Global
Criteria

Coercive Debt Exchange Criteria

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Introduction

This report describes Fitch's rating criteria for coercive debt exchanges (CDEs). While bankruptcy filings, or missed coupon or principal payments account for the vast majority of defaults, the incidence of CDEs is too significant to ignore. A CDE results when an issuer is essentially forced to restructure its debt obligations in an effort to avert bankruptcy or a liquidity crunch. By definition, this will cause a reduction in contractual terms from the creditor's perspective, and will be, to one degree or another, forced in nature. While junior creditors would ordinarily bear the brunt of any loss, senior creditors can be highly adversely affected as well. The principal techniques used to restructure securities on an out-of-court basis are: tender offers, exchange offers and consent solicitations.

Ratings Implications

Since Fitch considers a coercive debt exchange to be a default, ratings need to reflect this. However, because a CDE is considerably different from other types of defaults, some special handling is called for, particularly as ratings are prospective in nature. The rating treatment is as follows:

1. Issuer Default Ratings

When Fitch considers an exchange offer, as formally disseminated, as a coercive debt exchange, the issuer default rating (IDR), Fitch's benchmark probability of default rating, would be lowered to 'C'. This would typically occur at or shortly after publication of the formal tender offer. If the CDE is unsuccessful, the ratings may be restored to a (marginally) higher level (than 'C'), to reflect the avoidance of an imminent default. In the majority of such cases, if the threat of bankruptcy was a real one, the IDR would be likely maintained at 'C', or at best raised to 'CC'. If, on the other hand, the CDE executes successfully, the IDR would be lowered to 'D' or 'RD' as appropriate, before being raised to a rating appropriate for its prospects on a going-forward basis immediately after the effective date of the exchange. In this way, the default is registered for the market at large and within the agency's statistical tracking of defaults.

2. New Bond Issues

Any new bond issue or loan package resulting from a CDE will be rated purely on the issuing entity's credit profile post-exchange, any structural considerations related to the specific issue, and recovery prospects should a further default occur. The fact that the issue was a product of a CDE is not relevant to the rating.

3. Old (Untendered) Bond Issues

Typically in a "successful" coercive bond exchange anywhere from a few percent to maybe 10% (occasionally more) of securities are not tendered. Typically, there is a threshold amount of securities that must be tendered in order for the exchange to occur, and this percentage is usually set quite high; for bank debt, unanimity is typically required. If there are minimal amounts of securities that were not tendered in the exchange, it is very likely that the issue ratings will be withdrawn. However, if a sufficient number of securities remain outstanding, then it is possible that Fitch will continue to rate the issue(s). Following a successful exchange, these issues, as well as any that were not subject to exchange, will be rated on the same basis as any new securities – i.e. reflecting specific issue structure and recovery prospects, as well as the newly restructured company's credit and business profile.

Rating Definitions

C: Exceptionally high levels of credit risk

Default is imminent or inevitable, or the issuer is in standstill. Conditions that are indicative of a 'C' category rating for an issuer include:

- the issuer has entered into a grace or cure period following non-payment of a material financial obligation;
- the issuer has entered into a temporary negotiated waiver or standstill agreement following a payment default on a material financial obligation; or
- Fitch Ratings otherwise believes a condition of 'RD' or 'D' to be imminent or inevitable, including through the formal announcement of a coercive debt exchange.

RD: Restricted default.

'RD' ratings indicate an issuer that in Fitch Ratings' opinion has experienced an uncured payment default on a bond, loan or other material financial obligation but which has not entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, and which has not otherwise ceased business. This would include:

- the selective payment default on a specific class or currency of debt;
- the uncured expiry of any applicable grace period, cure period or default forbearance period following a payment default on a bank loan, capital markets security or other material financial obligation;
- the extension of multiple waivers or forbearance periods upon a payment default on one or more material financial obligations, either in series or in parallel; or
- execution of a coercive debt exchange on one or more material financial obligations.

D: Default.

'D' ratings indicate an issuer that in Fitch Ratings' opinion has entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, or which has otherwise ceased business.

Why a Bond Exchange Might be Considered a Coercive Debt Exchange

For a bond exchange to be considered a CDE and therefore considered a default, two requirements must generally be met. First, there must be a material reduction in terms vis-à-vis the original contractual terms; second, any such exchange would need to be coercive or de facto necessary even if technically voluntary.

