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Request For Comment: Expanding Recovery Rating Coverage And Enhancing Issue Ratings

(***Editor's Note:*** Standard & Poor's invites comments to be submitted via e-mail to: criteriacomments@standardandpoors.com. Comments should be submitted by Dec. 1, 2006. During the comment period, Standard & Poor's will be meeting with and inviting comments from key market segments affected by this review, including investment managers, risk management specialists, lenders, borrowers, bank and debt market regulators, and market intermediaries.)

Standard & Poor's Ratings Services is requesting comments on a proposal to expand global coverage of recovery ratings and analytics and to increase the weight of recovery prospects in issue ratings. We view this proposal as a natural evolution of the groundbreaking work we began in 2003 by rolling out recovery ratings for secured debt instruments of industrial speculative-grade issuers. Our traditional approach of using fundamental and quantitative analysis to assess the two main components of credit risk—default and recovery—will be expanded to cover secured, unsecured, and subordinated debt of speculative-grade (rated 'BB+' or below) industrial, financial services, sovereign, and non-U.S. public finance issuers. We propose that issue ratings for rated debt be based on a blend of default and recovery prospects, reflecting a revised "notching" framework (i.e., raising or lowering a specific issue rating from that of its issuer credit rating). Looking down the road—and using our expanded experience with recovery ratings such as we are proposing—we may move toward a more explicit and quantifiable "expected loss" approach to issue ratings.

Our current proposal for expanding coverage of recovery ratings is in response to the market's broad acceptance of our over 1,600 recovery ratings in place today, its increasing focus on post-default recovery prospects, and its demand for greater clarity and specificity with respect to recovery prospects on different debt instruments of all types of issuers globally.

By providing a default indicator, a recovery indicator, and a blended issue rating, our intent is to enhance ratings transparency, provide market participants the opportunity to deconstruct the risk of default and loss as components of the rating, and facilitate prevailing valuation and risk management disciplines in use in the credit markets. The introduction of the proposed methodology represents a meaningful transition in the ratings product. Consistent with our larger transparency initiative, we encourage market participants to review these potential changes and invite feedback to the specific questions posed or other issues raised by these proposed adjustments.

Proposal Summary

Key elements of our proposal:

Increased recovery analytics and recovery rating coverage. We propose extending recovery rating coverage to speculative-grade unsecured debt for industrials, and to speculative-grade secured and unsecured debt for financial services companies, sovereigns, and non-U.S. public finance entities. Currently, our recovery ratings cover issuers in developed markets, including the U.S., Canada, Western Europe, and Australia. We propose to expand recovery rating coverage globally, where insolvency regimes are reasonably well established and where sufficient precedent and data exist for analysis. Subject to market feedback, we intend to roll out recovery ratings by sector and region over 12-18 months following the comment period.

- ***Fundamental issuer and instrument-specific recovery analysis.*** Standard & Poor's recovery ratings indicate, via a separate scale, the range of expected ultimate recovery of principal post default. A recovery rating is informed by our proprietary LossStats database showing historical average recovery experience, but is determined primarily on a fundamental issuer and instrument-specific, scenario-based, recovery analysis.
- ***Expanded recovery rating scale.*** To accommodate the expansion of recovery rating coverage, we propose changing our recovery rating scale and our notching framework for issue ratings. We would make our recovery rating scale more granular, introducing a 7-point scale (1+ to 6) in place of our current 6-point scale (1+ to 5). This will allow us to show more recovery differentiation, particularly at the lower end of the scale.
- ***Enhanced notching framework.*** We propose standardizing our approach to issue ratings so that they reflect a combination of default and recovery prospects. As we roll out recovery rating coverage by sector, we would explicitly arrive at debt ratings through a notching approach relative to the default rating, using the recovery rating to determine the amount of up- or down-notching from the issuer credit rating (ICR). We propose certain changes to our current notching framework to accommodate the addition of unsecured debt, as described in detail below.

These initiatives, taken together, would move Standard & Poor's closer to an expected loss approach for corporate ratings. However, the proposed notching framework will intentionally keep issue level ratings closer to the default rating (i.e., issuer credit rating) than a pure expected loss framework. We believe many investors are not indifferent to default, regardless of recovery prospects. As we continue to expand our global coverage of recovery analytics, and market participants develop more familiarity and comfort with recovery/loss given default as a key factor weighted in overall creditworthiness, we would evaluate whether issue ratings should evolve even closer to an expected loss approach.

