takes into account aspects such as the loss given default or recovery rate. In a worst case scenario, for example, liabilities' structure (subordinated debt, à fonds perdu loans, etc.), the quality of the assets (liquidity, goodwill positions, etc.), or likely support from third parties (protection providers) are already taken into account when assigning an issuer rating.

Covenants

Common contractual clauses have a generally positive influence on the creditworthiness of an issuer due to their disciplinary effect. Of course, this only applies on condition that the purpose of the borrowing is in the long-term interests of the company or issuer. Furthermore, they rarely lead to differentiation between individual claims of an issuer. The prevailing standard clauses in the issue prospectuses, such as cross default, pari-passu, change of control, or negative pledge, are therefore normally not considered to be relevant to creditworthiness by fedafin, or the presence of the above clauses has no effect on the issue rating. If, on the other hand, exceptional contractual clauses exist, a more detailed examination is necessary. In the Swiss capital market, for example, particularly creditor-friendly clauses are often found in the bond terms and conditions of medium-sized companies or large corporations in a difficult market environment.

Non-Financial Covenants

General contractual clauses in loans and borrowings may oblige the company to take or refrain from taking certain measures in the creditor's interest. Positive clauses include, for example, compliance with certain accounting standards or information obligations towards creditors, but also equal treatment with other creditors in the event of bankruptcy. Negative clauses prohibit, for example, the pledging of assets for subsequent borrowings.

General contractual clauses are particularly relevant in specific segments such as hospitals. In many cases, prospectuses are designed in such a way that a bond matures when the issuer of a bond is no longer on the list of hospitals in the respective canton. Although the issuer's listing on the hospital list is already taken into account in the issuer rating in qualitative terms, the removal from the hospital list and the associated immediate maturity of the bond benefits the creditor of the bond, which may in principle be reflected positively in the issue rating.

Financial Covenants

Financial contract clauses are generally based on meeting certain performance indicators. Such clauses are particularly common in bank loans to SMEs, in issues by real estate companies on the capital market, or in structured financing, for example in the area of mortgage-backed and real estate collateralized CDOs and CLOs. So-called financial covenants, however, are also found in bonds issued by medium-sized companies, especially in so-called mini bonds on the capital market.

A breach of financial contract clauses is often associated with a so-called healing period (waiver). The issuer is granted a certain period of time during which it has to fulfil the agreed warranties or financial ratios. If the issuer fails to do so, the consequences are predefined in the contractual conditions. The borrower must then, for example, subsequently provide collateral that reduces the expected loss for the bank (subsequent collateralization) or accept renegotiation of the loan conditions. In extreme cases, the contractual relationship is terminated and the outstanding amounts (including interest payments) become due.

The following guidelines are applied when assessing financial covenants:

a) Examination of the definition of financial covenants

The first step is to examine how the covenants to be applied are defined. Since issuance conditions are generally not rigidly regulated, lead managers, together with the issuer, have a great deal of freedom in defining the provisions. Consequently, the definition of the financial covenants described in the offering prospectus must always be qualitatively assessed. Depending on the definition, net debt, for example, may be subject to major fluctuations in value, which may therefore also have an impact on the effectiveness of the covenant. In addition to net debt, there are also different methods of calculation for dividend payments, EBITDA, or the minimum capital floor. Therefore, the calculation must always be based on the individual case.

b) Valuation of financial covenants

	Influence on Rating	Values	Aaa / Aa	A / Baa	Ba / B / C
Minimum Capital Floor	weak medium strong	**20%** **30%** **40%**	0 0 0	0 +1 +2	+1 +2 +3
Dividend Lock-in	weak medium strong	**30%** **50%** **70%**	0 0 0	0 +1 +2	+1 +2 +3
Net Debt / EBITDA	weak medium strong	**3.5x** **2.5x** **1.5x**	0 0 0	0 +1 +2	+1 +2 +3
Secured Financing Ratio	weak medium strong	**80%** **70%** **60%**	0 0 0	0 +1 +2	+1 +2 +3

