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Recovery Analytics Update: Expanding Recovery Rating Coverage And Enhancing Issue Ratings

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Table Of Contents

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Recovery Analytics Update: Expanding Recovery Rating Coverage And Enhancing Issue Ratings

Standard & Poor's Ratings Services previously published two requests for comment on our proposals to expand our recovery rating coverage. (Please see " Request for Comment: Expanding Recovery Rating Coverage And Enhancing Issue Ratings," published on Oct. 4, 2006, and " Request for Comment: Introduction Of Sovereign Recovery Ratings" on Dec. 6, 2006, on RatingsDirect.) We would like to thank the many market participants who provided insightful comments on our proposals.

The comments we received were generally very supportive of our proposals. In response to feedback, we anticipate making some modifications to our proposed scale and roll-out schedule. We expect to publish our new criteria for expanded and enhanced recovery ratings in May, followed by the introduction of recovery ratings on speculative-grade sovereigns. Recovery ratings on speculative-grade non-U.S. local and regional governments will be introduced in the second half of 2007.

The roll-out for the revised recovery ratings on speculative-grade industrial and financial service issuers is expected to be accomplished in three main steps:

1) May 2007: Revised recovery ratings on secured debt in the U.S., Canada, Europe, Australia, and South Africa will be published, along with a revised recovery rating scale. Related issue rating changes will be made, and an updated recovery and issue rating table will also be published. The Global Structured Finance CDO group will also update the criteria for using recovery ratings in CDOs based on the updated recovery ratings.

2) September 2007: Recovery ratings on unsecured debt will be published, and related issue rating changes will be made on speculative-grade issuers in the jurisdictions listed in (1), above.

3) By year-end 2007: Recovery ratings will be rolled out in selected additional jurisdictions, including emerging markets, on a market-specific basis. This roll-out is expected to continue into 2008 as we complete relevant insolvency regime and restructuring practice research on a country-by-country basis.

Proposal Summary

The highlights of our Oct. 4, 2006, proposal were the following:

Increased Recovery Analytics And Recovery Rating Coverage

We proposed extending recovery rating coverage to speculative-grade unsecured debt for industrial issuers and to speculative-grade secured and unsecured debt for financial service companies, sovereigns, and non-U.S. public finance entities. Currently, our recovery ratings cover entities in the U.S., Canada, Western Europe, and Australia, and South Africa. We proposed expanding recovery rating coverage globally, where insolvency regimes are reasonably well-established and where sufficient precedent and data exist for analysis. We indicated that, subject to market feedback, our intention was to roll out recovery ratings by sector and region by the end of 2007.

Standard & Poor's recovery ratings indicate, via a separate recovery scale, the range of expected ultimate recovery of principal in the event of a default. For sovereigns, we proposed using the same recovery rating scale, but to calculate recovery on a net-present-value basis.

Fundamental Issuer- And Instrument-Specific Recovery Analysis

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

Expanded Recovery Rating Scale

To accommodate the expansion of our recovery rating coverage, we proposed changes to our recovery rating scale and our approach to incorporating recovery prospects in issue ratings. We proposed making our recovery rating scale more detailed by introducing a 7-point scale ('1+' to '6') in place of our current 6-point scale ('1+' to '5'). This would allow us to show more recovery differentiation among issuers, particularly for those at the lower end of the scale ('4' to '6').

Enhanced Issue-Level Rating Framework

We proposed standardizing our approach to issue ratings by expressing a combination of default and recovery prospects. As we roll out recovery rating coverage by sector, we proposed arriving at issue ratings explicitly through an issue-level rating approach relative to the default rating, i.e., using the recovery rating to determine the rating movement relative to the issuer credit rating. We also proposed certain changes to our issue-rating framework to accommodate the addition of recovery ratings on unsecured debt. We noted that we would continue to place primary emphasis for the issue rating on likelihood of default, and it would be higher or lower than 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 proposed to "re-base" the issue rating around a central recovery tendency of approximately 50%. Therefore, issues with recovery rates significantly above 50% would be rated above the issuer credit rating, and those significantly below 50% would be rated below the issuer credit rating.

Comments Received

We received numerous comments through our outreach meetings with market participants in North America, Europe, Asia, and Latin America, and through e-mail responses. Common themes included the following:

Strong Support For Incremental Recovery Rating Analytics And Increased Recovery Rating Coverage

Speculative-grade industry participants who have been relying increasingly on Standard & Poor's in-depth, facility-specific recovery reports and recovery ratings on secured loan and bond issues welcomed the proposed extension of our recovery analysis throughout the capital structure.

