

## REQUEST FOR COMMENT

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# Hybrid Equity Credit, Financial Statement Adjustments and REITs: Proposed Methodology Updates

## Summary

In this Request for Comment, we propose a number of changes to the [Hybrid Equity Credit](#) rating methodology, published in September 2018. Based on this proposal, we also propose to make conforming changes to our [Financial Statement Adjustments in the Analysis of Non-Financial Corporations](#) rating methodology, published in March 2023, our [Financial Statement Adjustments in the Analysis of Financial Institutions](#) rating methodology, published in August 2018, and our [REITs and Other Commercial Real Estate Firms rating methodology](#), published in September 2022. For purposes of the hybrid equity credit methodology, a hybrid instrument is a subordinated security (e.g., subordinate debt, preferred stock) that is not common equity and for which the omission of scheduled dividend, interest or principal payments is contractually allowable.

Our proposed approach for ascribing equity credit to hybrid securities of investment-grade issuers would provide simplified criteria based on the broad features of a hybrid instrument while retaining the key principles of our existing approach. Under our proposal, we would apply these criteria using a sequence of questions about certain key characteristics of a security, namely, about mandatory conversion features, coupon skip or deferral provisions, and maturity. Under our proposal, we would no longer consider some of the narrower technical features of hybrid instruments that we review in our existing approach. Where a security includes other features or terms that are relevant to an issuer's credit profile, but do not affect the quantitative equity credit we ascribe, we continue to consider these features in our overall credit analysis of the issuer.

The key proposed revisions to the current *Hybrid Equity Credit* methodology are as follows:

- » **Simplify our framework for ascribing equity credit to hybrid instruments of investment-grade issuers.** Our proposed changes reduce the complexity of our existing framework for ascribing equity credit. We would no longer include many of the criteria of our existing approach. Instead, we would focus on a few important characteristics of hybrid instruments, including mandatory conversion features, coupon skip features, and maturity. Our proposals reflect a reconsidered approach for ascribing equity credit, one that is better aligned to how we assess hybrid instruments in the broader context of issuer credit analysis. Our proposed approach also takes into account more recent structural features of instruments and issuer behavior.

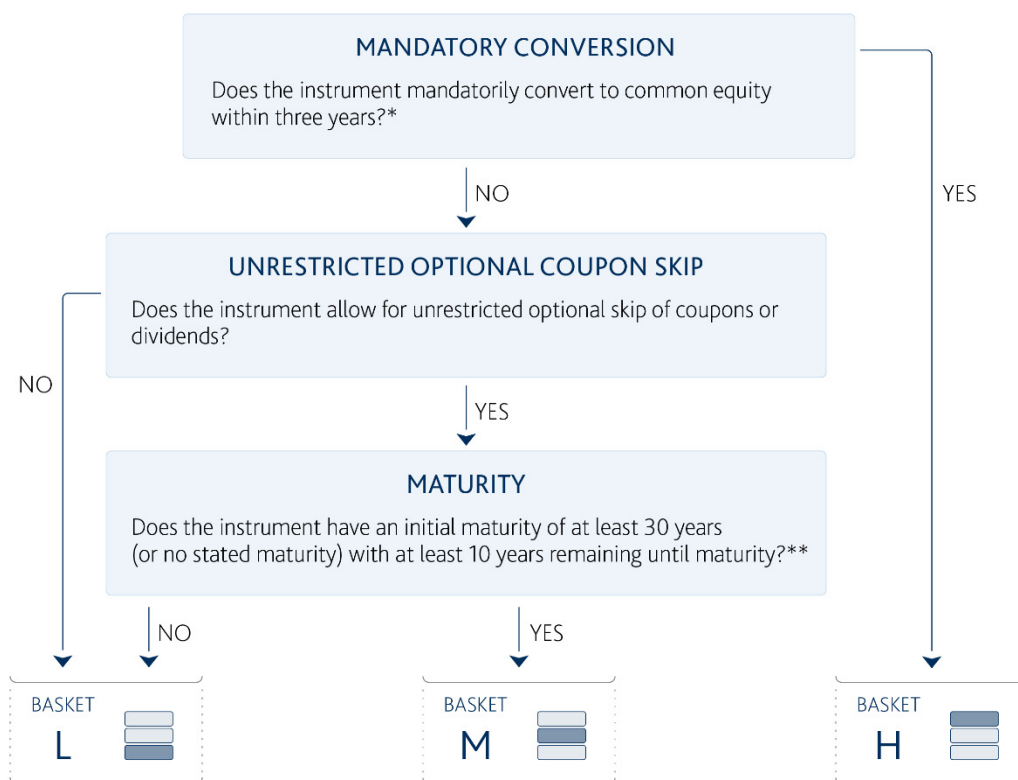
- » **Modify our equity-credit classification scale.** We propose to reduce the number of baskets in our scale for equity credit to three baskets, corresponding to 0%, 50%, and 100% equity credit, from five baskets. The gradations of our proposed scale better reflect the extent to which the equity content of hybrid instruments can be distinguished.
- » **Clarify how we assess shareholder loans.** We plan to update our analytical guidance to highlight that our principles for assessing the equity content of a shareholder loan, though largely unchanged, are anchored to our assessment of the financial policy and broader credit profile of the speculative grade issuer that issues the shareholder loan.

For purposes of displaying metrics (whether in credit opinions and other research and for scorecard output), we propose to implement the proposed updates described above to an issuer's most recent historical fiscal period and any subsequent financial statement periods. As a result, upon adoption of the proposed approach, an issuer's single-year metrics displayed in our published research would fully reflect the proposed updates, while the display of multi-year metrics (e.g., three-year averages) would be based on a combination of the proposed updates for the most recent period and historical hybrid basketing for prior periods.

The exhibit below illustrates how we propose to ascribe equity credit to hybrid securities of investment-grade issuers.

Exhibit 1

### Ascribing equity credit to hybrid instruments<sup>†</sup> – investment-grade entities



<sup>†</sup> The flowchart applies only to hybrid instruments, which are subordinated securities (e.g., subordinate debt, preferred stock) that are not common equity and for which the omission of scheduled dividend, interest or principal payments is contractually allowable.

\* For a Yes response above, the instrument must also convert to a fixed number of common equity shares.

\*\* Where an instrument has a meaningful coupon step-up, a Yes response to the Maturity question is replaced with a No response.