The most frequent financial covenants for private Swiss companies are the minimum capital floor, the dividend lock-in (limitation of the payout ratio), and the ratio of net debt to EBITDA. The benchmark values for the valuation of a minimum capital floor are 20%, 30%, and 40%. If a value of 40% is specified as a financial covenant in the issue regulations, fedafin considers this to be a strong covenant. If the issuer has a rating in the sub-investment area, the issue rating may be up to three notches above the issuer rating. The same procedure is applied analogously to the other financial covenants. The so-called secured financing ratio is frequently used for issues by real estate companies. It defines the ratio between secured debt and total liabilities; the lower this ratio, the stronger the influence on the issue rating.

In connection with the assessment of financial covenants, it is necessary to clarify the extent to which the financial covenants have an influence on the issue rating. At this point, it should be mentioned in particular that in individual cases the entire interest-bearing liabilities have the same financial covenants. An upnotching compared to the issuer rating becomes obsolete. Lenders naturally do not want to be financially worse off than all other lenders and will therefore probably insist on the same (risk-minimizing) financial covenants in the loan agreements or issue prospectuses.

c) Segment-specific benchmarks

In principle, the above pattern applies to all issuers in the private sector corporates sector (excluding banks and insurance companies), although it may be deviated from under certain circumstances. Capital-intensive sectors in particular often have higher debt ratios, which is why the covenant guidelines can be adjusted. Banks and insurance companies, on the other hand, have different covenants; these are often aimed at the CET1 ratio or the MSM or SST ratio. Banks and insurance companies often have their own bond categories, which by definition have financial covenants and PONV clauses (regulatory capital).

d) No accumulation of covenants

Financial covenants are measured non-cumulatively, i.e. if several covenants exist, the strongest covenant, i.e. the covenant most relevant to creditworthiness, is always used for measurement. For example, if the terms and conditions of the issue include both a minimum capital floor and a dividend lock-in, and the former is classified as highly credit positive and the latter as weak, the adjustment is only applied to the minimum capital floor. The range in which the issuer rating is located is important. Issues from issuers with a minimum rating of Aa, for example, benefit less from financial covenants than those from issuers with weaker credit ratings. It can also be noted that issuers with a good credit rating rarely include financial covenants in their issue prospectuses.

e) Examination of whether the risk effect is issue- or issuer-specific

In principle, financial covenants only have an influence on the issue rating. However, it should not be overlooked that certain covenants may have an influence on the issuer rating. This has to be examined by the rating analysts on a case-by-case basis. For example, it can be assumed that certain covenants may have a disciplinary influence on the financial conduct of the entire company and render issuance-specific notching obsolete.

Ranking of Collateralizations

Secured Bonds

Issues benefit in certain cases from so-called securitizations. These primarily include sureties or collaterals. Guarantees, on the other hand, are not aimed at individual issues but directly at the issuer (liability, deficit, financing guarantees). Collateralization has a positive impact on the issue rating in terms of creditworthiness. Similar to the approach for financial covenants, the assessment of securitizations always needs to be based on the respective individual case.

The following guidelines are applied in the valuation of securitizations:

a) Examination of the surety's category

In a first step, it must be clarified whether a surety exists at all and how the possible surety is structured. There are normally three different types of sureties. These include the joint and several surety, the co-surety (quota surety), or the simple surety. Depending on the surety category, a different valuation procedure is used.

b) Examination of the surety's size

In principle, if there is a surety on issues, the entire amount of the issue is backed. However, this is not a mandatory requirement and in some cases only a partial amount is covered, which generally has a negative impact on the issue rating.

