MARC RATING METHODOLOGY

EQUITY CREDIT AND NOTCHING APPROACH FOR CORPORATE SUBORDINATED DEBT AND HYBRID SECURITIES

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INTRODUCTION

This methodology outlines MARC's approach to equity treatment and notching for subordinated debt and hybrid securities of corporate issuers. The analytical approach taken by MARC to analyse a particular subordinated debt or hybrid security and assign equity credit is to place the instrument on a debt-equity continuum. MARC notches down subordinated and hybrid debt ratings from a senior rating or issuer rating to reflect the particular risk characteristics of these instruments.

In this methodology, MARC defines subordinated debt as debt which possesses similar features to senior unsecured debt but is subordinate in right of payment to the corporate issuer's senior obligations. MARC makes distinctions between subordinated debt with non-deferrable coupon or profit payments and subordinated debt which possesses certain equity-like characteristics such as junior ranking to other subordinated debts, long maturities, deferrable and cumulative/non-cumulative interest or profit payments.

The term hybrids refers to instruments that possess both debt and equity characteristics. Corporate hybrids are usually structured to obtain favourable equity credit treatment from rating agencies and lenders and to achieve tax deductibility of coupon payments or distributions. Hybrids generally are deeply subordinated within the issuer's capital structure. Some hybrids contain a deferral feature that permits the issuer to defer the payment of interest or dividends without triggering an event of default. Hybrids are typically non-dilutive at issuance and contain limited or no voting rights.

Hybrid securities issued by corporates in the domestic context have typically been in the form of convertible loan stocks and its variants,

redeemable preference shares, perpetual bonds, as well as exchangeable bonds. Domestic corporate hybrids have also been issued in the context of debt restructurings. MARC considers preferred securities (prefs) to be a subset of hybrid securities; these securities may be perpetual or have a stated maturity date, offer fixed period payments which may or may not be interrupted under certain scenarios and are senior only to the ordinary shares of the issuer.

To receive equity credit, the hybrid must exhibit features generally associated with an equity security, including permanency in the issuer's capital structure and ability to provide loss protection to senior creditors through interest or profit deferral features and/or junior ranking position in liquidation or other degraded financial situation. Some corporate hybrid structures allow the issuer to permanently cancel deferred interest if certain conditions are satisfied while other structures require the issuer to pay deferred interest through the issuance of capital up to a cap.

Under this methodology, the more equity-like the subordinated debt or the hybrid instrument is, the more favourable the equity credit treatment. The main objective of this methodology piece is to provide clarity on the equity credit treatment for such instruments and the general notching guidelines that MARC will apply to corporate subordinated debt and hybrid securities.

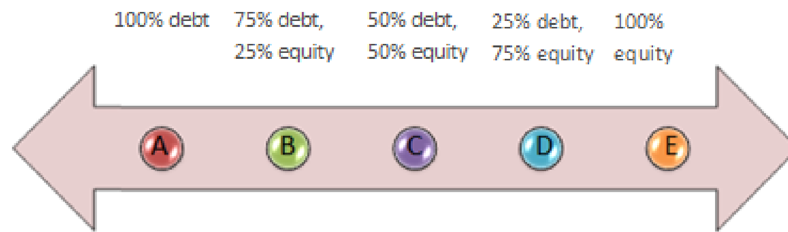
MARC'S DEBT-EQUITY CONTINUUM

MARC's debt-equity continuum consists of five classes, beginning with Class A (100% debt and 0% equity credit) through E (100% equity and 0% debt). No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. The weight given to any factor depends upon all the facts and circumstances and the overall effect of an instrument's debt and equity features is taken into account.

In order to assign a subordinated debt or hybrid securities to a class, MARC considers whether, how, and the extent to which the features of the securities replicate the following characteristics associated with common equity: absence of maturity/repayment requirement, ability to defer or dispense with ongoing payments without triggering a default and loss absorption in case of liquidation.

The exhibit on the following page provides an indication of the features and characteristics present in most common hybrid securities and the manner in which these would be considered in ranking subordinated debt and hybrids along the continuum. MARC will take into consideration the individual circumstances surrounding each issue during its analytic process.