Source: Moody's Investors Service

To assist readers in understanding the proposed revisions, this RFC includes an annex with comparative examples: In the annex we illustrate how equity credit would be ascribed under our proposals to a sample of common types of hybrid instruments issued by investment-grade issuers and how that would compare to how such instruments are treated under our current approach.

The key proposed revisions to the current *Financial Statement Adjustments in the Analysis of Non-Financial Corporations* methodology and the *Financial Statement Adjustments in the Analysis of Financial Institutions* methodologies would align our approaches to financial statement adjustments for hybrid instruments to our proposed update of the *Hybrid Equity Credit* methodology.

The key proposed revisions to the current *REITs and Other Commercial Real Estate Firms* (REITs) methodology would align the basketing categories referred to in REITs methodology to the basketing categories of our proposed update of the current Hybrid Equity Credit methodology.

The texts of the conforming changes for the *Financial Statement Adjustments in the Analysis of Non-Financial Corporations* methodology, the *Financial Statement Adjustments in the Analysis of Financial Institutions* methodology, and the *REITs and Other Commercial Real Estate Firms* methodology, follow the text of the proposed *Hybrid Equity Credit* methodology.

For these methodologies, we also propose to make some editorial changes to enhance readability.

## Impact on ratings

If this methodology is updated as proposed, we expect few, if any, changes to outstanding ratings.

This expected rating impact only reflects the methodological changes noted above and does not incorporate potential impact from other factors, including prevailing market conditions or factors specific to a particular issuer or transaction, such as financial metrics or qualitative considerations, that may be relevant to the rating analysis.

## How to submit comments

In this Request for Comment, we are seeking feedback on our proposed revisions to the *Hybrid Equity Credit*, *Financial Statement Adjustments in the Analysis of Non-Financial Corporations*, *Financial Statement Adjustments in the Analysis of Financial Institutions*, and *REITs and Other Commercial Real Estate Firms* rating methodologies. Prior to publication of the revised methodologies, we may also consider other changes to the methodologies as a result of the consultation process and our internal review.

We invite market participants to comment on the RFC by October 5, 2023, no later than 11:59 p.m. US Eastern time, by submitting comments on the [Request for Comment](https://ratings.moodys.com/) page at <https://ratings.moodys.com/>. Upon appropriate consideration of received comments, we plan to adopt and publish a revised *Hybrid Equity Credit*, *Financial Statement Adjustments in the Analysis of Non-Financial Corporations*, *Financial Statement Adjustments in the Analysis of Financial Institutions*, and *REITs and Other Commercial Real Estate Firms* rating methodologies.

## Proposed methodology

# Hybrid Equity Credit

## Introduction

In this rating methodology, we explain our general approach to ascribing equity credit to hybrid instruments globally (including shareholder loans) issued by investment-grade and speculative-grade issuers other than banks. A hybrid instrument is a subordinated security (e.g., subordinate debt, preferred stock) that is not common equity and for which the omission of scheduled dividend, interest or principal payments is contractually allowable. A hybrid security also may be subject to contractually allowable write-downs of principal or conversion of the hybrid host security to common equity<sup>1</sup>. Based on these and other structural features, hybrid instruments have both debt and equity characteristics.

Where hybrid instruments are material and we consider them to be relevant to our quantitative analysis of an issuer, we ascribe equity credit and make related financial statement adjustments to consider in our assessment of credit risk and to improve the comparability of financial data across peers.<sup>2</sup> Where a security includes other features or terms that are relevant to an issuer's credit profile (i.e., beyond those used to ascribe hybrid equity credit), we consider how these features affect the issuer's overall credit fundamentals, regardless of ascribed equity credit.

We assess whether a hybrid instrument's priority of claim is junior to a more senior obligation that exists in the capital structure. Where this is not the case, we typically do not ascribe equity credit to the instrument.

We typically do not ascribe equity credit to a parent entity, nor on a consolidated basis, for hybrids issued by a subsidiary entity because we do not consider, due to structural subordination, that the benefits of these securities would extend to the parent. Exceptions may exist where parent debts are guaranteed by the subsidiary issuing the hybrid, or where issuance is by a purely financing subsidiary or by a subsidiary subject to a consolidated regulatory framework, e.g., Solvency II insurance regulation.

For a security that is represented in financial reporting as more than one instrument (e.g., bifurcated reporting as two instruments, one debt and the other equity), our analysis is performed only on the instrument component with material hybrid characteristics. Derivatives do not typically meet our definition of a hybrid instrument.

Our presentation of this cross-sector methodology proceeds with (i) the scope of this methodology; (ii) the basket classification framework; (iii) the ascription of equity credit to hybrids issued by investment-grade entities; and (iv) the ascription of equity credit to hybrids issued by speculative-grade entities including shareholder loans. In the appendix, we discuss the hybrid equity credit cap as it applies to hybrids issued by investment-grade issuers.

## Scope

This methodology applies to hybrid instruments that are issued by insurance companies, finance companies, securities industry market makers, securities industry service providers, and asset managers globally. This methodology also applies to hybrid instruments issued by non-financial corporations including commercial real estate operating companies and investment trusts (REITs).<sup>3</sup>

<sup>1</sup> Therefore, the host security is a hybrid in the case of a convertible hybrid.

<sup>2</sup> For an explanation of our standard adjustments, please see the cross-sector methodologies that describe our financial statement adjustments in the analysis of non-financial corporations and financial institutions. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

<sup>3</sup> Please see our sector methodology for REITs and other commercial real estate firms. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

In cases where a sector methodology provides more specific guidance on hybrid equity credit, that guidance applies to that sector.

This methodology does not apply to banks, nor does it apply to those securities industry market makers rated using our methodology for banks.

In addition, this methodology does not apply to sovereigns, regional and local governments (including US public finance issuers), nonprofit organizations, multilateral development banks, project finance issuers or corporate infrastructure issuers with structural features that are highly similar to those found in project finance. Our approach for these issuers uses the broad principles outlined in this methodology as we analyze the credit support that hybrid equity may provide, but in these cases we adapt our approach to align with the relevant transaction-specific financial and legal structures.<sup>4</sup>

## Our basket classification framework

We classify hybrids into low (L), medium (M) and high (H) "basket" categories, with instruments placed into basket L receiving the least amount of equity credit and instruments placed into basket H receiving the greatest amount of equity credit. Each basket category corresponds to a specific equity credit percentage (see Exhibit 2), and these percentages are used to adjust an issuer's financial statements as part of our standard adjustments.<sup>5</sup> We consider the scorecard metrics to which adjustments are applied in our analysis of an issuer's overall credit fundamentals and the mix of its capital structure.

