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Publication Date*

May 30, 2007

Recovery Analytics Update: Enhanced Recovery Scale And Issue Ratings Framework

Standard & Poor's Ratings Services released on May 30, 2007, the enhanced recovery rating scale and issue rating framework for speculative-grade recovery and issue ratings. These enhancements were previewed and commented on by the market, as discussed in our articles published on Oct. 4, 2006, "Request for Comment: Expanding Recovery Rating Coverage And Enhancing Issue Ratings"; Dec. 6, 2006, "Request for Comment: Introduction Of Sovereign Recovery Ratings", and April 10, 2007, "."

We expect to roll out revisions for speculative-grade industrial and financial service issuers with existing recovery ratings on secured debt instruments to the market on June 7. This part of the rollout covers rated secured debt on speculative-grade issuers in the U.S., Canada, Europe, Australia, and South Africa. As indicated in the earlier articles, the changed ratings we will announce are due to the recalibration, or rebasing, of our recovery scale and issue-level ratings based on recovery.

We will follow on June 12 with the introduction of our recovery ratings on speculative-grade sovereign issuers, along with a sovereign criteria article. Therefore, the revised recovery rating scale will not take effect until the June revisions have been announced. We expect to introduce our recovery ratings for speculative-grade unsecured debt issues, for issuers in the jurisdictions listed above, in the fourth quarter of 2007. Other jurisdictions will be added by year-end 2007, continuing into 2008 as we complete relevant insolvency regime and restructuring practice research on a country-by-country basis.

Our expanded recovery analytics initiative is in response to the market's broad acceptance of our 2,000-plus recovery ratings on secured debt in effect today and the increasing focus on post-default recovery prospects. Our initiative also helps answer the demand for greater clarity and specificity with respect to recovery prospects on different debt instruments of all types of issuers globally.

The market is clearly interested in disaggregating the components of credit risk. By providing a default indicator (an issuer credit rating) and a recovery indicator (a recovery rating) and

combining both to arrive at the issue rating, our intent is to enhance ratings transparency, provide market participants the opportunity to deconstruct the risks of default and loss as components of the rating, and facilitate prevailing valuation and risk management disciplines in use in the credit markets. As we noted in our earlier publications, the introduction of this new methodology represents a meaningful transition in the ratings product.

The enhanced recovery and issue rating framework is shown below in table 1.

Table 1

<i>Revised Recovery Ratings, Ranges, And Issue Ratings</i>			
<i>Speculative-grade issuers</i>			
<i>Recovery rating</i>	<i>Description of recovery</i>	<i>Recovery range (%)</i>	<i>Issue rating notches*</i>
1+	Highest expectation, full recovery	100	+3
1	Very high recovery	90-100	+2
2	Substantial recovery	70-90	+1
3	Meaningful recovery	50-70	0
4	Average recovery	30-50	0
5	Modest recovery	10-30	-1
6	Negligible recovery	0-10	-2

*Indicates issue rating "notches" relative to Standard & Poor's issuer credit rating.

Recovery Rating Definition

Recovery ratings focus solely on expected recovery in the event of a payment default of a specific issue and use a numerical scale that runs from '1+' to '6'. The recovery rating is not linked to, or limited by, the issuer credit rating or any other rating and provides a specific opinion about the expected recovery prospects. Standard & Poor's recovery rating analysis for non-sovereigns generally compares the nominal value expected to be received at the end of the workout period or bankruptcy to exposure at default, the latter defined as principal plus accrued and unpaid interest at the point of default.

For sovereigns, political considerations and difficulties in obtaining and enforcing judgments create the possibility of protracted workout periods. Given the potential for significant accumulation of past-due interest in some sovereign defaults, and the prevalence of maturity extensions in sovereign workouts, we express the expected recovery rate for sovereign issuers in terms of net present value (NPV). The approach for sovereigns is equivalent to discounting both the remaining scheduled payments under the original debt instrument and the recovery given default at a post-restructuring discount rate.

Standard & Poor's recovery ratings, although informed by historical data (including our proprietary LossStats™ database for the U.S.) showing average recovery experience, are based on a fundamental issuer- and instrument-specific, scenario-based recovery analysis.

Recovery And Issue Rating Process

Once we have extended recovery rating coverage to a given sector and debt type, generally all new debt instruments issued by speculative-grade entities will be assigned recovery ratings as part of the assignment of their issue ratings. The analysis of these two elements—the likelihood of default, already incorporated in the issuer credit rating, and the expected recovery rate—are the integral components of the issue credit rating. We will, therefore, assign the issue rating based on the issuer credit rating as adjusted, if appropriate, per the recovery rating and the guidelines shown in table 1.