Exhibit 1: MARC's debt-equity continuum and equity credit treatment guidelines



Class	Equity Credit	Characteristics	Maturity*/Time to Conversion
A	0%	Senior debt as well as deeply subordinated securities which do not qualify for equity credit consideration on account of inability to defer coupon payments or distributions without triggering a default or limited permanency.	Less than seven years to maturity at issue or in the case of a mandatory convertible, more than five years to conversion.
B	25%	Security which is subordinated to all senior creditors with no coupon/dividend deferral but which is assessed to have low equity content on account of major constraints upon the ability of the issuer or inability to defer coupon payments or distributions. Substantial step-ups in coupon (which increase the likelihood of bonds being called at set call dates) could, likewise, justify Class B treatment for a deeply subordinated perpetual debt, as would debt-like events of defaults or covenants contained in the financing documentation.	7-10 years to maturity at issue or in the case of a mandatory convertible, conversion to equity occurs beyond three years but within five years.
C	50%	Security which only ranks senior to the claims of equity shareholders with optional cumulative deferral of coupon payments or distributions for at least five (5) years without triggering a default. Deeply subordinated perpetual debt with no step-up prior to five years and no ability to call within five years can be accorded Class C treatment provided the terms of coupon reset and the step-up in coupon do not, in MARC's view, give the issuer incentive to call the bonds at the first opportunity. Only benign events of defaults or covenants should be provided in the financing documentation. There should be no cross-default covenants that will affect higher ranking debt.	10 years or more to maturity at issue or in the case of a mandatory convertible, not more than three years to conversion.

Class	Equity Credit	Characteristics	Maturity*/Time to Conversion
D	75%	Security which only ranks senior to the claims of equity shareholders and is similar to a Class B security with the exception of mandatory coupon deferral features tied to triggers, for example, the breach of certain financial covenants. Coupon payments are automatically suspended until the financial covenant breach is cured. Non-payment of coupon payments or dividends will not trigger an event of default. Absence of dividend pusher or dividend stopper mechanisms. To be considered for 75% equity credit, a mandatory convertible security must be non-callable and convert into ordinary equity within three years. Only benign events of defaults or covenants should be provided in the financing documentation.	10 years or more to maturity at issue or in the case of a mandatory convertible, not more than three years to conversion.
E	100%	Security which only ranks senior to the claims of equity shareholders with no ongoing payments required. These attributes may be found in non-cumulative preferred securities or convertible securities which offer settlements of cumulative interest/coupon deferrals by way of ordinary shares. To be considered for 100% equity credit, a mandatory convertible security must be non-callable and convert into ordinary equity within three years. An accelerated conversion feature which provides for the conversion of the mandatory convertibles into ordinary equity in the event of insolvency would be regarded by MARC as offering superior loss absorption. Only benign events of defaults or covenants should be provided in the financing documentation.	No maturity or in the case of a mandatory convertible, not more than three years to conversion.

Note:
Mandatory convertibles include not only hybrid securities that automatically convert to equity at a pre-determined date, but also junior debt instruments that convert automatically to preferred or common equity upon bankruptcy, insolvency or restructuring.

* In the case of hybrids with long nominal maturities or no stated maturity and issuer call options, MARC's focus is on the expected maturity of the hybrid.

Perceived permanency in the issuer's capital structure is an important consideration. MARC will regard any security with a contractual maturity of less than seven years at original issue as 100% debt. MARC holds the view that non-convertible hybrids become more equity-like as maturities stretch beyond 10 years. The table in Exhibit 1 depicts MARC's view of the relationship between maturity and equity content. In the case of callable hybrids, MARC considers the likelihood that hybrids issued with call features will be redeemed on call dates, prior to their stated maturity. Substantial coupon step-ups increase call risk to the extent that the issuer will have an economic incentive to call. MARC is likely to view the date of a material rate step-up as the effective maturity of the security. For this reason, a hybrid that is perpetual on a legal basis would not be given equity credit if redemption after five years is expected. As for mandatory convertible securities (MCS), MARC opines that the closer the

security is to mandatory conversion, the more equity-like it becomes. MCS with a period to conversion of three years or less are adjudged to have strong equity-like characteristics. No equity credit will be accorded by MARC for permanency if the conversion date is more than five years in the future.

The financing documentation for corporate hybrids typically lacks meaningful protective covenants such as a limitation on indebtedness, limitation on restricted payments, limitation on the creation of liens, and limitation on the sale of assets as compared to that for non-hybrids. As a result of the lack of meaningful protection covenants, the position of the hybrid security holder can weaken in a distressed situation compared to the issuer's senior creditors who can take action to reduce exposure and/or take collateral.

