

FTSE Canada Bond Indexes – Index Ratings Methodology Review

18 September 2018

Date: 18 September 2018

FTSE Russell is considering a modification to the rules used to assign a composite credit rating to individual securities when four agencies provide a rating. FTSE Russell is consulting users and other stakeholders in the market. Proposed changes and any feedback will be reviewed at the next meeting of the FTSE Canada external advisory committee, set to take place **on 24 September 2018**, and will issue a market notice shortly thereafter. If changes are made, the new index rating methodology will be used for all issues from 24 September 2018 going forward. The proposal, outlined in detail below, does not affect the ratings for any existing constituent bonds.

Background

The FTSE Canada Bond Indexes utilize an [Index Rating Methodology](#) to assign a composite credit rating to each individual security for purposes of benchmark inclusion and segmentation by credit quality. To determine a composite rating in cases where four agencies rate a bond, the current methodology is:

- If four agencies rate a security, use the most common rating;
- If four agencies rate a security with a two way split, use the lower rating;
- In the highly unlikely event that all four agencies disagree, consider the three lower ratings applying the three rating methodology rule.

The application of the first bullet, the **use of “most common rating”, can lead to unintuitive results in the fringe case where 4 rating agencies rate a security with a three way split**. The table below shows an example: if the index rating of a bond has previously determined by application of the two-way split rule, and one of the agencies that had assigned one of the lower ratings subsequently downgrades its rating further, the index rating will increase since the most common rating is then used.

| Index Event | | Rating 1 | Rating 2 | Rating 3 | Rating 4 | Rule applied | Current (Mode) | Proposed (Mean) |
|-------------|------|----------|----------|----------|----------|-------------------------------------|----------------|-----------------|
| Downgrade | Pre | AA | AA | A | A | 4 agency / 2 way even split / lower | A | A |
| | Post | AA | AA | A | BBB | 4 agency / most common | AA | A |

New Rule

FTSE Russell is proposing to enhance the current Index Rating Methodology, with immediate effect:

| Current | Proposed Update |
|---|--|
| <ul style="list-style-type: none"> If four agencies rate a security, use the most common rating; If four agencies rate a security with a two way split, use the lower rating; In the highly unlikely event that all four agencies disagree, consider the three lower ratings applying the three rating methodology rule. | <ul style="list-style-type: none"> If four agencies rate a security with a two way split (2:2), use the lower rating; If four agencies rate a security with a two way split (3:1), use the most common rating; If four agencies rate a security with a three way split, use the middle rating; In the highly unlikely event that all four agencies disagree, consider the three lower ratings applying the three rating methodology rule. |

The application of this modified logic does **NOT affect any current index constituents**.

The table below details the composite ratings that would result under various scenarios in applying the updated logic on using middle rating where 4 agencies rate a security with a 3 way split.

| Index | | Rating 1 | Rating 2 | Rating 3 | Rating 4 | Current (Mode) | Proposed (Mean) |
|---------|---|----------|----------|----------|----------|----------------|-----------------|
| IG | 1 | AA | AA | A | BBB | AA | A |
| | 2 | AA | A | A | BBB | A | A |
| | 3 | AA | A | BBB | BBB | BBB | A |
| IG / HY | 4 | A | A | BBB | BB | A | BBB |
| | 5 | A | BBB | BBB | BB | BBB | BBB |
| | 6 | A | BBB | BB | BB | BB | BBB |

Next Steps

We welcome any feedback you may have on the proposed changes. Please reach out to us at ftsebond@ftserussell.com /416.572.7979. The proposal outlined above together with any feedback received will be discussed at the FTSE Canada Fixed Income Advisory committees on 24 September 2018 and any changes to the index rating rule will be communicated to the market shortly thereafter. In future, FTSE Russell is reviewing potential further enhancements for objective and transparent handling through the application of a mapped mathematical average in the determination of composite ratings, and extending information to show notched composite ratings at the bond level. We will communicate with market as these reviews progress.

Appendix: Index Rating application for Canadian Bank Bail-In Bonds

The proposal to enhance Index Ratings Methodology, as outlined above, would impact the composite index rating considered for upcoming Canadian Bail-In Debt, which can be issued from September 23 2018. The rating agencies recently communicated expected ratings for Bail-In Debt from all Canadian DSIB issuers, shown in the table below. The composite rating on some of these would be impacted with the adoption of the updated methodology proposed here.

| Issuer | DBRS | Fitch | Moody's | S&P | Expected Index Rating | Expected Index Rating NEW Logic |
|--------|--------|-------|---------|------|-----------------------|---------------------------------|
| BMO | AA (L) | AA- | A2 | A- | A | A |
| BNS | AA (L) | AA- | A2 | A- | A | A |
| CM | AA (L) | AA- | A2 | BBB+ | AA | A |
| NA | A (H) | A+ | A3 | BBB+ | A | A |
| RY | AA (L) | AA | A2 | A | A | A |
| TD | AA (L) | AA- | Aa3 | A | AA | AA |

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