Great Interest In Expanding Sector And Geographic Coverage

Our intention to extend recovery rating coverage to sovereigns generated significant interest from banks and capital market participants who focus on emerging markets, as well as from multilateral lenders. It was broadly accepted among these parties that a net-present-value approach to sovereign recovery is the most appropriate approach. Extension of recovery rating coverage to speculative-grade financial institutions also received significant interest.

There was marked interest in our proposal to expand geographic coverage of industrial recovery ratings beyond the countries covered to date. This was a result of continued growth in speculative-grade issuance globally and Basel

II-related initiatives among banks to increase focus on loss-given-default analysis. There is also increasing demand for recovery analytics generated by the collateralized debt obligations (CDO) market, especially following the October 2006 release of criteria specifying how recovery ratings can be used in CDO transactions.

Interest In Investment-Grade Issuers' Recovery Ratings

Several respondents expressed an interest in our extending recovery rating coverage to investment-grade issuers, especially to "cross-over" credits, i.e., those in the 'BBB' category. In particular, we heard this comment from banks and regulators, who, for Basel II-related purposes, require loss-given-default assessments for credits across the rating spectrum. We also heard this from capital market participants in countries or regions with a concentration of credit exposures in the 'BBB' category, as well as from investors exposed to non-U.S. local and regional governments.

Request To Compress Our Roll-Out Schedule

Several respondents asked if we could compress the proposed roll-out schedule to reduce market uncertainty and to ensure that comparable credits are assigned recovery ratings at approximately the same time.

Support For Fundamental Issuer- And Issue-Specific Recovery Analysis

Most respondents were very supportive of our fundamental approach to recovery analytics. Many speculative-grade investors noted that with growing complexity in both corporate organizational structure and instrument structure, it is increasingly difficult to predict recovery based on historical debt class averages or with actuarial models trained on such averages. This supports our notion of providing case-specific recovery analytics.

Our Proposed Change To The Recovery Scale And Related Issue Ratings Grid

We received a number of comments on the proposed scale calibration and related ratings grid. A few respondents requested a narrower "middle basket," that is, where issue ratings are not affected by recovery expectations. Others requested evenly calibrated distinctions between cases where issue ratings are raised based on recovery prospects versus those lowered based on recovery prospects. Still others questioned whether a recalibration of our recovery scale and issue rating approach would create uncertainty for market participants that had already benchmarked their approach on ours.

Transparency, Consistency, And Market Education Are Critical

Many respondents reminded us that transparency and consistency in our final proposal and related roll-out will be critical, along with clear communication and education for market participants on our revised approach.

A Preference For Enhanced Issue-Level Ratings Rather Than Expected Loss As The Methodology For Reflecting Recovery Analytics

Although some respondents found the expected-loss approach theoretically appealing, most preferred enhanced issue-level ratings as the more practical approach.

Recognition Of Fundamental Differences Among Certain Sectors In The Global Debt Markets

Respondents did not raise major concerns about this issue, while others specifically supported maintaining the different analytical approaches being applied to structured finance and U.S. public finance debt.

Standard & Poor's Preliminary Conclusions

Based on our review of the comments received, our preliminary conclusions are:

1) We plan to expand our recovery ratings while maintaining our fundamental analytical approach to recovery

analysis.

2) The first phase of expanded recovery rating coverage will apply to entities with speculative-grade issuer-level ratings, as originally proposed. However, given market interest in investment-grade coverage, we will continue to develop an appropriate approach to assigning recovery ratings on investment-grade-rated issuers in the future.

3) We plan to extend the sector coverage of recovery analysis beyond the industrial sector to include sovereigns, non-U.S. local and regional governments, and financial services.

4) We plan to extend the geographic coverage of recovery analysis, as noted in the schedule below.

5) There will be no immediate change to the analytical methodologies applied to structured finance or U.S. public finance ratings (both issuer and issue) connected with this initiative. Structured finance ratings will continue to include our consideration of recovery prospects of assets in rated pools, with no further adjustment made for potential differentiated recovery at the rated liability level.

6) We expect to modify the treatment of past-due "pre-petition" interest (i.e., interest accrued but unpaid at the time of default) in our recovery ratings. Until now, recovery ratings have indicated expected recovery of nominal principal. We have received requests from some market participants, particularly bank credit risk managers, to include past-due interest in our calculations. Our preliminary conclusion is that it would be beneficial to include such interest, and we plan to do so in conjunction with the introduction of the revised recovery scale. Based on our analysis of historical data, we expect to add six months of past-due interest to the principal amount as the basis for analyzing our expected recoveries.