To be eligible for Class E classification, the hybrid security, like common equity, must have either no fixed repayment obligation or no maturity. Any debt security with fixed payments and a stated maturity less than seven years to maturity at issue will be treated as 100% debt (Class A). Subordinated debt and hybrids classified as Class B typically absorb losses for a 'gone concern' given their minimal equity content, little or questionable permanence, and terms or nomenclature that restrict or discourage discretion over payments. A mandatory convertible with an option to convert that lasts beyond three years and/or the presence of a make-whole cash payment obligation on the part of the issuer in the event of early conversion could result in the convertible being assessed as having minimal equity content despite other strong equity-like features of the security.

Subordinated debt and hybrids that will give the issuer some measure of flexibility to defer or eliminate payments on these securities for a specified period of time or until its financial health is restored will generally be eligible for classification in the intermediate to high equity content classes, Class C, Class D and Class E, based on the instrument's stated maturity or expected maturity in the case of securities with no stated maturity. Coupon or dividend payments may be cumulative or non-cumulative. In contrast, non-payment of principal or interest on a Class A or Class B debt security generally will constitute an event of default. Being senior to only common equity in liquidation, hybrid securities typically provide some measure of loss absorption or cushion with the issuer's capital structure in a corporate liquidation or upon the occurrence of other adverse events.

Intermediate equity content securities which provide the issuer with full discretion to defer coupons or distributions for at least five years will generally be eligible for Class C classification. They must also be characterised by deep subordination and limited events of default. Hybrids with mandatory deferral features based on set triggers can be eligible for Class D classification. The securities may have a mandatory deferral feature rather than an optional one or this may be combined with an optional deferral. MARC views mandatory deferral triggers as more credit supportive compared to optional deferral mechanisms given the tendency of management to maintain dividend payments notwithstanding a deterioration of credit quality. The rating agency

believes it is important for the trigger(s) be tied to financial measures that closely relate to the issuer's financial health for the mandatory deferral feature to contribute to a higher assessment of equity content.

Characteristics regarded as consistent with Class E classification would be unlimited and/or non-cumulative deferral rights, permanence in the issuer's capital structure (as in the case of perpetual non-cumulative securities), extremely long maturities or near-term conversion into a fixed number of common equity shares on a basis that would not be deemed unpalatable to the issuer at the time of conversion. In the case of callable hybrids, MARC may deem the remaining time to the first call date as the effective remaining maturity of the hybrids if the issuer is not subject to replacement language (issuer does not have to replace the called instrument with a similar instrument or equity) and/or the coupon step-up rate is deemed to be a level which creates expectation that the call will be exercised by the issuer. These instruments are structured with call dates typically after five and/or 10 years from the date of issuance. Mandatory convertible securities with three years or less to the conversion date would qualify as Class E securities provided other qualifying criteria are met.

MARC assigns equity credit to subordinated debt and hybrid securities based on their equity credit classification, making pro-forma adjustments to an issuer's debt leverage measures as required. Any equity credit given to long-dated securities at original issue date classified by MARC as Class B, C or D will amortise to 0% at three years prior to its contractual maturity or expected redemption date where a hybrid security's call features, coupon rate resets and step-ups will, in MARC's view, affect the permanence of the security. A security with a contractual or expected maturity of seven years at original issue, for instance, will amortise to 0% equity credit at three years to maturity using a four-year amortisation schedule; an incremental 25% of the instrument is treated as debt until, at three years to maturity, the issue is viewed as 100% debt.

MARC'S NOTCHING POLICY

Similar to MARC's general approach to rating subordinated debt and hybrid securities issued by a financial institution, the rating agency notches down from the corporate issuer's senior debt rating. The underlying rationale behind the notching practice is that if a corporate issuer defaults on one issue, typically all its debt becomes due immediately. It follows, therefore, that the probability of default for all debt issues of a corporate issuer is typically equal. Recovery rates, however, may vary across institutions, across issues and along economic cycles. Although secured bondholders and holders of senior debt issues may receive some distribution of corporate assets in a corporate liquidation or dissolution, it may not be possible to ensure all creditors are made whole. Also, the issuer may be able to defer payment of interest or distributions on subordinated debt and hybrid instruments in the case of financial difficulties, giving rise to incremental deferral risk.

Subordinated debt and hybrids represent junior claims on the funds and assets of a corporate relative to those of senior debt and are also potentially subject to deferral of dividend or interest payments where the security contains a deferral feature. Accordingly, MARC's practice of notching for subordinated debt and hybrids incorporates deferral risk where optional or mandatory deferral is allowed and there is higher expected loss severity relative to senior debt in the event of the issuer's insolvency. Generally, notching narrows at higher rating levels and widens at the lower end of the scale due to significantly higher risk of deferred coupon or distributions in addition to higher expected loss severity for issuers at lower rating levels in the event of a winding-up scenario.