c) Appraisal of the surety

Normally, the issue rating of a surety-backed issue is close to the rating of the guarantor. Especially in the case of a surety by the federal government, there is no difference between the credit rating of the federal government and the issue. For all other guarantors, usually the credit rating of the guarantor minus one or two notches applies. In exceptional cases, the issue rating may correspond to the rating of the guarantor. This is the case if the risk capacity of the guarantor is very high in relation to the assured (maximum) amount (high in the sense of financial income, balance sheet total, etc.) and the guarantor can therefore easily lift the surety. In the case of joint and several sureties with several guarantors, the best credit rating of all guarantors is usually used as the issue rating. In individual cases, especially if a small guarantor (small in terms of financial income, balance sheet total, etc.) has the best credit rating, it is possible to deviate from this rule for reasons of prudence. In the case of the so-called co-surety, the various guarantors are liable according to a predefined key, such as number of inhabitants, consumption in kWh, etc. The issue rating here is typically derived from a weighted average of all credit ratings less one or two notches.

Subordinated bonds

The following overview shows examples of the different seniority levels of bonds. A group of subordinated bank and insurance bonds poses special requirements for the valuation in view of their regulatory characteristics. The valuation of subordinated bonds is not limited to banks and insurance companies, but can also be applied to issuers outside these sectors. Hybrid corporate bonds are valued at seniority levels 5 and 6. The so-called CoCo bonds (mandatory convertible bonds) are or have been issued only by banks and insurance companies. As described above, analytically, the issuer rating corresponds to the issue rating of a senior unsecured bond. Thus, an unsecured bond without financial covenants has the same credit rating as the corresponding issuer.

Capital Structure of Banks & Insurance Companies (subject to Seniority Level)

Seniority Level		BANK		INSURANCE COMPANY		
S 1	Senior Secured	**Secured Liabilites** repo, LTRO, covered bonds		**Secured Liabilites** covered bonds		
S 2	Secured	**Deposits, Derivatives, Swaps** can rank higher due to bank resolution regimes		**Insured Claims** can rank higher due to insurance resolution regimes		
S 3	Senior Unsecured	**Senior Unsecured Debt** straight bonds - interest to be paid (no IPD)		**Senior Unsecured Debt** straight bonds - interest to be paid (no IPD)		
S 4	Senior Subordinated	**Subordinated Debt** non-regulatory capital	**Basel I & II LT2** straight - no DIP	**Solvency I LT2** straight - no DIP	**Subordinated Debt** non-regulatory capital	Sub Debt
S 5	Subordinated	**Basel II T2** straight - DIP cum	**Basel III (CoCo) T2** straight - DIP cum - P WD/SS@Trigger	**Solvency I & II LT2** straight - DIP cum	**Solvency II (CoCo) LT2** straight - DIP cum - P WD/SS@Trigger	Hybrid Debt
S 6	Junior Subordinated	**Basel II T1** perpetual - DIP cum or non-cum		**Solvency I UT2** perpetual - DIP cum or non-cum		Hybrid Debt
S 7	Deeply Subordinated	**Basel III (CoCo) AT1** perpetual - DIP non-cum or cum - DIP or P WD/SS@T	**Preferred Securities** perpetual - DIP non-cum or cum - DIP or IP SS@T	**Solvency II (CoCo) UT2** perpetual - DIP non-cum or cum - DIP or P WD/SS@T	**Preferred Securities** perpetual - DIP non-cum or cum - DIP or IP SS@T	Hybrid Debt
S 8	Very Deeply Subordinated	**Eigenkapital**		**Eigenkapital**		Equity

Regulatory capital instruments

In the wake of the global financial crisis from 2007 onwards, the stability of the financial system and of individual banks was reassessed and requirements in this regard were tightened. This led to the Basel III reform package of the Basel Committee on Banking Supervision, which focuses on the capital base and liquidity of banks. The implementation of this regulatory framework in Switzerland is governed by the Federal Council's Ordinance on Capital Adequacy and Risk Distribution and takes effect from 2013. This triggers enormous adjustments in the financing of some banks.