Under an expected loss framework, Standard & Poor's would continue to provide a probability of default indicator (issuer rating) for all entities. In addition, for speculative-grade entities (rated 'BB+' or below), each issue would be assigned both a recovery rating and an issue rating that is based on a mathematical blend of the default probability associated with a given rating and the expected recovery prospects for a given issue. For example, the issue rating could be determined by multiplying the probability of default (%, based on historical default rate averages for the given ICR) times loss given default (1 – recovery), and mapping the results to a published expected loss table (see Appendix: Expected Loss Approach To Issue Ratings: An Illustration, for a description of what an expected loss approach might resemble).

The use of notching to account for issue-level recovery prospects generally has not been applied to Structured Finance or U.S. Public Finance ratings, and is not currently contemplated under this proposal. However, we request market comment on this topic (see section "Standard & Poor's Seeks Comment On Key Issues").

Background: Recovery And Issue Ratings

Recently, debt markets have increasingly focused on post-default recovery while historically it was often a secondary consideration in credit. Several factors—from Basel II and other risk management regimes to the continuing growth of collateralized debt obligation and credit default swap markets—have combined to expand market focus on decomposing credit into its key components, in particular default and recovery.

In recognition of this market focus, Standard & Poor's has for some time defined its issuer ratings, in particular for financial and non-financial issuer ratings, as estimates of issuer default risk. On issue ratings, we have a longstanding approach of notching issue ratings up or down from the ICR dependent upon the presence of security and relative position in bankruptcy. Since December 2003, we have estimated recovery risk in our secured bank loan recovery ratings and incorporated rating credit for recovery prospects based on this analysis. Expanded work by Standard & Poor's on specific recovery and default estimates has prompted an overall review of issue-level ratings with a focus on how they should best incorporate default and recovery components of credit. We believe this is a complex issue with potential implications for many debt market participants.

The role of our issue-level ratings is to provide instrument holders with transparent estimates of the instrument level credit risk, testable against historical and current data on default and relative loss experience. Standard & Poor's recognizes that there are alternative ways to define this risk, but we believe that market participants are best served by relatively standard and transparent measures of instrument level risk, which can be tested against clear performance data.

Corporate issue-level credit ratings are based on several factors, including likelihood of payment, nature of and provisions of the obligation, and protection or disadvantage from relative position of the obligation in the event of bankruptcy or reorganization. For example, for corporate debt, we have noted that issue ratings are a blend of default risk and the recovery prospects associated with the specific debt being rated.

The use of notching to account for issue-level recovery prospects generally has not been applied to Structured Finance ratings. These ratings incorporate an analysis of the expected default frequency and loss severity of the underlying asset pool, and as a result can incorporate analysis of potential loss exposure. However, current criteria prioritize the assessment of default risk in the ratings, primarily through the focus on first dollar payment risk under stress testing of cash flows or asset performance. For example, the ratings do not differentiate between different debt tranches within the same structure that have the same default probability but different expected loss prospects, due to differences in their size or relative seniority within the capital structure. In other words, the ratings do not incorporate a view on recovery prospects if the stress-case scenario is exceeded and the security defaults.

Recovery Ratings And An Enhanced Issue-Level Notching Framework

We first note that the proposal, similar to our current methodology, would intend to provide an indicator of likelihood of default through the ICR. We would also, for speculative-grade issuers (whose ICR is 'BB+' or below), provide an indicator of recovery for individual debt instruments, through our recovery ratings. Our recovery ratings employ fundamental recovery analysis, based on an issuer- and instrument-specific scenario. We intend to slightly modify our current recovery scale for secured ratings to move to a 7-point scale ('1+' to '6') and to extend recovery ratings to encompass secured, unsecured, and subordinated debt for industrial, financial services, and sovereign issuers. The rollout is expected to occur by sector and region over the next 12 to 18 months where insolvency regimes are reasonably well established and where sufficient precedent and data exist for analysis.

Simultaneous with this expanded coverage, we will increasingly give additional weight to absolute, as opposed to relative, recovery prospects in issue ratings through a revision in our notching criteria. Standard & Poor's would continue to place primary emphasis for the issue rating on likelihood of default, and it would be notched up or down from the ICR 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 would revise the notching criteria in line with our expectations to extend recovery analytics to unsecured ratings, to "re-base" up and down notching around a central recovery tendency of approximately 50%. Therefore, issues with recovery rates significantly above 50% would be notched up, and those significantly below 50% notched down. Table 1 below shows our proposed recovery rating scale and updated notching criteria.

