Article Title: ARCHIVE | General Criteria: Request For Comment: Refinements To Joint Support Criteria Proposed Data: Editor's note:Standard & Poor's Ratings Services published the criteria article titled, "Criteria Update: Joint Support Criteria Refined," on Feb. 3, 2006, following the criteria review process we initiated with this request for comment. Standard & Poor's Ratings Services is requesting comments from market participants regarding proposed refinements of its criteria for rating jointly supported obligations when each obligor is fully responsible for the entire obligation. In this situation, a default on the obligation would occur only if both obligors default. Common examples of joint support include a primary obligor plus a guarantor or a primary obligor and a letter-of-credit (LOC) provider. The risk that both obligors will default is less than the risk that either one will. As a result, the obligation may be rated higher than the rating on the stronger obligor (supporter). This article explains the proposed criteria revisions and seeks comments on them. It is estimated that 300-400 outstanding ratings could be affected if these revised criteria are implemented. A significant number of rating upgrades and some downgrades are anticipated. We welcome comments on any aspect of the proposal. In particular, we encourage responses on the application of joint-support analysis to short-term obligations and government-supported entities as well as default risk correlation within emerging market countries. In addition to the jointly supported issues described below, are there other rating situations in which this approach could be applied? