

Criteria:

Request For Comment: Framework For Rating Notes Linked To Non-Interest-Rate References

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The growing volume and increasing complexity of debt market instruments issued by financial institutions, as well as the potential for market misunderstanding of the terms of these instruments, have led Standard & Poor's Ratings Services to review its approach to rating notes linked to non-interest-rate references. This is all the more pressing in light of the recent and severe debt market turbulence, which has increased demand for clarity in disclosure, including on credit ratings. Standard & Poor's is reviewing ways to enhance the transparency of issue credit ratings, particularly in investment guidelines that refer to credit ratings. We seek comments from market participants on alternatives that may provide greater transparency regarding the risks of these types of instruments.

Introduction

Financial institutions, particularly the 30 largest global investment and commercial banks, issue a huge volume and wide variety of securities from multi-purpose issuance programs. Standard & Poor's rates financial institutions' issuance programs generally, and then assigns ratings to specific issues of the rated programs at the time of sale. The majority of issues from such programs have conventional debt market repayment terms: periodic interest payments that are fixed or floating based on a reference rate, with principal repayment at par at maturity. The credit and interest rate risk of these traditional debt instruments are relatively straightforward.

In contrast, a growing volume of issues consists of more complex notes whose interest payment and/or principal repayments are linked to the price or value of a reference security, fund, or index--for example, an underlying equity, currency, bond fund, commodity price, or market index. Sometimes the payments are linked to baskets of any of the above. In some cases, the principal repayment is conventional (or guaranteed) and only the interest payments are linked to a market reference. Financial institutions often fashion tailor-made notes with market reference links to meet the unique risk/return needs of a single investor or group of investors. We refer to notes with interest payment and/or principal repayment linked to market references other than benchmark interest rates as market-linked notes, or MLNs for short. MLNs issued through financial institutions' multi-purpose issuance programs are general obligations of the issuing institution. Although this article refers mainly to financial institutions, MLNs may be issued by sovereign and corporate entities as well.

Proposal Summary

This request for comment revisits the decision Standard & Poor's made in 2000 to withdraw the 'r' qualifier from MLN ratings. Market developments since then have led us to consider the following three alternatives to underscore the meaning of our MLN ratings and enhance transparency regarding the credit and market risks inherent in MLNs.

Alternative 1

Reinstitute the 'r' qualifier on newly issued MLNs that have a variable return of principal due to a market reference. The 'r' qualifier would signal the volatility of principal as a significant market risk.

Alternative 2

Reinstitute the 'r' qualifier on all newly issued MLNs that have principal and/or periodic coupon payments linked to a market price or value. The 'r' would signal the volatility of total return as a significant market risk.

Alternative 3

No longer assign credit ratings to MLNs with principal repayment or interest payments linked to a market price or value reference.

The fourth option is to continue with the status quo, that is, to rate MLNs according to the terms of the instrument, irrespective of the market risk embedded in the terms, with no differentiating marker such as the 'r' qualifier.

Consistent with our recent leadership actions (see "Detailed Descriptions Of S&P's New Actions Aimed At Strengthening The Ratings Process," published Feb. 7, 2008, on RatingsDirect), we are reviewing ways to supplement our ratings analysis by providing opinions on debt instruments' potential volatility, liquidity, and post-default recovery. The three alternatives under review to enhance transparency on MLN ratings do not preclude any supplemental indicators of these factors. The 'r' qualifier is a simple marker that signals the presence of market risks--defined as risks other than interest rate and credit risks--that are not covered in the credit rating. The 'r' qualifier does not, however, measure the market risk in any way. Supplementary opinions addressing volatility, liquidity, or recovery prospects would complement the alternatives we present in this request for comment.

Ratings Impact

Examples of the ratings impact of alternatives 1 to 3 appear below (see "MLN Examples Illustrate Possible Ratings Impact"). The implementation of alternative 1, 2, or 3 would not change the credit ratings on any outstanding issues. The impact of alternatives 1 and 2 going forward would be the application of the 'r' qualifier to the ratings of newly issued MLNs. The impact of alternative 3 going forward would be the absence of issue ratings on newly issued MLNs.

Response Deadline

Standard & Poor's seeks market input on the benefits, concerns, and implications of the three alternatives under review, as well as the fourth option of continuing our current approach. Please submit your comments on any aspect of this proposal through July 31, 2008, to criteriacomments@standardandpoors.com. You may also contact the analysts listed in this article.

Current Rating Practice In Place Since 1994

The holders of MLNs bear two broad types of risk:

- The credit risk of the issuing institution, and
- The market risk of change in the price or value of the reference link (the underlying security, index, currency, or commodity).

