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Credit FAQ:

Why Standard & Poor's Proposes To Expand Its Recovery Ratings And Enhance Issue Ratings

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Table Of Contents

Frequently Asked Questions

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Credit FAQ:

Why Standard & Poor's Proposes To Expand Its Recovery Ratings And Enhance Issue Ratings

In an article published today, Standard & Poor's Ratings Services requests comments on its proposal to expand global coverage of recovery ratings and to increase the weight of recovery prospects in issue ratings. The proposal contemplates adding to our existing recovery rating coverage of secured debt for speculative-grade industrials, by now including recovery ratings for unsecured and subordinated debt, and proposes adding recovery rating coverage for financial services, sovereign, and non-U.S. public finance issuers. Issue-level ratings would also be revamped. Under a new framework, we would provide a default indicator, a recovery indicator, and a blended issue rating. Here are answers to some questions that our proposal raises.

Frequently Asked Questions

Why are you making this proposal now?

This proposal builds on our nearly three years experience of doing fundamental recovery ratings in different markets. During this time we've talked with hundreds of issuers and investors, through both formal and informal discussions, and we are confident that the marketplace will welcome additional recovery ratings coverage.

We believe that the proposal we have put out for comment is responding in a timely and deliberate manner to marketplace demands, including the increasing focus on post-default recovery. Our proposal is an evolution of our innovative recovery ratings, a natural extension beyond the secured loan and note ratings we have traditionally provided. We will cover a wider variety of debt instruments, particularly at the lower range of the rating scale, than others have done, giving the marketplace the greater visibility it wants.

It should be noted that the implementation of the new Basel II agreement for bank capital adequacy and the explosion in the CDO and CDS markets have also been major drivers, as they both require recovery inputs.

What are recovery ratings?

Standard & Poor's was the first rating agency to introduce recovery ratings, in 2003, providing an estimate of the range of principal likely to be returned to lenders in the event of a borrower payment default. Recovery ratings, while informed by our proprietary LossStats database showing historical average recovery experience, are based on a fundamental issuer- and instrument-specific, scenario-based, recovery analysis.

Are recovery ratings available on all issues and issuers?

We have assigned recovery ratings to more than 1,600 corporate issues, the majority on secured loans (including second liens). Currently, our recovery ratings are assigned only to secured corporate loans and notes in the U.S., Canada, Europe, and Australia.

Does this proposal indicate that you will eventually assign a recovery rating to all issues?

Our proposal deals only with expanding our coverage further in the speculative-grade category, and to include financial services, sovereign, and non-U.S. public finance debt in addition to the corporate secured ratings we do now. Using our expanded experience with recovery ratings as we are proposing, we may move toward a more explicit and quantifiable "expected loss," or recovery, rating with our issuer credit ratings at a later date.

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What exactly are the changes to your recovery ratings that you are asking the market to comment on?

We are contemplating three specific changes that we want the market to comment on before implementation.

The first change would be to incorporate recovery ratings more fully and directly into our issue ratings through a revision in our notching criteria. Currently our criteria for raising or lowering (i.e., notching) a specific issue rating from that of its issuer credit rating derive from several different methodologies, not all of which focus consistently on the issue's recovery prospects. As we assign recovery ratings to unsecured and other issues up and down an issuer's capital structure, it will allow us to base our notching exclusively on the recovery rating, which will make our notching policy simpler, more consistent, and easier to understand.

To accomplish this, we propose changing the notching scale by using a 50% recovery rating as the "central recovery" point, and notch up or down from there, as shown in table 1 of the Request For Comment: Expanding Recovery Rating Coverage And Enhancing Issue Ratings. Using 50% as a neutral starting point for notching up or down is consistent with empirical data showing that typical "unenhanced" credit issues –- neither advantaged via security or seniority nor disadvantaged via subordination or an otherwise junior legal status –- tend to recover about 50% in default. Therefore, it seems reasonable to notch up or down based on the degree to which recovery is expected to exceed or fall short of that 50% starting point.

What is the second change?

The second change correlates with the first. Having refined our notching scale around a "normalized" recovery –- neither enhanced nor disadvantaged –- of 50%, we want to ensure that our recovery rating scale shows sufficient recovery differentiation at both ends of the scale. To that end, we propose making our recovery rating scale a 7-point scale ('1+' to '6') in place of our current 6-point scale ('1+' to '5'). This will allow us to expand from two rating categories to three for those issues that span the range from 50% recovery down to zero. This sets the stage for our third change.

Which is?

We propose to broaden our coverage of recovery ratings beyond the secured corporate loan and bond markets to all of the secured, unsecured, and subordinated debt of speculative grade industrial, financial services, sovereign, and non-U.S. public finance issuers. We would introduce these in the 12-18 months following adoption of our proposal. The rollout will be by sector and industry, and in those jurisdictions where insolvency practices are reasonably well established and where sufficient precedent and data exist for analysis.

Once we've completed this step, our recovery ratings experience and market acceptance will allow an analysis for a possible migration to an expected loss framework for our issue ratings.

How many ratings will be changed with this revised scale?

Based on a preliminary review, we estimate that roughly 45% of speculative-grade secured debt with recovery ratings may increase by one notch, and a small number, under 10%, could be notched down.

What impact will this proposal have on structured finance ratings, particularly your CDO ratings?

It is important to note that our CDO ratings are based on two separate inputs: probability of default and an estimated recovery. This means that proposed changes to the notching policy would not have an impact on the inputs to the CDO ratings, since the issuer credit rating (i.e., default rating) will not be affected.

With respect to expanding the use of recovery ratings in rating CDOs, on June 19, 2006, we published Request For Comment: Refinement Of Global CDO Cash Flow Modeling Assumptions, which contained our proposal to

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provide asset managers with the option to include Standard & Poor's recovery ratings in CDO transactions. We expect to be updating the marketplace within the next 10 days with further information about this option. In general, the broader the use of recovery ratings throughout the debt markets, the greater flexibility CDO managers will have in fine-tuning their portfolios.

When will you decide whether and how to implement what is contained in your current proposal?
We have established a two-month comment period. We will be working actively during that time to solicit comments from all market participants and interested parties, and will be discussing their comments with them as they come in.

The comment period ends Dec. 1, and we would hope to be ready to let the marketplace know of our decisions sometime before year-end.

Will these changes affect the existing recovery ratings?
A number of our 245 existing recovery ratings of '5' might be lowered into the new recovery rating category of '6'. This rating will be reserved for instruments with expected recovery between 0%-15%. Though the recovery rating for these instruments may be lowered, we would expect this to have a small impact on instrument ratings, as many are already two notches lower under existing criteria for second liens.

How many new recovery ratings do you expect to assign over the next 12 to 18 months after the rollout?
Our current 1,600 ratings could rise to perhaps 3,000 or so.

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