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Introducing Recovery Ratings In Mexico

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Introducing Recovery Ratings In Mexico

Like many other markets where Standard & Poor's Ratings Services has a presence, we believe that post-default principal recovery has become an important focus in Mexico's debt markets. The launch of our recovery ratings scale in Mexico represents a new stage in our efforts to keep ahead of Mexico's evolving debt markets. The ratings scale enables us to provide issue-specific recovery estimates for secured debt, and soon, unsecured debt.

The new initiative is supported by our recent review of Mexico's insolvency regime and our analysis of several debt restructures involving Mexican issuers in the international and domestic capital markets.

During the past few months, we have published a number of articles on our efforts to extend recovery ratings to specific debt instruments.

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

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 with the opportunity to deconstruct default and loss risks as rating components, and facilitate prevailing valuation and risk management disciplines in the credit markets. The introduction of this new methodology represents a meaningful transition in the ratings product.

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. Our recovery rating analysis for non-sovereigns generally compares the nominal value we expect at the end of the workout period or bankruptcy to exposure at default—principal plus accrued and unpaid interest at the point of default.

Based on our recent review of the Mexican insolvency regime and our analysis of several debt restructures involving Mexican issuers in the international and domestic capital markets, we have determined that we will be able to assign a recovery rating as high as '2' on our recovery scale.

Our recovery ratings, although informed by historical data 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, 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 the table below. The aforementioned scale will replace the traditional notching guidelines that we have been using for speculative-grade issuers in the Mexican market.

This process will be applied across the capital structure once the rollout is complete (i.e., secured, unsecured, and subordinated debt will be rated based on the issuer credit rating and recovery rating). In Mexico, we will begin with the rollout of secured debt and unsecured debt recovery ratings simultaneously with our efforts in other markets during the next few months.

Revised Recovery Ratings, Ranges, And Issue Ratings

Speculative-grade issuers			
Recovery rating	Description of recovery	Recovery range (%)	Issue rating notches*
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.

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 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, up to one notch in Mexico, 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.

In our analysis of selected post-default restructures in Mexico, we have observed nominal recoveries as high as 100% and as low as 40%. The weighted average of our sample, which is drawn from a pool of 30 senior unsecured- and secured-debt securities issued in Mexico and the international capital markets between 1993 and 2005, was about 76%. The average time between default and recovery was about two years.

Recovery ratings will not be applied to securitizations, including corporate securitizations or 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 many 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.

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 affected negatively by weak insolvency regimes.

In connection with its global assignment of recovery and issue ratings, we have assessed Mexico's insolvency regime as a Group B jurisdiction, based on the regime's relative degree of "creditor-friendliness" as defined in our report titled, "Jurisdiction-Specific Adjustments To Recovery And Issue Ratings," published July 5, 2007, on RatingsDirect.

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 lesser likelihood of default. We expect to assign recovery ratings to selected investment-grade issuers with secured debt obligations, as we have for some time on utility first-mortgage bonds in the U.S. Otherwise, we would assess instrument recovery based on class-level recovery assumptions and incorporate these in the issue rating. For example, investment-grade issuers' subordinated debt will generally continue to be rated one notch lower than the issuer credit rating. Given the introduction of our recovery ratings scale in Mexico, very well-secured debt could be rated higher than the issuer credit rating.

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