Standard & Poor's current practice, in place since 1994, is to rate general obligation MLNs based on the likelihood that interest and principal payments will be made according to the terms of the instrument ("rate to terms"),

irrespective of the market risk embedded in the terms. Consequently, the issue ratings on a financial institution's senior unsecured MLNs typically are the same as the credit rating on the issuer (called an Issuer Credit Rating, or ICR) and the same as the issue rating on the issuer's traditional senior unsecured debt instruments. The issue rating of a general obligation MLN does not reflect the market risk of the instrument. The issue rating on an MLN reflects the credit risk inherent in the issuer's promise to pay, but not the potential volatility of payments due to market risk.

We typically assign ratings to issues even when the market reference links are complex, and/or if they dominate the risk profile of the issue. Indeed, the secondary market valuation of an MLN may fluctuate substantially based on the movement of the reference index or market price. MLNs with the same credit rating and comparable credit risk may have substantially different market risk, depending on their terms.

Greater Need For Transparency

We are reviewing our practice of rating MLNs "to terms" due to the increasing complexity and growing volume of issuance of these type of notes issued as general obligations of financial institutions. We reinforce our message that issue credit ratings on financial institutions' general obligations do not reflect the market risk embedded in the terms. The severe turbulence in global debt markets since the summer of 2007 draws even greater attention to demands for clarity in disclosure, including for credit ratings. We are reviewing ways to enhance the transparency of issue credit ratings particularly investment guidelines that refer to credit ratings. For example, a rated market-linked general obligation note that was in substance an equity derivative could be misclassified as debt because it carried a credit rating.

In the 1980s, when MLNs began to appear in appreciable volumes in the marketplace, Standard & Poor's required at least minimum terms to assign ratings. Initially, we required a minimum interest rate and return of principal. In 1994, we broadened the terms we accepted and introduced an 'r' qualifier to MLN ratings to signal the presence of "nontraditional" (non-interest-rate) market risk in the instruments' terms. The intention of the 'r' qualifier was to alert market participants to both the presence of non-interest-rate market risk and the specific scope of our issue credit rating. At the same time, the introduction of the 'r' in 1994 allowed us to accommodate more diverse terms in rated MLNs. Standard & Poor's discontinued the use of the 'r' in 2000, when consultation with market participants indicated that the risks of MLNs were well understood and disclosed, and that the 'r' was not a material factor in investment guidelines or the risk assessment process.

Cases Where The Issuer Credit Rating Is Not Assigned

Standard & Poor's deviates from the "rate to terms" policy and does not assign the ICR on the issuer to general obligation MLNs when:

- A material amount of credit risk is embedded in the terms of the issue,
- The terms of the note are unclear, in particular regarding the reference market link, or
- The terms are self referencing (in other words, the reference link is the share price of the issuing entity).

Embedded credit risk

When a general obligation MLN has a material amount of credit risk embedded in its terms or structure, we do not automatically assign the credit rating on the issuer to the issue. If the amount of interest or principal to be repaid is directly dependent on credit risk, we reflect that credit risk in the issue rating.

The most frequent credit reference link is the debt security of a third party. Market convention is to refer to this type of instrument as a credit-linked note (CLN). We assign to a single-reference CLN the lower of the ICR on the issuer and the credit rating on the referenced security. An example of a single-reference CLN is a bank general obligation whose interest payments and principal repayment are linked to the performance of the bonds of an emerging market government, such as Brazil. When the CLN is linked to multiple credits, such as a basket of debt securities, we typically apply structured finance analytics to assess the credit risk of the link.

Some general obligation MLNs have embedded third-party credit risk as a result of a hedge position of the MLN. We usually view the hedge positions in these cases as representing immaterial credit risk to noteholders. An example is a four-year general obligation note issued by a global banking group denominated in Australian dollars. The note's return is based on the performance of a basket of 25 Asian equities managed actively according to the terms of the note. The equities are denominated in several Asian currencies such as the New Taiwan dollar and Korean won. The issuer enters into contracts with counterparties to hedge the equity and currency risks of the basket. If defined hedging disruption events--including the default of a hedging counterparty--occur, then the issuer has the right to pass along the increased cost of hedging to the noteholder, according to the terms of the note. We rate this MLN to terms--the issue rating is the same as the ICR on the issuer. The MLN in this example clearly has a high degree of market risk; specifically, equity and currency risk. In this case, we consider the hedges as part of the market risk of the terms.