A systematic differentiation of rating assignments to different debt claims is all the more appropriate the lower the probability of default of a debtor. Consequently, the range of notching increases with the creditworthiness of a debtor, as the table below illustrates. This methodological approach is consistent with the observation that Swiss companies with higher credit ratings are hardly dependent on the issuance of subordinated financial instruments. The exception to the rule on the Swiss capital market is a series of subordinated bonds (straight, perpetual, convertible, variable rate bonds) issued mainly by banks and insurance companies.

Exemplary, the chart above shows the credit rating of subordinated bonds depending on the respective seniority level (left). Regulatory capital instruments can generally be differentiated into Cumulative Deferred Interest Payment Bonds (Cum DIP) and Non-Cumulative Deferred Interest Payment Bonds (Non-Cum DIP). The temporary or final suspension of ordinary interest payments can - under certain restrictions such as the dividend pusher - be voluntary and optional by the issuer (Discretionary DIP) or enforced by regulatory requirements (Mandatory DIP). As a result, issues that continue to pay the unpaid interest payments have a higher credit rating than those that can or must cancel the interest payments without substitution. Depending on the structure of the bond terms and conditions, perpetual bonds, for example, can be counted as regulatory core capital of category AT1 for banks or T1 for insurance companies.

These financing instruments have different positions within their subordination, which is reflected in a differentiated credit rating. Certain hybrid instruments in category AT1 have very similar risk characteristics to participation certificates and usually receive the highest markdowns in notching due to their lowest position in the ranking (junior subordinated). These include in particular the regulatory capital instruments known as Mandatory Convertible Bonds or Contingent Convertible Bonds. These CoCo bonds are usually structured with several triggers (single trigger, dual trigger, multi-trigger). In the case of bank issues, the most important trigger events relate to the CET-1 quota and the point of non-viability (PONV event) that needs to be declared by FINMA. CET-1 capital is also referred to as hard equity. The CET-1 ratio puts the hard equity in relation to the risk-weighted assets. If the specified ratio falls below the trigger, the nominal amount of the issue is automatically partially written off (P-PWD), fully written off (P-WD), or alternatively converted into shares of the issuer (P-SS).

Normally, the markdowns shown in the table below are applied. However, if the issuer has a sufficiently large capital cushion, the risk of a trigger event is much lower. If the issuer has a CET-1 ratio of 2.5 times the trigger threshold, down notching by one notch is possible. If the CET-1 ratio is even 3.5 times the trigger threshold, down notching by up to two notches is possible. In other words, the risk for the creditor is lower for issuers with a strong capital base (and the issue rating is therefore higher) than for issuers who only have equity close to the trigger threshold. All subordinated bonds have a maximum rating (Top Rating Benchmark). Issues in seniority level 4, for example, have a maximum rating of A-, regardless of the issuer's credit rating. The more subordinated a bond, the lower the issue rating. Issues that are last serviced in the event of insolvency (but before equity) can achieve a maximum rating of Baa.

	Top-Rating Benchmark	Standard Down-Notching			
S 4	A-	-1 lower sub debt	-2 no lower sub debt		
S 5	A-	-2 cum	-3 non-cum	-3 cum WD/SS@Trigger	-4 cum WD/SS@High-Trigger
S 6	Baa+	-3 cum	-4 non-cum		
S 7	Baa	-3 cum	-4 non-cum	-5 non-cum WD/SS@Trigger	-6 non-cum WD/SS@High-Trigger Preferred Securities

Another special case are the so-called cat bonds (catastrophe bonds). These are issued by insurance companies and serve to absorb financial losses in the event of natural disasters. If the predefined event (hurricane trigger event) occurs, a total loss of the nominal amount must normally be expected. Due to the high risk and the uncertain predictability of occurrence in view of climate change, such issues are always capped at Ba+. Cat bonds from issuers with a very high credit rating can therefore achieve a maximum credit rating of Ba+.

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