



R&I's Analytical Approach to Notching Up for Secured Debt

(This report is an English translation of the original report in Japanese.)

When R&I assigns ratings for individual debts, it first analyzes the possibilities of an issuer going into default and next considers each conditions arranged with each debts, including collateral provisions or covenants such as negative pledge clauses. After taking these factors into consideration, it assigns a rating to individual debts. When the rating of an individual debt (issue rating) is higher than the Issuer Rating, this is referred to as "notching up" and when the rating is below the Issuer Rating, it is referred to as "notching down".

In addition to the level of an Issuer Rating, R&I takes into consideration a number of factors when assigning a rating for an individual bonds to determine the breadth of the notching up. These factors are: adequacy of the collateral assets in comparison with the subject debts, liquidity of the collateral assets, the degree to which disposal of the collateral will be subject to legal constrains, and the period of time taken until the completion of debt recovery.

R&I also considers when the subject bonds are moved off the balance sheet by putting high-quality financial assets into a trust for repayment of the principal and interest in a so-called "in-substance defeasance" (debt reduction) arrangement. In such cases, the bonds which have an A rating or lower will be included as subjects considered for notching up. Likewise, it will be necessary to consider notching down the remaining bonds that are not subject to in-substance defeasance arrangements.

ISSUER RATING	DEGREE OF RECOVERY		
	EXTREMELY HIGH	HIGH	A LITTLE HIGH
BBB zone and above	0 - 3	0 - 2	0 - 1
BB zone and below	3 - 4	2 - 3	1 - 2

The breadth of notching up increases as the rating gets lower. This is because the higher the rating, the lower the possibility of default and, therefore, the lesser the need to be cautious of recovery following default. However, as the rating falls, the probability of default rises and the importance of recovery following default increases when considering investment earnings.

The horizontal axis signifies the degree of recovery and is classified according to three levels: "extremely high", "high", and "a little high". The following four points are important when R&I is making decisions on the position of the subject debt on the horizontal axis:

1. Adequacy of the collateral assets in comparison with the subject debt
2. Liquidity of the collateral assets
3. Degree to which disposal of the collateral will be subject to legal constrains
4. Period of time until the debt recovery is completed

Taking the above perspectives into consideration, R&I comprehensively assesses factors, such as the nature of the secured assets of the debt in question and the business sector the issuer belongs to, and then determines on a case-by-case basis the position of the subject debt on the horizontal axis indicating the reliability of recovery following default.

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