For investment-grade issuers (rated 'BBB-' or higher), it is more difficult to predict a path to default and, therefore, to perform a scenario-based recovery analysis. We believe there is also less market interest in such analysis given the lower likelihood of default. Consequently, Standard & Poor's proposes generally not to provide recovery ratings for these issuers, though we would assess instrument recovery based on class-level recovery assumptions, and continue to allow for moderate notching from the issue-level rating based on these class-level assumptions. For example, subordinated debt will generally continue to be notched down one notch from the ICR.

Very-well secured debt could be notched up from the ICR. For example, first mortgage bonds of investment-grade utilities can be up to two notches above the ICR.

The proposed revised notching for speculative-grade issuers, while shifting the rating focus to instrument-specific recovery prospects, would retain key accepted market benchmarks:

- Unsecured debt would typically be rated at the ICR level, unless recovery prospects for principal are deemed worse than 30% or better than 80%. Similar to today's framework, down notching for unsecured debt would typically occur when debt is significantly "subordinated" by the presence of contractually or structurally senior creditor layers.
- Senior secured debt with superior recovery prospects would be rated higher than the ICR.
- Subordinated debt, with typically poor recovery prospects, would generally be rated lower than the ICR.

The revisions represent a next phase in our intermediate-term objective of orienting issue ratings and analysis to include more information on expected loss and its principal subcomponents, default and recovery prospects.

Table 1

Recovery Ratings And Proposed Issue-Rating Notching Criteria

Recovery Rating	*Recovery description*	*Recovery range**	*Existing notching criteria*	*Updated notching criteria*
			Speculative grade	Speculative grade
1+	Highest expectation, full recovery of principal	100%+	+3 notches	+3 notches
1	Strong expectation, full recovery of principal	100%	+1-2 notches	+2 notches
2	Substantial recovery of principal	80%-100%	0 notches	+1 notch
3	Meaningful recovery of principal	50%-80%	**	0 notches
4	Average recovery of principal	30%-50%	**	0 notches
5	Modest recovery of principal	15%-30%	**	-1 notch
6	Negligible recovery of principal	0%-15%	**	-2 notches

*Recovery defined as ultimate recovery of principal amount within two to three years from default. The '1+' recovery rating is assigned to differentiate unusually-well-protected issues wherein a combination of factors—collateral quality, coverage ratio, deal structure, among others—increase the overall likelihood of full recovery, even compared to other issues on which full recovery is expected. **Current notching-down rules are distinct for secured debt, where we notch down one to two notches for relatively lower expected recovery prospects for second lien debt, compared to unsecured (or subordinated) debt, where we notch down one to two notches based on relative position in bankruptcy. The current proposal would harmonize notching rules for secured and unsecured debt.

Benefits Of The Enhanced Notching Approach And Implications For Corporate Ratings

The proposed enhanced notching for recovery methodology would:

Provide separate indicators for default and recovery, and a transparent methodology for combining these two in issue ratings;

- Maintain a primary emphasis on default and increase the emphasis on recovery compared to current practice;
- Lead to moderate rating changes upon initial implementation;
- Not affect default studies that are currently conducted with reference to issuer level ratings; and
- Where likelihood of default at the instrument level is different from that indicated by the ICR, we would continue to increase notching to reflect additional non-payment prospects. An example of this is when a coupon deferral option indicates a higher likelihood of default on the issue than for other debt of the issuer.

The notching proposal is intended to apply to traditional secured, unsecured, and subordinated debt. As noted above, the proposal would not apply to securitizations, including corporate securitizations, equipment-trusts, and covered bonds, all of which would continue to be rated based on asset-specific criteria.

We expect modest rating changes as a result of implementing the notching criteria revisions. However, certain securities would be affected.

Speculative-grade secured debt

Based on a preliminary review of our existing recovery ratings on speculative-grade secured debt ratings of industrial issuers, we anticipate that debt issues with recovery ratings of '1' or '2' would be upgraded by one notch. These account for roughly 45% of our rated universe of about 1,600 issues that currently have recovery ratings. A portion of secured debt with a current recovery rating of '5' could be downgraded. (Currently, debt secured by second liens, with a '5' recovery rating, is already notched down, but senior secured debt with a '5' recovery rating is typically not yet notched down from the ICR and would likely be notched down under the proposed framework.)

Speculative-grade unsecured debt

We expect most unsecured debt would continue to be rated equal to the ICR. However, there could be some upgrades for unsecured debt with superior recovery prospects, and some downgrades for unsecured debt with poor recovery prospects, but we would expect a small and balanced number of such rating changes.