For investment-grade issuers, we use the entire basket spectrum shown in Exhibit 2 to adjust certain balance sheet accounts, whereas for speculative-grade entities, we ascribe either no equity credit (basket L) or full equity credit (basket H) to adjust all financial statements. We may also consider other metrics. For example, for our analysis of a hybrid instrument's income statement or cash flow statement impact on an issuer's financial flexibility, we may consider both coverage of interest and coverage of interest and dividends.

If an issuer that has hybrid instruments outstanding moves from investment grade to speculative grade status, the speculative grade approach would apply, and vice versa. For Government-Related Issuers, the approach we use is based on the issuer's senior unsecured (or equivalent) rating regardless of the level of the Baseline Credit Assessment (BCA).<sup>6</sup>

Exhibit 2

### Level of equity credit (EC)\*



\* For investment-grade issuers, we limit the total equity credit that may be ascribed to the issuer's hybrid securities. The equity credit percentages shown apply when the total hybrid equity credit accorded an issuer does not exceed our equity credit cap. Hybrid issuances that exceed the cap are placed into a basket, but they are generally ascribed 0% equity credit. Please see the Appendix for more information of the cap's application to hybrids.

Source: Moody's Investors Service

<sup>4</sup> A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

<sup>5</sup> For an explanation of our standard adjustments, please see the cross-sector methodologies that describe our financial statement adjustments in the analysis of non-financial corporations and financial institutions. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

<sup>6</sup> For an explanation of BCAs, please refer to Rating Symbols and Definitions (a link can be found in the "Moody's related publications" section).

## Ascribing equity credit: Hybrids issued by investment-grade entities

In ascribing equity credit to hybrid instruments of investment-grade entities, we focus on a few basic features of a security, principally whether it is mandatorily convertible, its coupon skip or deferral provisions, and its maturity profile. Using a flowchart-based approach, we position a hybrid in a basket by answering a sequence of questions about these features (Exhibit 3). Because the flowchart applies only to hybrid instruments, it does not apply to senior debt or common equity. In addition, we do not typically make basket adjustments to securities (including shareholder loans) of investment-grade issuers in cases where such securities are held by related parties.

Exhibit 3

### Ascribing equity credit to hybrid instruments<sup>†</sup> issued by investment-grade entities



<sup>†</sup> The flowchart applies only to hybrid instruments, which are subordinated securities (e.g., subordinate debt, preferred stock) that are not common equity and for which the omission of scheduled dividend, interest or principal payments is contractually allowable.

\* For a Yes response above, the instrument must also convert to a fixed number of common equity shares.

\*\*\* Where an instrument has a meaningful coupon step-up (as detailed in the "Maturity" section below), a Yes response to the Maturity question is replaced with a No response.

Source: Moody's Investors Service

### Mandatory conversion

A hybrid instrument that mandatorily converts to a fixed number of common equity shares within three years is placed into basket H (reflecting a Yes answer to the mandatory conversion question) and there is no further application of the flowchart, as shown in Exhibit 3.<sup>7</sup> If the answer to the question on mandatory conversion is No, then less equity credit is ascribed to the

<sup>7</sup> Convertible instruments may feature a variety of other hybrid characteristics that benefit the issuer or other creditors. Where these are material, they are considered qualitatively in our credit analysis of an issuer. However, equity credit is based on the flowchart criteria, including the mandatory conversion question.

instrument and it is placed into either basket L or basket M depending on the answers to the questions in the following sections about the instrument's coupon skip and maturity characteristics.

In addition, if the instrument is subject to a write-down or converted to common equity as a going concern in the event of a breach of a regulatory solvency threshold, we would place the instrument into basket H. Conversely, if the instrument is subject to a write-down or converted to common equity as a gone concern in the event of a breach of a regulatory solvency threshold, we would answer No the question in this section of the flowchart.

### Unrestricted optional coupon skip

This section is relevant for instruments where we have a No answer to the mandatory conversion question and addresses whether an instrument's terms include an option to skip coupon or dividend payments. An instrument that does not allow for optional coupon skip is placed directly into basket L and thus does not receive equity credit. An instrument with an optional coupon-skip mechanism is placed into either basket L or basket M, depending on its maturity characteristics, as discussed in the following section.

In answering the question in this section, we consider that a hybrid has an option to skip (leading to a Yes answer) provided that such optionality is unrestricted based on the considerations described here. Hybrid instruments in certain jurisdictions include dividend pushers, which restrict the ability of an issuer to opt to skip a coupon payment.<sup>8</sup> Dividend pushers are instrument features that require an issuer to make payment on a hybrid if the issuer has made payment on an instrument with the same or lower priority of claim. If an issuer has to stop payments on parity and more junior securities for a long period before skipping a hybrid coupon, its ability to avail itself of cash flow relief might come too late to avoid a default. All else being equal, a hybrid with a dividend pusher of more than six months receives a No answer to this question and placement into basket L. Also, hybrid instruments are placed into basket L if the coupons must be paid upon payment on junior or parity securities. However, if such payments on the parity or more junior security were made at the issuer's discretion, we consider that the instrument has an unrestricted optional coupon skip.

In addition, the coupon skip option should be available to the issuer for a length of time sufficient, typically at least several years, for the issuer to return to a stronger credit profile. In the absence of a sufficient length of time, the instrument is placed into basket L.<sup>9</sup>

### Maturity

The final question in our assessment of a hybrid's equity credit addresses maturity. This question is relevant for instruments where we have a No answer to the mandatory conversion question and a Yes response to the coupon skip question.

An instrument with an initial maturity of at least 30 years (or that has no stated maturity) with at least 10 years remaining until maturity is placed into basket M (reflecting a Yes answer to the maturity question). If the answer to this question is No, then the instrument is placed into basket L. For this question, we consider "Add-on offerings" occurring within one year of the initial offering as part of the initial offering.

We note that for instruments with meaningful step-ups we use the time to the first call date of the instrument as the effective maturity instead of the stated maturity. Where there are no meaningful step-ups, we do not consider an instrument's first call

<sup>8</sup> For clarity, language stating that if a hybrid coupon is skipped, coupon payments on junior (and, also in some cases, parity) securities must also be stopped (i.e., "dividend stoppers") represents a provision that is distinct from dividend pushers. Dividend stoppers do not affect the equity credit we ascribe but may be considered qualitatively.