7) Considering the comments we received, we expect to make some adjustments to the proposed recovery ranges and related issue-level rating criteria. For example, we are considering the revised table 1, shown below, compared with our October proposal, shown in table 2. Our original estimate in the October request for comment was that roughly 45% of our rated universe of secured debt with recovery ratings would experience a one-notch upgrade, and a portion of secured debt with a recovery rating of '5' could be downgraded. Because of the additional scale recalibration, we now expect additional rating changes compared with what we announced in our Oct. 4, 2006, proposal. There would also be a number of two-notch upgrades for secured debt near the upper end of the recovery range (where expected recovery is between 90% and 100%). However, the ultimate amount of rating changes will depend on the final rating scale and issue rating guidelines. We would also like to emphasize that any rating changes would be a reflection of the recalibration of issue rating guidelines, rather than any change in our view of the fundamental creditworthiness or default probability; there should be no changes in issuer credit ratings as a result of the recalibration or re-basing of the recovery rating scale.

Table 1

Proposed Revised Recovery Ratings, Ranges, And Issue Ratings

For speculative-grade issuers

Recovery rating	Description of recovery*	Recovery range (%)	Issue rating notches¶
1+	Highest expectation, full recovery	100	+3
1	Strong expectation, full recovery	90-100	+2
2	Substantial recovery	70-90	+1
3	Meaningful recovery	50-70	0
4	Average recovery	30-50	0

Table 1

Proposed Revised Recovery Ratings, Ranges, And Issue Ratings (cont.)			
5	Modest recovery	10-30	-1
6	Negligible recovery	0-10	-2

*Recovery of principal plus accrued and unpaid interest at the point of default. See also point 6 under the section "Standard & Poor's Preliminary Conclusions." ¶Indicates issue rating "notches" relative to Standard & Poor's issuer credit rating.

Table 2

From Oct. 4, 2006, Proposal: Recovery Ratings, Ranges, And Comparison Of Issue Ratings

For speculative-grade issuers

			Notches (+/-)	
Recovery rating	**Description**	**Recovery range**	**Existing rating criteria***	**Proposed criteria***
1+	Highest expectation, full recovery of principal	100%	+3	+3
1	Strong expectation, full recovery of principal	100%	+1-2	+2
2	Substantial recovery of principal	80%-100%	0	+1
3	Meaningful recovery of principal	50%-80%	¶	0
4	Average recovery of principal	30%-50%	¶	0
5	Modest recovery of principal	15%-30%	¶	-1
6	Negligible recovery of principal	0%-15%	¶	-2

*Indicates issue rating "notches" relative to Standard & Poor's issuer credit rating. ¶Current issue-rating rules are distinct for secured debt, which are one or two notches lower than the issuer rating when there are relatively lower expected recovery prospects for second-lien debt, compared with unsecured (or subordinated) debt, which can be one to two notches lower than the issuer rating based on relative position in bankruptcy. The current proposals would harmonize issue-rating rules for secured and unsecured debt.

Open Issues

As a result of the scale revisions under consideration, we continue to work toward finalizing the proposed recovery scale and related issue ratings grid. These will be announced as per the schedule below.

Next Steps

In response to requests to streamline the roll-out schedule, we expect to proceed according to the following timeline:

May 2007: Roll-Out Recovery To Speculative-Grade Sovereigns, And Apply Revised Scale To Speculative-Grade Secured Debt For Industrial And Finance Companies

- Publish final recovery rating scale and related issue rating guidelines;
- Launch sovereign recovery ratings;
- Publish revised recovery ratings and related issue rating changes on rated issues that currently have recovery ratings assigned under the previous recovery scale (these will be on industrials with secured debt in the U.S., Canada, Europe, Australia, and South Africa, and on finance companies with secured debt in the U.S.); and
- Publish updated recovery analysis methodology for industrials, including extension of recovery analysis throughout the capital structure for speculative-grade entities.

September 2007: Roll-Out To Speculative-Grade Unsecured Debt, Industrials, And Financial Services

- Publish recovery ratings and related issue rating changes on industrial and financial service companies and speculative-grade unsecured and subordinated debt in jurisdictions where recovery ratings were previously introduced (the U.S., Canada, major European jurisdictions, Australia, and South Africa).

By Year-End 2007

- Begin publishing recovery ratings and related issue rating changes, if applicable, for speculative-grade industrial and financial service companies in additional jurisdictions, including select emerging markets, following Standard & Poor's insolvency regime reviews and evaluation of historical recovery data. (For a list of the insolvency regime reviews conducted to-date, RatingsDirect subscribers can search by title, "Insolvency Regime.")
- Introduce non-U.S. local and regional government recovery ratings.