Most issuers of general obligation MLNs are rated financial institutions. The ICRs of these institutions reflect their capacity and willingness to honor their financial obligations. From an analytical perspective, the ICRs reflect commercial and financial strengths, and also necessarily take into account the capacity of the entities to operate competently their business lines, including the investment banking and asset management lines most directly involved in the issuance and administration of general obligation MLNs. While the ICR does not specifically address professional responsibility, we expect a high degree of professionalism from rated financial institutions active in the business lines cited above. This general approach to issuer ratings underpins our ratings on issues, including general obligation MLNs.

When the reference fund price or index value in an MLN is transparent and clearly defined, Standard & Poor's typically views the reference as a market link, even when the reference is a bond fund or a bond or credit derivative index. If the price of the fund or the bond index is transparent and clearly defined, then we typically consider that the amount to be paid (which fluctuates with movements in the price or index) is a market risk outside the scope of the credit analysis of the general obligation MLN in question. In this case, the MLN rating reflects our opinion on the promise to pay (credit risk), but not the amount to be paid (market risk).

Unclear terms

When we rate general obligation MLNs issued by financial institutions, we expect them to adhere to minimum standards of disclosure. The terms of the MLN should be clearly displayed and not subject to material arbitrary modification by the issuer. The reference link also needs to be disclosed clearly in the prospectus or offering memorandum. The standard financial industry practice for MLNs is to include in the offering memorandum a prominent notification of the degree of market risk and potential of volatility in payments. We support this practice, particularly in retail placements and in less mature parts of the capital markets. While we anticipate adequate disclosure of market risks, we fully expect issuers and investors mutually to understand the nature and terms of all instruments, including MLNs.

Self-referencing market links

When the reference link of a general obligation MLN is a security of the issuer itself, we do not automatically assign the issuer's senior credit rating to the issue.

One example is a security whose reference link is the issuer's share price at a future date. Our policy in this case is to assign to the issue the same rating that we would assign to the issuer's preferred shares. While this approach does not capture perfectly the credit risk of the reference security, it serves to differentiate the risk of equity securities from the debt securities of the same issuer.

Calculation Agents And Market Disruption Events

Certain general obligation MLNs of financial institutions include provisions that allow the issuer, or the calculating agent, to change the calculation or valuation of the reference index, and, consequently, the payment terms of the MLN under defined circumstances. We assume good faith with respect to the activities of the calculation agent, including when the agent is in the same corporate group as the issuer. We generally do not consider the services provided by the calculation agent as a source of market or credit risk in the issue ratings on financial institutions' general obligation MLNs.

As stated above, we assume a high degree of professionalism on the part of rated financial institutions active in the issuance and administration of general obligation MLNs. This general approach to issuer ratings serves to offset concerns that an issuer would abuse its responsibilities as calculation agent to manipulate the returns in a manner counter to the investor's interests.

Standard & Poor's does not view a market disruption event (MDE) that results in a payment delay of 30 days or less as a default event for our ratings on financial institutions' general obligation MLNs. MDE covenants allow for the issuer or calculation agent to delay payment when unable to determine the price or value of the reference link. We view the existence of MDE covenants as a sensible market practice equivalent to payment grace periods for traditional notes and programs.

Examples Illustrate Possible Ratings Impact

The following examples of hypothetical MLNs illustrate our current policy and indicate the treatment under the proposal's three alternatives.

Fixed interest rate, repayment of principal linked to equity index

Investment bank V, with an 'A+' ICR and senior debt rating, issues a general obligation MLN out of its structured note program. The note has quarterly fixed interest payments while the amount of principal repayment at maturity is linked to the S&P 500. We would now rate the note 'A+', reflecting the investment bank's promise to pay interest and principal, but not reflecting the potential volatility of principal repayment. Under alternatives 1 and 2, we would rate this note 'A+r'. Under alternative 3, we would not rate it.

Interest and repayment of principal linked to equity index

Investment bank W, with an 'A+' ICR and senior debt rating, issues a general obligation MLN out of its structured note program. The note's quarterly interest payments and principal repayment at maturity are linked to the S&P 500. We would now rate the note 'A+', reflecting the investment bank's promise to pay interest and principal, but

not reflecting the potential volatility of repayments. Under alternatives 1 and 2, we would rate this note 'A+r'. Under alternative 3, we would not rate it.

Interest linked to equity index, repayment of principal guaranteed by issuer

Investment bank X, with an 'A+' ICR and senior debt rating, issues a general obligation MLN out of its structured note program. The note's quarterly interest payments are linked to the S&P 500. The principal repayment at maturity is guaranteed by the issuer. We would now rate the note 'A+', reflecting the investment bank's promise to pay interest and principal, but not reflecting the potential volatility of the interest payments. Under alternative 1 we would rate this note 'A+'. Under alternative 2 we would rate it 'A+r'. Under alternative 3, we would not rate it.