<sup>9</sup> Other creditor-friendly forms of coupon skip, including mandatory requirements to suspend coupons on a hybrid, do not affect the equity credit we ascribe but are considered qualitatively in our overall credit analysis of the issuer. In addition, settlement provisions (e.g., cumulative or non-cumulative) do not affect the equity credit we ascribe but may be considered qualitatively. Non-cumulative hybrids are hybrids where skipped coupons are canceled and do not have to be repaid.



date in answering the question about maturity.<sup>10</sup> A step-up is the contractual increase in the credit spread applying to a hybrid's coupon or dividend if the hybrid is not called at a preset date.

A step-up in any amount prior to 10 years after issuing the instrument is considered meaningful except in a change-in-control event, in which case a step-up of more than 500 basis points is considered meaningful. Otherwise, a step-up is considered meaningful if it exceeds 100 basis points. For instruments that convert from a fixed to floating rate we assess whether a meaningful step-up exists based on whether the contractual interest rate spread over the risk-free rate (at the time that the rate resets) exceeds 100 basis points from the initial contractual interest rate spread. In addition, we consider that a rate step-up has not occurred in cases where an actual rate step-up is followed by a full step-down in rate before the first call date.

For instance, a hybrid instrument with a No answer to the mandatory conversion question maturing in 30 years and featuring optional deferral and a small step-up (e.g., 50 bps) at year 10 is placed into basket M. However, if the same instrument included a large step-up (e.g., 150 basis points) at year 10 with first call date at year five, we consider that the effective maturity is five years, and the security is placed into basket L.

### Ascribing equity credit: Hybrids issued by speculative-grade entities including shareholder loans

We ascribe either no equity credit (basket L) or full equity credit (basket H) to hybrid instruments issued by speculative-grade entities and make related financial statement adjustments. For an explanation of our standard adjustments, please see the cross-sector methodologies that describe our financial statement adjustments in the analysis of non-financial corporations and financial institutions.<sup>11</sup>

Relative to investment-grade issuers, speculative grade issuers are materially closer to default, have shorter-dated, dynamic and typically more complex capital structures, and have debt with more covenants. Speculative-grade issuers often opt to cease hybrid coupon payments because such actions are contractually allowable without triggering a default. Also, there is less certainty relative to investment-grade issuers that speculative-grade issuers will make hybrid coupon payments, particularly if they can avoid a debt default by ceasing hybrid coupon payments. However, our analysis of any credit support that hybrid instruments provide to a speculative-grade issuer's capital structure and financial flexibility is often more nuanced than what is reflected in our adjusted financial metrics based on this binary approach to ascribing equity credit to these instruments.

Our approach ascribing equity credit to hybrid instruments of speculative-grade issuers reflects our expectation about the treatment these instruments would receive in a bankruptcy scenario.<sup>12</sup> Specifically, we assess certain rights, i.e., whether the terms of a hybrid include the ability to trigger bankruptcy upon certain events or offer security holders creditor rights in bankruptcy, as shown in Exhibit 4. A hybrid instrument that provides for either of these rights receives 0% equity credit (basket L) and therefore is treated as 100% debt in calculating a speculative grade issuer's financial metrics. A hybrid instrument that provides neither of these rights receives 100% equity credit (basket H) in calculating the issuer's adjusted financial metrics.

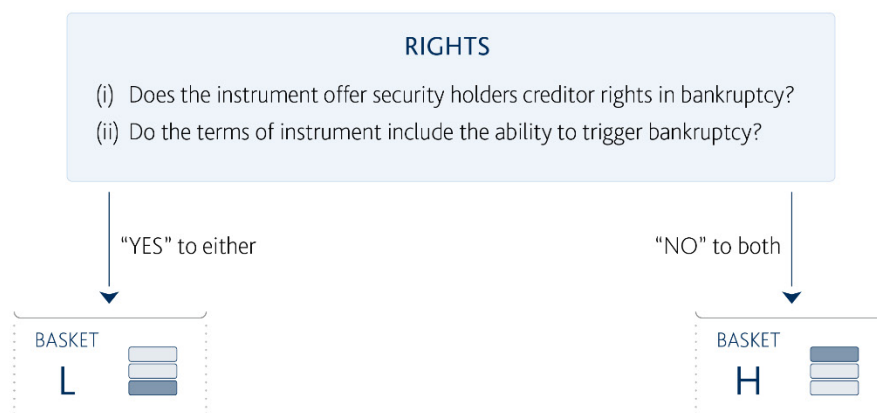
<sup>10</sup> Equity credit is based solely on the flowchart criteria, including the maturity question. However, in our credit analysis, we may consider other features that incentivize but do not obligate a borrower to redeem a hybrid instrument qualitatively, including in conjunction with our analysis of financial policy. For example, we may consider the likely effects on borrower behavior of an instrument with a springing conversion to equity feature, which provides an incentive to the borrower to redeem the instrument in order to avoid the dilutive effect of conversion. Conversely, allowing conversion to equity ultimately reduces debt and provides credit support in a time of stress. Also, the sudden, public expression of the intention to call a hybrid may indicate a credit weakness.

<sup>11</sup> A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

<sup>12</sup> Thus, our approach for speculative grade issuers is aligned with our definition of default in that only debt instruments or debt-like obligations can default and with the application of our LGD model, which is used to help assign ratings to debt issued by speculative grade corporates. Please see our cross-sector methodology for loss given default for speculative grade companies. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.



Exhibit 4

**Ascribing equity credit to hybrid instruments<sup>†</sup> issued by speculative-grade entities**

<sup>†</sup> The flowchart applies only to hybrid instruments, which generally are subordinated securities (e.g., subordinate debt, preferred stock) that are not common equity and for which the omission of scheduled dividend, interest or principal payments is contractually allowable. The flowchart does not apply to shareholder loans.

Source: Moody's Investors Service

For clarity, certain deeply subordinated instruments held by the owners of the issuer's common stock, often referred to as shareholder loans and typically issued by corporates, feature specific conditions that make them effectively functionally equivalent to equity (i.e., with no ability to influence the probability of default and loss given default on the more senior debt of a company). For speculative grade issuers, if the shareholder loans meet the criteria described in the "Treatment of shareholder loans" section that follows, we treat them as similar to equity from a credit perspective.