Speculative-grade subordinated debt

Under the proposed framework, in place of notching for subordination, speculative-grade subordinated debt would be notched from the ICR based on instrument-specific recovery prospects. This could result in some upgrades or downgrades from current issue-rating levels, depending on issuer- and instrument-specific characteristics. We expect that most subordinated debt of speculative-grade issuers would receive a recovery rating of '6' on the revised scale (0%-15% recovery of principal post default), which would imply a rating of two notches down from the ICR, similar to the two-notch cut these instruments currently receive for subordination.

Implications For Emerging Market Debt

For issuers in markets with very poor expected recoveries, due to creditor-hostile insolvency regimes and/or poor enforcement, such that creditors generally could not expect to recover 30% or more of principal post default, we would expect this approach to result in issue rating downgrades.

Implications For Preferred Stock And Equity Hybrids

Current Standard & Poor's methodology is to notch down ratings for preferred stock and equity hybrids from the ICR, based on (a) subordination and (b) interest or dividend deferral characteristics. Under the proposed framework, in place of notching for subordination, speculative-grade preferred stock and equity hybrids would be notched down based on instrument-specific recovery prospects. However, we expect few rating changes based on this shift. We expect that most such instruments of speculative-grade issuers would receive a recovery rating of '6' on the revised scale (0%-15% recovery of principal post default), which would imply two notches, similar to the current two-notch cut these instruments receive for subordination. We also expect to continue to notch additionally for deferral characteristics. Market feedback is solicited on this and other implementation issues of the proposed notching framework.

Implications For Collateralized Debt Obligations (CDOs)

Standard & Poor's does not expect that the extension of recovery analysis to unsecured debt and the revised notching framework would have a direct impact on CDO analytical methodology or on CDO ratings. Under our current CDO methodology, we consider the default probability and recovery expectations for each individual asset in the rated pool, such that a change in the issue rating on a given security would not affect a CDO holding that security. In "Request for Comment: Refinement Of Global CDO Cash Flow Modeling Assumptions," (published on June 19, 2006, on RatingsDirect) we put forward a proposal that would incorporate Standard & Poor's recovery ratings as the source of recovery estimates for CDO purposes. In this way, CDO managers would benefit directly from our growing recovery analytics coverage. Standard & Poor's expects to release a separate commentary on the use of recovery ratings in cash-flow CDOs.

Standard & Poor's Seeks Comment On Key Issues

Industrial, utility, financial services, and sovereign ratings, and public finance

1. What are your views on incorporating absolute recovery more fully into issue ratings through a revision in Standard & Poor's notching criteria?
2. Do you have comments on the proposed approach, versus a more direct and immediate move to an expected loss framework?
3. What are your views of Standard & Poor's proposal to extend its recovery ratings and analytics from the current coverage of only secured debt for speculative-grade industrial issuers to the wider universe of secured, unsecured, and subordinated debt for industrial, utility, financial services, sovereign, and non-U.S. public finance issuers? Should recovery ratings and related notching framework also be applied to all investment-grade issuers?
4. Do you have comments on the 7-point recovery rating scale ('1+' to '6')?
5. What are your views on Standard & Poor's proposed phased rollout plan for recovery ratings and revised notching guidelines? What other implications of the proposal should Standard & Poor's consider in implementation?
6. Do you have comments on the proposed application to preferred stock and equity hybrids?
7. Do you have comments on our proposal for emerging markets that issue ratings would incorporate absolute recovery prospects only in regions where bankruptcy/insolvency regimes are well developed and appropriate historical recovery is available?
8. Will the proposal affect how ratings will be used for regulatory purposes and investment guidelines?
9. Is there a market need for recovery analytics for public finance issuers in the U.S. or outside the U.S.?
10. Standard & Poor's considered various alternative approaches to meet the market's need for more information with respect to recovery. We would appreciate your views and comments on these alternatives, which included:
    a) Expanding recovery rating coverage, but keeping our current approach to notching (up-notching for full principal recovery prospects, down-notching for position in bankruptcy);
    b) Expanding recovery rating coverage, but providing only a default and recovery indicator for each issue rating and not combining them into a single rating at the issue level. This approach would eliminate notching for issue-level ratings altogether, by setting all issue ratings equal to the issuer credit ratings, and providing a separate recovery rating for each issue. What are your thoughts on this alternative?