MARC's notching recommendations vary depending on where the issuer's senior debt rating (SDR) is located on the rating scale. Hybrids, including prefs, will typically be rated two notches below the SDR for a corporate issuer with a SDR of AA and above, three notches below the SDR for a corporate issuer with a SDR between A to AA- and four notches for a corporate issuer rated A- and below.

Subordinated debt will generally be rated one notch below the SDR for a corporate issuer with a SDR of AA and above, two notches below the SDR for a corporate issuer with a SDR between A to AA- and three notches for a corporate issuer rated A- and below. Generally speaking, all subordinated debt impacts the credit quality of the senior debt; subordinated debt adds to the issuer's overall debt leverage and consequently increases the likelihood of default on senior debt and the severity of loss when a default occurs. However, it is acknowledged that some forms of subordinated debt have less impact than others on the credit quality of the senior debt. Accordingly, in determining the SDR, MARC considers the amount of the subordinated debt relative to senior debt and the extent to which the presence of subordinated financing will affect overall default probability. This approach is taken to avoid assigning more favourable than justified SDRs and subordinated debt ratings.

The rating that will be finally assigned will reflect the risk carried by the security and its equity content. Generally, notching for initial issue ratings on hybrids and subordinated debt should not exceed the guidance provided below. At SDRs below AA, MARC may narrow the notching for a hybrid with a priority of claim above preference shares to the level that is indicated for subordinated debt if the issuer does not have a substantial amount of senior subordinated or ordinary subordinated debt outstanding.

Exhibit 2: MARC's notching guidance for hybrids and subordinated debt

Instrument	Notching down from senior debt rating (SDR)		
	SDR of AA to AAA	**SDR of A to AA-**	**SDR of A- or lower**
Hybrids (including prefs)	Two notches down from SDR	Three notches down from SDR	Four notches down from SDR
Subordinated debt	One notch down from SDR	Two notches down from SDR	Three notches down from SDR

In addition to the risk of payment deferral, the notching relationship to the SDR should primarily reflect equity content of the security and post-default recovery characteristics. This is determined by the security's core features, its post-default ranking and the legal remedies available to holders of subordinated debt and hybrids through defined events of default and covenants contained in the financing documentation.

In examining the depth of the security's subordination, MARC will consider all the total debt in the issuer's capital structure, and the size of the subordinated debt and hybrids. MARC also considers "double leverage" that could occur through the issuance of hybrids by a non-operating holding company to fund equity in an operating subsidiary. If the operating subsidiary incurs significant indebtedness, this will cause the holding company hybrids to be structurally subordinated to all obligations of the operating subsidiary. Structural subordination may increase over time as the operating subsidiary whose cash flow on which the non-operating holding company depends incurs debt.

The issuer's ability to defer payment on the subordinated debt and hybrids without triggering a default and deep subordination of the securities relative to other senior indebtedness or the converse could respectively broaden or narrow the notching relative to the guidelines. Generally, the more equity-like the structure and the higher the equity credit assigned by MARC, the higher will be the number of notches below the SDR. MARC is mindful of covenants in senior ranking debt instruments which can prevent distributions on the subordinated debt and hybrids even when financial measures indicate a capacity to pay. Typically, 'dividend pusher' or 'dividend stopper' mechanisms are employed to balance the interests of equity holders and hybrid security holders. A 'dividend stopper' prevents the issuer from paying dividends if it does not pay the hybrid coupon. The 'dividend pusher', on the other hand, makes it mandatory for the issuer to pay the hybrid coupon if a dividend is paid. A major difference between corporate hybrid and bank capital instruments is that the regulatory context increases the risk of coupon deferral and extension (in the case of callable securities).

Exceptions to the notching guidelines could also be made on account of the issuer's financial profile, industry fundamentals and management intent. The issuer's financial policies and past behaviour concerning subordinated and hybrid issues will be taken into consideration in assessing the permanency of the security in the entity's capital structure and the willingness of the issuer to defer payments. Changes in MARC's qualitative assessment of management intent after the security has been issued will warrant a reassessment of the equity content of the security.

As issue- or issuer-specific risk characteristics will require MARC to supplement this methodology with appropriate analytical judgment, MARC will ensure that any departure from its standard notching practices will be explained in the credit analysis report accompanying the rating action.

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