I) Material Reduction in Terms

Fitch rates debt and preferred securities issues according to the original contractual terms. The agency cannot appraise when and at what price the majority of investors purchased an issuer's securities. Further, while the price behavior of an issuer's securities may provide some interesting clues as to the nature of the exchange, securities prices themselves do not enter into our determination as to whether investors have suffered what we call a "material reduction in terms."

A material reduction in terms is defined as an exchange offer that results in holders of a security receiving terms that, taken in their totality, materially impair the value. It is important to remember that an exchange action that results in the company materially improving its financial profile from a credit perspective will typically be caused by a reduction in debt issue terms for certain (or all) creditors — there is a symmetrical relationship here. This does not mean the exchange is a "bad idea" given where the company is in terms of its financial condition at the time the exchange is proposed. Quite to the contrary, it could be the logical (or only) choice; however, it must be recognized that the exchange itself is an acknowledgement of credit impairment.

What constitutes a material reduction in terms could be any one of the following or a combination thereof:

- Reduction in principal amount;
- Reduction in coupon/interest or fees;
- Significant extension of maturity date;
- Change from a cash pay basis to pay-in-kind (PIK), discount basis or other form of non-cash payment;
- Swapping of debt for equity, hybrids or other instruments;
- Cash tender for less than par;
- Tender with associated exit consents that materially impair the position of the holder that chooses not to accept the tender;
- Contractual or structural reduction in seniority.

Generally, CDEs involve one or more of the above, which would, for a solvent company, ordinarily be considered detrimental to creditors' interests. If there are no offsetting factors, determining whether there was a material reduction in terms may be quite easy, as the presence of any one of the above factors may be sufficient by itself. If an exchange of straight debt results in the investor receiving anything other than an equal amount of straight debt and/or cash (eg receipt of equity, warrants, in place of debt issues), there is a strong presumption that the exchange should be considered for treatment as a CDE. In general, with the possible exception of certain cash tenders, if the terms are significantly worse than the original contractual terms, there is a very high likelihood that the exchange was a CDE. Sound companies would typically not even request much less garner bondholders' acceptance of a significant reduction in terms (with limited exceptions).

If offsetting factors are also present, shown below as possible mitigants, then these are also considered, as the terms of the exchange offer are evaluated in their totality to determine whether creditors have suffered a material reduction in terms.

Possible mitigants could include the following:

- Increase in coupon;
- Increase or initiate security interest;
- Payment of consent fee; or
- Elevation of issue seniority.

If offsetting factors are present, a net present value analysis (NPV) may be undertaken in an effort to quantify whether the new terms represent a material reduction from the original terms. The goal of the analysis would be to determine whether or not the NPV is materially lower — based purely on the change in terms, as opposed to any differences in perception as to whether or not the level of credit risk has changed, consistent with an orderly refinancing to take advantage of lower market interest rates or credit spreads for solvent issuers, or other factors.

In such an analysis, adjustments to the baseline discount factor used to discount cash flows might need to be made. For example, if the exchange calls for a maturity extension, the fact that longer corporates typically trade at a greater spread to Treasuries than shorter corporates implies that the factor used to discount cash flows for the new issue would need to be adjusted by some assumption as to the steepness of the credit curve for a similar-type solvent issuer that was not trading at distressed levels. Or, for example, if there is a change in seniority, the only way to account for this quantitatively is to make some assumption as to the value of the change, by adjusting the discount factor up if seniority is lowered, and down if it is raised.

Therefore, while some aspects of an NPV are simple, such as plugging in new coupon rates, other aspects are not, and will require key assumptions to be made. However, this analysis need only be carried out if significant offsetting factors are present.

II) Exchange Either Coercive or de Facto Involuntary

While indicative of a CDE, a reduction in terms, by itself, is insufficient for an exchange to be classified as a CDE. For example, consider the case of a company tendering for a specific bond issue at a price possibly significantly below par. The company may have multiple motivations for doing so, including repurchasing debt thought to be too cheap and/or sending a message to the market that it is so, but unless it is felt that the action was being undertaken to stave off bankruptcy or a liquidity crunch, the tender would not be considered a CDE. In general, for an exchange to be considered a CDE, there must either be:

1. an explicit threat of bankruptcy; or

2. a high probability of bankruptcy or insolvency over the near term absent the exchange.