Structured finance ratings

1. If we decide that industrial, utility, financial services, and sovereign ratings are to combine default and recovery risk in issue-level ratings, would it be acceptable for structured finance ratings to continue to only address default probability/first dollar of loss on the rated instrument?
2. For structured finance ratings, should Standard & Poor's develop an issue-level expected loss rating that combines both probability of default and recovery/loss given default to replace the existing default-based ratings?
3. If so, to what extent would the resulting rating changes be disruptive to or otherwise problematic for the marketplace?

4. Alternatively, should Standard & Poor's develop an issue-level structured finance recovery rating, similar to what we are currently providing for secured industrial debt issues, but not develop an expected loss rating? Or should recovery, loss given default, and/or expected loss analytics be developed to complement but not replace the existing default-based ratings framework?
5. Which structured finance asset classes (ABS, RMBS, CMBS, or CDOs), if any, should Standard & Poor's prioritize when developing its recovery/expected loss analytics?

Next Steps

During the two-month comment period ending Dec. 1, 2006, Standard & Poor's will be meeting with various market participants in addition to reviewing comments received via e-mail. After that time, we will publish a final methodology for combining default and recovery prospects in issue-level ratings, which we would expect to begin implementing by year-end. The rollout would begin first with secured industrial debt issues, where we have been using recovery ratings for some time. From there, we would proceed with unsecured industrial ratings, first for developed markets as we provide recovery ratings: U.S., Canada, Western Europe, and Australia. We plan to roll out coverage to other sectors and geographic regions where market interest is significant, including for sovereigns, non-U.S. public finance, and financial services companies, within 12-18 months from the time we finalize our proposal.

Standard & Poor's welcomes market comment on any of the various topics covered in this paper, and in particular on the questions raised above. Kindly send your comments via e-mail by Dec. 1, 2006, to: criteriacomments@standardandpoors.com

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Appendix: Expected Loss Approach To Issue Ratings: An Illustration

In order to facilitate discussion with market participants, we are providing the following hypothetical illustration. Although Standard & Poor's is not proposing moving to an expected loss approach at this time, we are interested in market views if we were to consider such a move.

In an expected loss approach, Standard & Poor's would continue to provide a probability of default indicator (issuer credit rating) for all entities. In addition, for speculative-grade entities (rated 'BB+' or below), each issue would be assigned both a recovery rating and an issue rating that is based on a blend of default and recovery. The main difference from the proposed notching approach, is that under an expected loss approach, this issue rating would be determined by a mathematical blend of the default and recovery characteristics of a given debt issue, in place of notching up or down from the issuer credit rating.

For a simplified example, expected loss could be arrived at by multiplying the probability of default (%, based on historical default rate averages for the given issuer credit rating) times loss given default (1 – recovery), and mapping the results to a published expected loss table (see table 2).

For example, assume Corporation X is rated with a 'BB' ICR and has issued a secured loan, which is given a recovery rating of '2' (recovery range: 80%-100% principal recovery). The probability of default (PD) associated with a 'BB' ICR might be considered to be 10.4% based on table 2. The secured loan would have an expected loss of 2.08%, based on multiplying the PD of 10.4% times the expected loss given default (20%, or the equivalent of (1-80%) expected recovery). From table 2, this would map closest to a 'BBB-' rating, and therefore, the secured loan would be rated 'BBB-'. (Per table 2, 'BBB-' ratings have an expected loss of 2.59%, vs. 1.16% for 'BBB'.)

Table 2

Average Expected Loss Levels

Rating	Probability Of Default	Loss Given Default	Expected Loss
BBB+	1.391	0.5	0.696
BBB	2.323	0.5	1.162
BBB-	5.179	0.5	2.59
BB+	7.02	0.5	3.51
BB	10.424	0.5	5.212
BB-	14.595	0.5	7.298
B+	18.571	0.5	9.286
B	24.463	0.5	12.232
B-	34.333	0.5	17.167
CCC+	55.809	0.5	27.905
CCC	70.042	0.5	35.021
CCC-	85.513	0.5	42.757

The probability of default data points used here are for illustration purposes only, and are based on idealized historical 5-year cumulative corporate default rates, as used in Standard & Poor's CDO Evaluator 3.2. The loss given default data point of 50% chosen here to define a typical issue rating—again, for illustration purposes only—is based on the mean historical recovery rates across all debt types, as drawn from our LossStats database. The issue rating effect is somewhat similar to our proposed notching framework: instruments with recovery prospects well above 50% would tend to be notched up from the ICR, and instruments with recovery prospects well below 50% would tend to be notched down from the ICR.

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