### Treatment of shareholder loans

The majority of shareholder funding for many corporate transactions is made through the issuance of shareholder-owned deeply subordinated debt. In many countries in Europe, for example, these instruments are called shareholder loans or preferred equity certificates.<sup>13</sup>

Shareholder loans are often structured to provide a level of credit support that is equivalent to equity from the perspective of the issuer's other creditors, similar what we observe for preferred stock instruments in the US. The primary principle in our approach to ascribing equity credit to shareholder loans of speculative grade issuers is an assessment, based on credit documentation (including the loan, bond and inter-creditor agreements), that the credit risk associated with more senior debt would not be affected by the relative proportions of equity and shareholder loans in the issuer's capital structure.

While transactions structures may vary, shareholder loans of speculative grade issuers that are placed into basket H (100% equity credit) share the characteristics shown below in bold. In each bullet, we also describe the related structural features that are often present in the transaction documentation of these instruments.

- » **A shareholder loan is junior to all liabilities, with the exception of other tranches of shareholder loans that also meet the conditions for placement into basket H.** The subordination of the shareholder loan is captured in transaction documentation, typically an inter-creditor agreement or subordination agreement that also documents enforcement processes and the application of recovery proceeds. In addition, the shareholder loan likely is or will be contractually subordinated to all liabilities within the rated group, including non-financial liabilities such as trade creditors.<sup>14</sup> In certain

<sup>13</sup> In regions where preferred stock is commonly issued by corporates (e.g., North America), the issuance of shareholder loans that would meet the conditions for 100% equity credit is likely to be rare or even non-existent.

<sup>14</sup> The presence of preference shares that rank junior to the shareholder loan would not compromise equity credit for the shareholder loan if other eligibility tests are met.

cases, holders of the shareholder loan may have a claim following an insolvency event. In assessing such scenarios, we consider whether the inter-creditor agreement provides credit support by ensuring that any claim is junior to all other debt claims, in particular, whether proceeds from any enforcement of collateral are applied first to all other financial and non-financial creditors until those claims have been fully discharged before any proceeds go to shareholder loans. The maturity of any shareholder loan typically extends beyond the maturity of any other debt or debt-like obligation within the rated group. This is an important consideration due to inherent uncertainties in insolvency proceedings in a number of jurisdictions.

- » **The shareholder loan does not affect the issuer's probability of default or the position or recovery prospects of any other creditors within the rated group following any form of default or bankruptcy proceeding.** Therefore, a number of features are absent from the terms of the shareholder loan and the inter-creditor agreement, including covenants (other than informational covenants where failure to comply has no consequences), acceleration rights, the right to declare default or an event of default; or, if such rights exist, they are unenforceable until all debt that ranks senior to the shareholder loans has been repaid in full. The following would also be absent from shareholder loan transaction documentation:
  - Security encumbrances within the rated group.
  - Amortization, redemption or other prepayment allowable prior to maturity of the instruments in the capital structure that rank senior to the shareholder loans, except to the extent that such payments could have been accommodated out of equity distributions in an all-equity structure and are subject to a restricted payments test, which is no different than the typical restrictions on repurchasing common stock.
  - Enforceable put options prior to the maturity of the debt, even if permitted by a restricted payments test.
- » **The economic interests of the common equity and the shareholder loan are enduringly aligned.** Typically, the alignment is achieved through “stapling” (i.e., evidence at issuance that the shareholder loan is owned by the common stockholders and, after issuance, restrictions on transferability of the shareholder loan to a party other than a common shareholder that ensure that such alignment is maintained).<sup>15</sup>
- » **Protections for other creditors are present in the event changes are made to the terms of the shareholder loan.** Any changes to the terms of financing documentation, including the shareholder loan and the inter-creditor agreement, that affect any of the conditions outlined above need majority approval of senior financial creditors, or equivalent protections are present.<sup>16</sup>

For shareholder loans that meet the criteria for equity treatment, their impact on a company's credit risk profile can depend on a number of factors including, for example, the issuer's financial policy, the economic interests of the lender/shareholder, the financial sponsor's track record, and the evolution of an issuer's capital structure, including our assessment of the likely scenarios for the replacement of the shareholder loan or a financial sponsor's exit. For example, shareholder loans may allow a sponsor to add capital on a tax-advantaged basis into a multi-level corporate structure while concurrently retaining equity. Our credit analysis would also assess what the issuance of shareholder loans instead of common equity implies about financial policy.

We may assess whether more senior debtholders are protected from cash leakages resulting from cash interest or principal payments associated with the shareholder loan. Similarly, we do not consider that the presence of the shareholder funding implies greater flexibility to increase cash distributions. Hence, for a shareholder loan receiving fully equity credit, a restricted

<sup>15</sup> While differences in percentage ownership of the common equity and the shareholder loan may arise, for example, to facilitate management incentives, the stapling provides sufficient overlap in ownership to ensure commonality of interests.

<sup>16</sup> Equivalent protections would ensure that permitted changes are (i) minor, administrative or correct a technical error; or (ii) not materially less favourable to senior financial creditors.

payments test should not differentiate in any way between a dividend payment on common equity and a cash payment made under the shareholder loan.<sup>17</sup>

Subsequent to the initial assignment of a company's ratings based on the issuance of a shareholder loan meeting the requirements for placement into basket H, if we become aware that any of the terms have changed such that the required conditions discussed above are no longer met, we will treat the shareholder loan as 100% debt in calculating a company's adjusted financial metrics. Where we consider that this change materially affects credit risk, ratings would reflect our revised view of the creditworthiness of the company including the likelihood of a default and the expected loss suffered in the event of default.

In some structures, once the senior debt of the company has been refinanced or paid off, the restrictions imposed by the inter-creditor agreement may no longer apply, and standard covenants within the shareholder loan may have force, including rights to trigger a default event and acceleration. In these cases, we would usually consider the specific terms of the inter-creditor and shareholder loan agreements, and we may not be able to ascribe equity credit if the issuer has the right to subsequently issue new senior debt without the protections of the original inter-creditor agreement in place.

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<sup>17</sup> Early distribution of cash in a highly leveraged company is credit negative and may negatively affect the corporate family rating even in the absence of an explicit debt adjustment. The payment could affect other metrics, including free cash flow, and would also weigh on financial policy considerations.