At times this will be clear cut, at other times not; the determination of what time horizon is appropriate is highly subjective and depends on the specific facts involved.

III) Coercive or Voluntary — Looking for Clues

Classifying an exchange as coercive or voluntary can be either very easy or very difficult. Often, it is very clear that the issuer has every intention to file should the exchange offer fail; it is not unusual in the exchange prospectus for the issuer to disclose that the failure of the requisite number of affected creditors to tender their issues will result in the company filing for bankruptcy (in fact, if the exchange offer fails, the issuer may later solicit votes on a pre-packaged Chapter 11 plan of reorganization for the tendering or exchange of subject securities on equal or worse terms.)

If an explicit threat of bankruptcy is made, nothing more need be done analytically to make a CDE classification. Other times, however, it can be more difficult, which is why we may need to look for certain clues. Such clues commonly associated with CDEs are:

- Underlying fundamentals and ratings since original issuance have deteriorated. For originally investment-grade entities, there has likely been significant deterioration; for speculative entities, there may have been only minor deterioration, or even simply a lack of improvement for original issue ‘CCCs’.
- Bond prices trending down (due to widening spread levels) over the previous 6-18 months and trading at possibly very distressed levels. A bond rally following the announcement of the exchange offer is not atypical of CDEs, and is by no means proof of anything other than possibly that the market’s expectation of a bankruptcy filing or missed coupon payment in the near term has been reduced.

- The issuer has tendered for a broad array of issues. The goal of a CDE is to stave off bankruptcy or a liquidity crunch; consequently, such offers must be sufficiently broad or relevant, by targeting all or at least those issues necessary to reduce interest and debt service to the point where the company's cash flow can service debt. The targeting of one or two specific issues that alone would not accomplish this goal may indicate that the transaction should not be characterized as a CDE, although again, this will be evaluated on a case-by-case basis.

It is important to note these are only potential clues—it is possible that a CDE determination could be made in contradiction to one or more of the above.

Hypothetical Example of Subjective Determination of CDE

Consider the case of a struggling company with significant debt maturities over the next few years. It is possible that the company would be able to fund operations over the near term. Cash flow, along with ratings, has continued to deteriorate over the past few years.

The company decides to launch an exchange offer that includes a material reduction in terms for most of its bonds, including all bonds that are currently cash pay. Absent the exchange, the company probably would not be able to refinance the nearest maturity that is just over one year out, particularly if the company's financial condition deteriorates even further. No overt threat of a bankruptcy filing has been made.

If the reduction in terms is clear, then it is very likely that this exchange would be considered a CDE. It is important to remember that even if companies are technically solvent, they can still seek to file bankruptcy pre-emptively if they believe it to be the best option, as could theoretically happen in the case of a failed proposed exchange offer.

Bank Loans

In general, Fitch's CDE criteria would be applied to bank loan restructurings in a similar fashion as it would to CDEs of bond and preference stock issues. However, the following nuances are worth noting.

Frequently, terms of bank loans are amended or technical defaults caused by covenant violations are waived. These events are not considered to be a CDE unless the economic terms of the credit agreement are impaired.

In a CDE, often the bank creditors do not suffer any impairment of their payment terms or principal amount. Creditors that are junior to bank loans, which are typically at the top of capital structures, are the ones that absorb most of the losses associated with CDEs.

Sovereign Issues

In addition to the terms and conditions of a corporate CDE noted on page 2, a sovereign CDE could have all or some of the following characteristics:

- The currency denomination or indexation of the securities is altered in a way that could be disadvantageous to bondholders;
- Existing obligations are de-listed from securities exchanges;
- Regulations are issued that penalise holders of the original securities; or
- The legal jurisdiction under which the new bonds are governed has changed in a way that could be disadvantageous to bondholders (eg change from a jurisdiction in the major international capital markets, such as New York or London, to a local jurisdiction).

A CDE occurs in an environment in which, in the absence of the exchange offer, a missed interest and/or principal payment would be highly likely. In this way, the CDE is a tool designed to avoid a suCDEn, disorderly default, a moratorium on debt service, the imposition of capital controls, or another event less favorable to the sovereign than a CDE. The CDE clearly yields benefits to the sovereign issuer, usually in terms of lower near-term debt service.

