

# Definitions of Default, Recovery Rate, and Loss Given Default

To standardize the proper use of default, recovery rate, and loss given default, and to scientifically and reasonably assess these important credit risk indicators in credit rating practices, Anrong (Hong Kong) Credit Ratings Company Limited (hereinafter referred to as "ARHK") stipulates the following definitions for default, recovery rate, and loss given default:

## 1. Default

Default refers to the state in which a debtor fails to repay the principal and interest of a debt as agreed in the contract during credit rating.

ARHK considers default to include three types: Payment Default, Distressed Exchange, and Bankruptcy.

"Payment Default" refers to the debtor's failure to pay interest or principal according to the contractual schedule, and such default is not within the grace period allowed by the contract.

"Distressed Exchange" refers to a situation where, due to financial difficulties, the debtor avoids bankruptcy and greater losses by forcing creditors to exchange their claims for cash or other instruments through principal reductions, coupon reductions, extensions of maturity, or other agreed-upon term reductions.

"Bankruptcy" refers to the state in which the debtor is unable to repay debts due or is declared bankrupt or taken over through legal procedures.

## 2. Recovery of Rate

Rate of Recovery refers to the amount of principal and accrued interest recovered by investors after a default event through methods such as foreclosure, default claims litigation, guarantor compensation, disposal of collateral, bankruptcy proceedings, or debt restructuring, expressed as a percentage of the face value of the debt instrument. The formula for calculating the recovery rate is usually:

Rate of Recovery = (Repaid Principal + Repaid Interest) / (Default Principal + Default Interest) × 100%

Here, repaid principal and repaid interest refer to the amounts actually received by investors after the default event, while default principal and default interest refer to the amounts stipulated in the bond contract but not paid on time by the debtor.

### 3. Loss Given Default

There is a direct relationship between the recovery rate and the loss given default (LGD). Loss given default refers to the ratio of the creditor's loss to the risk exposure in a default event, i.e., (1 - Rate of Recovery). Therefore, the higher the Rate of Recovery, the lower the loss given default; conversely, the lower the recovery rate, the higher the loss given default.