## Appendix

### Limit on hybrid equity credit for investment-grade issuers<sup>18</sup>

We limit the amount of total equity credit that can be ascribed to all hybrid instruments within an issuer's capital structure to 30% of the company's adjusted equity.<sup>19</sup> That is, we only ascribe equity credit to the extent that:

$$\frac{\text{Hybrid Equity Credit}}{\text{Adjusted Equity}} \leq 30\%$$

The hybrid equity credit cap applies to hybrids issued by investment-grade issuers.<sup>20</sup>

Hybrid issuances that exceed the cap are still placed in a basket but are typically treated as 100% debt in the calculation of financial metrics. Where there is an exceedance of the cap, issuers would receive equity credit from these basketed securities in the event that room is created under the cap in the future.

The greater the total hybrid equity credit ascribed to an issuer's hybrids, the smaller the amount that can be added, subject to the cap. For example, if a company has adjusted equity outstanding of \$2.94 billion (including equity credit ascribed so far of \$140 million), then subject to the 30% cap, the maximum possible equity credit for the issuer would be \$1.2 billion.<sup>21</sup> If the company were to issue hybrid securities, this maximum would apply regardless of the amount of securities issued to-date or in the future or the combination of instruments involved. In this context, if \$140 million of equity credit has been ascribed to hybrid securities issued by the company, then the headroom for ascribing additional equity credit would sit below the cap by the amount of equity credit already ascribed. In this example, the company has \$1.06 billion of headroom based on \$140 million of existing equity credit.

The table below further illustrates this example. For each hybrid basket, we show the threshold for the additional amount of hybrids beyond which the company's total equity credit would be limited to the \$1.2 billion cap. We also illustrate, at each basket level, the amount of additional equity credit that would be ascribed subject to the issuer's existing headroom, and the issuer's total equity credit, following the hypothetical issuance of \$1.1 billion issuance of hybrids.

<sup>18</sup> Please refer to the "Scope" section.

<sup>19</sup> The numerator (hybrid equity credit) is the total amount of equity credit ascribed to the issuer's hybrids. The starting point for the denominator (adjusted equity) is the issuer's reported equity, to which we apply our standard adjustments, one of which is an adjustment for hybrid equity credit, and we may also apply non-standard adjustments. Please see our cross-sector methodologies that discuss standard adjustments in the analysis of, respectively, non-financial corporations and financial institutions.

<sup>20</sup> The hybrid equity cap does not apply to speculative grade issuers. Given other, more significant sources of risk for speculative grade issuers, any added risk from hybrids not behaving as expected does not have the same relative importance for the average speculative grade versus the average investment grade issuer.

<sup>21</sup> Based on how we define the equity credit ratio and the 30% cap requirement, the maximum available equity credit is formulaically three-sevenths of the adjusted equity outstanding excluding equity credit ascribed to-date. That latter figure is \$2.8 billion in this example. The maximum available equity credit is therefore \$1.2 billion and the remaining headroom is \$1.06 billion.

Exhibit 5

**Illustration of hybrid equity credit tolerance**

(USD Millions)

Adjusted Equity (including equity credit to date)	Ascribed Equity Credit to date	Equity Credit Ratio	Equity Credit Cap*	Headroom	Moody's Basket	Basket Equity Credit	Additional- issuance Threshold**	Illustrative Issuance	Additional Equity Credit***	Total Equity Ascribed	Equity Credit Ratio (by scenario)
\$2,940	\$140	4.8%	\$1,200	\$1,060	L	None	Unlimited <sup>†</sup>	Unlimited <sup>†</sup>	None	\$140	4.8%
					M	50%	\$2,120	\$1,100	\$550	\$690	20%
					H	100%	\$1,060	\$1,100	\$1,060	\$1,200	30%

<sup>†</sup> Unlimited from the perspective of the cap because no equity credit is given to a basket L hybrid.

\* We use the threshold ratio defined above to compute the maximum available equity credit. In particular,  $1,200 / (2,800 + 1,200) = 30\%$ . The 4.8% equity credit ratio is well below the 30% limit and is based on existing hybrid equity credit as a percentage of adjusted equity, i.e.,  $140 / (140 + 2,800) = 4.8\%$ .

\*\* The threshold represents the additional amount of hybrids securities beyond which no further equity credit would be ascribed. Based on the 1,060 headroom, the threshold for issuing hybrids placed into basket M is  $1,060 / 0.50 = 2,120$ .

\*\*\* The additional equity that would be ascribed from a \$1,100 million issuance depends on the basket classification of the hybrids issued and is subject to the headroom (\$1,060 million). For example, additional equity credit in the basket H scenario is limited to the headroom (\$1,060 million).

Source: Moody's Investors Service

Exhibit 6 summarizes how the cap and adjusted equity are calculated for investment-grade issuers:

Exhibit 6

Calculating the 30% Equity Credit Cap	
Cap Condition:	Hybrid Equity Credit / Adjusted Equity $\leq$ 30%
Numerator:	Sum of the amount of each of the issuer's hybrid instruments times the equity credit level associated with that instrument's basket
Denominator:	Adjusted Equity = Reported Equity +/- Moody's standard adjustments (including hybrid equity credit) +/- non-standard adjustments

Source: Moody's Investors Service

In some instances, we may consider that there is a substantial difference between equity as stated on an issuer's balance sheet and the economic value of the company. For example, some companies show negative balance sheet equity but consistently report net income and cash flow that implies a substantially higher economic value. In such cases, when balance sheet equity is minimal or negative, we may use an EBITDA multiple to estimate enterprise value and arrive at a proxy for reported equity in the above ratio.<sup>22</sup>

<sup>22</sup> For such companies with low or negative equity, we typically use the following as a proxy for the as-reported equity:  $6 \times \text{EBITDA} - \text{Total Liabilities} + \text{Deferred Taxes} + \text{Minority Interest}$ .

## Text of conforming changes for Financial Statement Adjustments in the Analysis of Non-Financial Corporations

### Proposed methodology

# Financial Statement Adjustments in the Analysis of Non-Financial Corporations

### Hybrid securities

#### The reporting issue

Hybrid securities have characteristics of both debt and equity instruments. For a given hybrid instrument, we may consider whether the mix of such characteristics suggests a different classification from the accounting treatment. For example, certain subordinated instruments accounted for as debt have important equity-like attributes, and certain instruments accounted for as equity have debt-like attributes.