In the case of corporates, a CDE may be pursued in order to avoid filing for bankruptcy protection. In the realm of sovereigns, where a bankruptcy-type reorganisation is not possible, a CDE may be pursued for the following reasons: 1) to avoid a sudden, disorderly default; 2) under pressure from official creditors — i.e. the multilateral agencies (eg IMF, World Bank), which may be perceived as requiring private sector burden-sharing as a condition for further lending; and Paris Club bilateral creditors, which may demand "comparable treatment" in the event they restructure a sovereign's obligations; 3) to cordon off, through a domestic debt exchange, domestic payment pressures from external debt service; 4) to avert a deposit run in the banking system, driven by sovereign credit concerns; 5) to avoid imposing capital controls; and 6) to avoid other painful and politically difficult fiscal adjustments, such as tax hikes or cuts in public wages and social programs.

Special circumstances in the case of sovereigns can blur the dividing line between a CDE and a voluntary, market-based exchange. For example, as far as domestic resident holders of sovereign debt are concerned, it is often difficult to assess how voluntary their participation in a debt exchange is. The sovereign is both the debtor to and regulator of domestic financial institutions, and can therefore bring regulatory forbearance and moral suasion to bear in pressuring for participation in the exchange. Likewise domestic institutions' fortunes are tied to the sovereign — in terms of future economic growth, real interest rates, exchange rate volatility, and access to foreign exchange and external credit — making the alternative to non-participation in the exchange, namely a disorderly sovereign default, appear unattractive to these institutions.

CDS Restructuring Language

The International Swaps and Derivatives Association (ISDA) has promulgated language used by market participants in credit derivatives in the determination of whether or not a corporate or sovereign restructuring action qualifies as a credit event for the purposes of triggering a contingent payment to the protection buyer. While in many respects ISDA's definition parallels that of our own, in other, material respects, it clearly does not. For example, the majority of the items listed in the *Material Reduction in Terms* section above that point to a reduction in terms are those specified by ISDA for the same purpose. However, the ISDA definition varies from that of Fitch in at least two key respects:

Current ISDA language appears to be much more oriented toward loan amendments as opposed to bond exchanges. In fact, it appears to be relatively unlikely that any bond exchange (absent a concurrent loan restructuring) could be termed a credit event in the future. Current ISDA language requires "all holders to be bound" to the terms of an exchange, which would technically not be the case in a typical bond exchange, as holders do technically have the option of not tendering their bonds. While typically at least some bondholders will choose not to tender, loan documentation typically requires 100% lender consent for changes to maturity, principal amount or interest rates/fees.

Fitch looks at the exchange in its totality, whereas the ISDA definition does not look at offsetting factors, as previously discussed. For example, assuming other requirements were met, a maturity extension could result in a determination of a credit event, even if investors were offered what ordinarily would be considered fair compensation in return, such as a sufficiently higher interest rate and/or other enticement.

The ISDA's language is aimed at setting standards that seek to avoid credit event disputes. However, for Fitch's purposes, subjective factors must enter the equation. As mentioned, the agency looks at the terms of the deal in their totality in making a determination as to whether a particular exchange is to be classified as a CDE. Further, Fitch does not consider the fact that a bond exchange offer may be nominally voluntary in making this determination. Rather, the agency looks at whether or not bondholders realistically have any alternative to participating apart from a bankruptcy filing.

Ultimate Post-Restructuring Outcome Difficult to Predict

Following a successful restructuring, whereby a requisite number of creditors have tendered (or have not refused to tender), a wide range of outcomes is possible at the investor level. At times, companies that have restructured once will restructure on an out-of-court basis again or file into bankruptcy, leading to further losses for investors. However, in some cases the company will be able to honour its new, restructured obligations, including payment of principal at maturity. This principal amount may very well have been reduced through the CDE, effectively locking in a loss for investors that purchased the securities at or near the original issuance price (par).

On occasion, patient investors who have the ability (a key consideration) to hold the new instruments (which can include equity, warrants, convertibles, discount bonds) that were exchanged for the original bonds, may actually be amply rewarded if the specific company's fundamental prospects improve. The point is that while a wide range of outcomes is possible, predicting those outcomes can be very difficult, and many investors may not be able to hold the new instruments because of restrictions in their investment guidelines.