This process will be applied for debt across the capital structure once the roll-out is complete, i.e., secured, unsecured, and subordinated debt will be rated based on the issuer credit rating and recovery rating.

We will continue to place primary emphasis for the issue rating on the likelihood of default, and the instrument rating will be higher, lower, or equal to the issuer credit rating based on the specific issue's recovery expectations relative to the long-term average recovery rate for unsecured debt, rather than based on relative position in insolvency. We have "re-based" the issue rating around a central recovery tendency of approximately 50%. Therefore, issues with recovery rates significantly above 50% (i.e., with an expected recovery rate of 70% or above) will be rated higher than the issuer credit rating, and those significantly below 50% (expected recovery rate of 30% or below) will be rated below the issuer credit rating.

Recovery ratings will not be applied to securitizations, including corporate securitizations, or to covered bonds, all of which will continue to be rated based on asset-specific criteria.

Jurisdiction-Specific Adjustments For Recovery And Issue Ratings

The distinctive characteristics of particular jurisdictions' insolvency regimes have a significant effect on the amounts ultimately recovered by both secured and unsecured creditors, the time to recover such amounts, and the overall predictability of the process. In addition, for most jurisdictions outside the U.S., there is very little reliable historical default and recovery data available to verify in practice the predictability of insolvency proceedings and actual recovery rates.

To consistently incorporate this legal analysis in our recovery and issue ratings consistently, we are reviewing all significant jurisdictions to assess how insolvency proceedings in practice affect post-default recovery prospects. We have reviewed 12 systems so far and expect to analyze and classify a total of about 40 before year-end.

The general concept is to cap both the recovery and issue ratings in countries where we expect the recovery process and actual recovery rates to be negatively affected by weak insolvency regimes. Further guidance on our approach to classifying insolvency regimes and related recovery and issue rating guidelines will be included as part of the roll-out for industrial and financial service recovery ratings.

Recovery Analytics For Investment-Grade Issuers

For investment-grade issuers (those rated 'BBB-' or higher), it is more difficult to predict a path to default and, therefore, to perform a scenario-based, firm- and instrument-specific recovery analysis. We believe some markets have less interest in such analysis, given the lower likelihood of default. We expect to assign recovery ratings on selected investment-grade issuers with secured debt obligations, as we have for some time on utility first-mortgage bonds. Otherwise, we would assess instrument recovery based on class-level recovery assumptions and incorporate these in the issue rating. For example, subordinated debt of investment-grade issuers will generally continue to be rated one notch lower than the issuer credit rating. Very well-secured debt could be rated higher than the issuer credit rating. For example, first-mortgage bonds of investment-grade utilities can be rated up to two notches above the issuer credit rating.

Implications For Preferred Stock And Other Equity Hybrids

Once we have rolled out recovery ratings on unsecured and subordinated debt (expected by fourth quarter 2007), speculative-grade preferred stock and equity hybrids will be rated based on instrument-specific recovery prospects. However, we expect few rating changes based on this shift.

We expect most such instruments of speculative-grade issuers to receive a recovery rating of '6' on the revised scale (0% to 10% recovery after a default), which implies being rated two notches below the issuer credit rating for purposes of reflecting ultimate recovery prospects, similar to the two-notch cut these instruments have historically received for subordination.

Currently, we also reflect heightened payment risk represented by deferral features in rating equity hybrids. Therefore, in addition to adjusting the issue rating on equity hybrids to account for ultimate recovery prospects, we would also make further adjustments to reflect deferral features. Our current convention is to rate such instruments at least one additional notch lower to account for the deferral risk. For example, a preferred stock with a recovery rating of '6' would typically be rated three notches below the issuer credit rating: two notches for negligible ultimate recovery prospects, and one notch for the deferral feature. When we have heightened concerns that the issuer may defer—whether because of the exercise of its right to defer optionally, the breaching of a mandatory deferral trigger, or the exercise of the prerogatives of a regulator—we increase the gap between the issuer credit rating and the issue rating, and we do not impose any arbitrary limit on the size of the gap. (See “Criteria: Assigning Ratings To Hybrid Capital Issues,” published March 28, 2006.)

Implications For Collateralized Debt Obligations (CDOs)

The enhancements described above do not have a significant effect on CDO analytical methodology or on CDO ratings. Under our current CDO methodology, we consider the default probability to be driven by the issuer rating for industrial, financial, and sovereign debt. The recovery expectations are asset-specific, based on the seniority and security of the asset. In an Oct. 17, 2006, article titled “CDO Spotlight: Using Standard & Poor’s Recovery Ratings in Cash Flow CDOs,” we highlighted that CDO managers have an option to incorporate our recovery ratings as the source of recovery estimates for CDO purposes. We expect to release a separate commentary updating guidelines on the use of recovery ratings in cash flow CDOs.