#### Our analytical response

Where hybrid instruments are material and we consider them to be relevant to our analysis of an issuer, we ascribe equity credit based on the security's particular features using our hybrid equity credit methodology.<sup>23</sup>

We adjust an issuer's balance sheet in accordance with the level of equity credit we ascribe to its hybrid instruments. In doing so, we adjust the classification in current accounting, which classifies instruments as all debt, all equity, partly debt and partly equity, or in some cases, non-controlling interest. For example, we may ascribe 50% equity credit and make the corresponding reclassification to equity to a subordinated instrument that is classified as 100% debt based on accounting standards.

In certain cases, we limit the amount of equity credit we ascribe.

We also adjust the income statement and cash flow statement to reflect interest expense or dividends, depending on our balance sheet classification. For example, if we consider a portion of a debt instrument as equity-like, we typically reclassify the corresponding amount of interest expense to dividends. Conversely, if we consider a portion of an equity instrument as debt-like, we typically reclassify the corresponding amount of dividends as interest expense.

<sup>23</sup> A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

## How we adjust the financial statements

The following two exhibits describe our adjustments related to hybrid securities.

Exhibit 7

### Standard adjustments for reclassification to equity for hybrid securities classified as debt

Balance Sheet	We reclassify to equity (i.e., preferred stock) hybrid securities classified as debt, based on the hybrid basket treatment assigned to the particular hybrid security.
Income Statement	We reclassify interest expense to preferred dividends for the calculated equity portion of hybrid securities based on the hybrid basket treatment.
Cash Flow Statement	We reclassify interest paid (an operating cash outflow) to preferred dividends (a financing cash outflow) for the calculated equity portion of hybrid securities based on the hybrid basket treatment.

Source: Moody's Investors Service

Exhibit 8

### Standard adjustments for reclassification to debt for hybrid securities classified as equity

Balance Sheet	We reclassify to debt (i.e., subordinated debt) hybrid securities classified as equity, based on the hybrid basket treatment assigned to the particular hybrid security.
Income Statement	We reclassify preferred dividends to interest expense for the calculated debt portion of hybrid securities based on the hybrid basket treatment.
Cash Flow Statement	When paid, we reclassify preferred dividends (a financing cash outflow) to interest expense (an operating cash outflow) for the calculated debt portion based on the hybrid basket treatment.

Source: Moody's Investors Service



## Text of conforming changes for Financial Statement Adjustments in the Analysis of Financial Institutions

### Proposed methodology

# Financial Statement Adjustments in the Analysis of Financial Institutions

## Standard adjustments that apply to banks and insurers

### Hybrid securities

#### The reporting problem

Hybrid securities are used by financial institutions to finance their operations and in some cases to meet regulatory capital requirements. They have characteristics of both debt and equity instruments.

For a given hybrid instrument, we may consider whether the mix of such characteristics suggests a different classification from the accounting treatment. For example, certain subordinated instruments accounted for as debt have important equity-like attributes, and certain instruments accounted for as equity have debt-like attributes.

#### Our analytical response

Where hybrid instruments are material and we consider them to be relevant to our analysis of an issuer, we ascribe equity credit based on the security's particular features using our hybrid equity credit methodology.<sup>24</sup>

We adjust an issuer's balance sheet in accordance with the level of equity credit we ascribe to its hybrid instruments. In doing so, we adjust the classification in current accounting in which instruments are classified as all debt, all equity, partly debt and partly equity or in some cases, non-controlling interest. For example, we may ascribe 50% equity credit and make the corresponding reclassification to equity to a subordinated debt instrument that is classified as 100% debt based on accounting standards.

In certain cases, we limit the amount of equity credit that we ascribe.

We may also adjust the income statement and the cash flow statement to reflect interest expense or dividends, depending on our balance sheet classification. For example, if we consider a portion of a debt instrument as equity-like, we typically reclassify the corresponding amount of interest expense to dividends. Conversely, if we consider a portion of an equity instrument as debt-like, we typically reclassify the corresponding amount of dividends as interest expense.

Due to regulatory oversight and the importance of capital adequacy to a bank's standalone financial strength, hybrids issued by banks behave differently than those issued by non-banks.<sup>25</sup> This difference, in turn, affects how we treat bank hybrids from an equity credit perspective, which is discussed in our methodology for banks.<sup>26</sup>

#### How we adjust the financial statements

We make balance sheet adjustments, as described above, for banks, securities firms, finance companies and insurers. We make income statement adjustments for banks, securities firms and finance companies. We do not adjust an insurer's income statement based on the equity credit that is ascribed to its hybrid instruments because we calculate the company's earnings and cash flow coverage metrics based on the total fixed distributions, including interest and dividends on preferred stock.

<sup>24</sup> A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

<sup>25</sup> Non-banks include securities firms, finance companies, and insurers for the hybrid securities standard adjustment.

<sup>26</sup> See our methodology for rating banks. For non-banks, see our cross-sector methodology for assigning hybrid equity credit. A link to these and other sector and cross-sector credit rating methodologies can be found in the "Moody's Related Publications" section.

## Text of conforming changes for REITs and Other Commercial Real Estate Firms

### Proposed methodology

# REITs and Other Commercial Real Estate Firms

### Hybrid equity credit

Commercial real estate firms may issue preferred stock, deeply subordinated debt and other forms of hybrid equity. Hybrid equity credit is assigned in accordance with our hybrid equity cross-sector rating methodology;<sup>27</sup> however, for REITs, we also apply the following sector-specific considerations.

If hybrid equity (including preferred stock and subordinated debt) issued by a REIT would otherwise qualify for Basket M (50%) equity credit in accordance with our cross-sector methodology, the equity credit for that instrument would typically only qualify for 25% equity credit. This treatment is consistent with our view that the legal structure of REITs, and more specifically the requirement to make distributions in order to maintain their tax status, means that REITs are relatively unlikely to cut preferred dividends to preserve financial flexibility. Thus, we consider it is not appropriate to give the hybrid security of investment-grade REITs the same hybrid equity credit as hybrid instruments of non-REITs that are placed into basket M. However, if the terms of the hybrid security permit the REIT to suspend the hybrid coupon payment even in instances where the REIT continues to pay common dividends, the hybrid would be eligible for the full amount of hybrid equity credit in accordance with the cross-sector methodology.

Basket M treatment is highlighted in this methodology primarily due to the propensity of a REIT to continue to pay dividends on preferred stock, which is a prevalent form of financing in some regions that, for non-REITs, often qualifies for this basket. We may also consider restricted optionality of coupon deferral in the basketing of other hybrid securities, in accordance with our hybrid equity cross-sector rating methodology.