Variable interest rate, principal payment linked to commodity price

Commercial bank Y, with a 'AA' ICR and senior debt rating, issues a general obligation MLN with a variable interest rate based on LIBOR. The principal repayment is linked to the price of a specific gold contract traded on the New York Mercantile Exchange. We would now rate the note 'AA', reflecting the bank's promise to pay, but not reflecting the potential volatility of payment. Under alternatives 1 and 2, we would rate this note 'AAr'. Under alternative 3, we would not rate it.

Principal repayment linked to a range of currency values

Commercial bank Z, with a 'AA' ICR and senior debt rating, issues euro bonds with fixed interest payments and principal repayment linked to the Russian ruble (RUR) within a range. At the time of issuance, the exchange rate is RUR35 to €1. At maturity, Commercial bank Y promises to repay a minimum of €900 per bond if the exchange rate is RUR40 or more to €1 and up to €1,100 if the exchange rate is RUR30 or less to €1. We would now rate the bond 'AA', reflecting the bank's promise to pay, but not reflecting the potential volatility of payment. Under alternatives 1 and 2, we would rate this note 'AAr'. Under alternative 3, we would not rate it.

The Structured Finance Approach Differs From That For Financial Institutions

Structured financings (and notes in structured financings) that Standard & Poor's structured finance group rates also may have market risk references. But the structured finance group's ratings approach differs from that of the financial institutions group.

"Structured" MLNs take two basic forms:

- Structured credit notes issued by a financial institution whose promised payments are a general obligation of the financial institution, and
- Notes issued by a special-purpose entity (SPE) that have no recourse to the sponsoring or arranging entity.

General obligations

For general obligations issued by financial institutions through note-issuance programs, the nature of the referenced risk may require the use of structured finance analytics to assess the credit risks to which promised payments are linked. These notes' interest and/or principal payments may at times be linked to the credit performance of a specific pool of credits. In that event, Standard & Poor's typically uses quantitative models, among them the CDO Evaluator, to analyze and quantify the credit risk relative to a specified first-loss amount. The rating we assign to a general obligation of a financial institution with a single reference credit link will equal the lower of the rating on the issuer and the credit assessment on the referenced credit risk.

Non-recourse MLNs issued by SPEs

For non-recourse MLNs of SPEs, the promised payments may be partly or completely linked to the credit or market performance of a specific risk pool or market index. As with the general obligation MLNs, our rating reflects any direct or indirect credit risks, and specifically those risks that may affect the ability of the SPE to deliver the promised payments. In the absence of such imbedded credit risk, we generally rate non-recourse MLNs of SPEs in accordance with their terms and do not specifically address the impact of non-credit-related market risks on the investor's return on investment. This approach is consistent with how we rate other types of structured market-linked securities. An example is interest-only and principal-only mortgage-backed notes where market risk (specifically, the prepayments on the underlying mortgage loans) greatly affects an investor's return on investment. In this case, the rating addresses the SPE's ability to deliver the promised payments without addressing the likelihood of achieving a specific return.

A typical SPE structure uses part of the note issuance proceeds to fund an investment that covers a portion of the promised note payments. This investment has credit risk that is commensurate with the rating on the MLN, which typically is the principal-protected portion. The remaining proceeds fund an investment that provides a variable return to note holders and is not analyzed by Standard & Poor's. These structures often achieve 'AAA' ratings based on the certainty of payment ascribed to the principal-protected portion of the notes, in accordance with the terms of the instrument.

Appropriate Standards For Special-Purpose Entities

The rating approach to structured MLNs of SPEs differs in certain areas from that applied to general obligation MLNs issued by financial institutions. Payment problems on an MLN issued by a financial institution directly reflect on the reputation of the institution. Structured financings, in contrast, do not necessarily affect the reputational risk of the entity behind them. As a result, structured financings need to be more explicit about certain roles and responsibilities of the various parties that are part of the deal than do financial institutions' comparable general obligations. The differences reflect general market practice as well as some transactional elements, which often enable structured MLNs of SPEs to achieve high ratings due to structural and legal protections that are not linked to sponsor creditworthiness and credit rating.

The key differences between Standard & Poor's approaches to rating structured MLNs of SPEs and general obligations of financial institutions are:

- Standard & Poor's structured finance group reviews whether the market index or risk basket to which the repayment of an SPE's structured MLN is linked is transparent and replicable from the investor's standpoint. When they are not replicable, and evaluating their performance requires judgment or subjective analysis, the calculation agent should be independent from the sponsor.
- The trustees for an SPE's structured MLN should generally be independent from the sponsor.

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