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<sup>27</sup> A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

## Annex: Additional background for hybrid equity credit RFC proposals

This annex provides additional background for our proposals for ascribing equity credit to investment-grade issuers of hybrid securities.

The flowchart-based approach of our proposals focuses on answering a specific sequence of questions about certain key characteristics of a security, namely, about mandatory conversion features, coupon skip or deferral provisions, and maturity. While these elements have direct antecedents in our existing approach for investment-grade issuers, we believe the proposed flowchart provides a more focused approach and a clearer presentation compared to the existing approach, which describes many characteristics of hybrid security structural features at a granular level, often with specific additional criteria for each characteristic.

For example, we currently distinguish five subcategories of coupon skip for non-convertible hybrids as shown in Exhibit A and consider other instrument mechanisms. While these and other features may in some cases be relevant to our overall credit analysis of an issuer, they are not incorporated into our proposed framework for ascribing equity credit. Our proposed basketing criterion for coupon skip and deferral is simpler, focusing on whether the security comes with an unrestricted option to skip a coupon or defer a dividend.

Exhibits 2 and 4 of our [existing hybrid equity credit methodology](#) illustrate the relationship between the numerous instrument features we consider and the ascription of equity credit for common types of convertible and non-convertible hybrids. We have recast these illustrations in Exhibit A and Exhibit B below to illustrate the basket into which we expect the same set of instruments would be placed based on our proposed approach. We have added a row to the bottom of Exhibit A and a column on the right-hand side of B to provide these illustrative indications.<sup>28</sup>

<sup>28</sup> For clarity, these exhibits do not appear in our proposed methodology above nor would they appear in an updated hybrid equity credit methodology if our RFC proposals are adopted.

## Exhibit A

Exhibit 2 of the existing hybrid equity credit methodology – updated to illustrate<sup>†</sup> basket outcomes based on the RFC proposals for non-convertible hybrid securities issued by investment-grade entities

	#1	#2	#3	#4	#5	#6	#7	#8	#9	#10	#11	#12
Coupon skip	Mandatory Weak <sup>1</sup>	X										
	Restricted Optional <sup>2</sup>		X							X		
	Optional	X		X	X		X	X			X	
	Optional and Mandatory Strong <sup>3</sup>					X			X			X <sup>4</sup>
Settle-ment	Cumulative	X	X	X	X	X	X		X			
	Non-cumulative							X		X	X	X
* Ranking	Subordinated	X	X	X	X	X						
	Preferred						X	X	X	X	X	X
	Equity											
	< 30 years	X										
	30 – 59 years			X				X				
	>= 60 years		X	X	X	X	X		X	X	X	X
	Irredeemable											
Basket (existing methodology)		A	B	B	B	B	C	C	C	C	C	D
Basket (based on proposals)		L	L	M	M	M	M	M	M	M	M	M

<sup>†</sup> This table is illustrative of common types of non-convertible hybrids but is not an exhaustive compendium.

\* As described in the existing methodology, Ranking refers to Moody's classification of the security for purposes of assessing equity credit.

1 Mandatory weak triggers include minimum regulatory capital ratios set at low levels.

2 With restricted optional coupon skips, if the issuer has to stop payment on parity or junior securities for more than six months before being able to skip hybrid coupon payments, equity credit would be reduced from what is shown in this exhibit.

3 Optional and mandatory strong triggers include optional coupon-skip mechanisms and mandatory coupon suspension tied to the breach of strong or "meaningful" triggers, such as triggers that would be breached well in advance of a company-wide default.

4 The mandatory coupon suspension is non-cumulative; the optional coupon suspension can either be cumulative or non-cumulative.

## Exhibit B

**Exhibit 4 of the existing hybrid equity methodology – updated to illustrate<sup>†</sup> basket outcomes based on the RFC – proposals for convertible hybrid securities issued by investment-grade entities**

Instrument Type	Host Security			Timing to Conversion/ Write-down	Underlying Security	Conversion Ratio or Principal Write-down	Existing HEC	Proposal HEC
	Maturity	Coupon Skip/ Settlement	Ranking					
US Common Units	5 to 10 years	None	Senior debt	3 years	Common equity	Fixed number of shares	A	L
Contingent Capital Securities**	5 to 10 years	None	Subordinated debt	Depends on where trigger level is set	Conversion to common equity or principal write-down	Varies	B	L
US Common Units*	5 years	Cumulative/ ACSM	Junior sub debt	3 years	Common equity	Fixed number of shares	B	L
US Preferred Units*	> 10 years	Cumulative/ ACSM	Junior sub debt	Earlier of 5 years or breach of regulatory cap trigger	Non-cumulative preferred	Par	B	L <sup>††</sup>
Contingent Capital Securities**	Perpetual	Non-cumulative	Preferred stock	Depends on where trigger level is set	Equity or principal write-down	Varies	C	M
European Mandatory Convertible Securities	≤ 3 years	Cumulative	Equity***	Earlier of insolvency or maturity	Common equity	Fixed number of shares	E	H
US Mandatory Convertible Preferred	3 years	Cumulative	Preferred	Maturity	Common equity	Fixed number of shares	E	H

<sup>†</sup> This table is illustrative of common convertible hybrids but is not an exhaustive compendium.

\* The basket B treatment assumes that the host security will be remarketed as a subordinated debt security. This footnote would not be applicable under the proposed methodology.

<sup>††</sup> The proposed basket placement of L for the instrument is based on an initial maturity assumption of less than 30 years for the instrument. In instances where the initial maturity is 30 years or greater, the proposed basket placement would be M.

\*\* In instances where the contingent capital security is considered to be a high-trigger contingent capital security (i.e., triggering principal write-down or equity conversion), we typically increase the level of equity credit by one basket. Under the proposed methodology, these instruments would be placed into basket H.

\*\*\*Typically, the host security is subordinated debt at issuance, but in bankruptcy, it has an equity claim.

## Moody's related publications

Cross-sector credit rating methodologies are typically applied in tandem with sector credit rating methodologies, but in certain circumstances may be the basis for assigning credit ratings. A list of sector and cross-sector credit rating methodologies can be found [here](#).

For data summarizing the historical robustness and predictive power of credit ratings, please click [here](#).

For further information, please refer to *Rating Symbols and Definitions*, which is available [here](#).

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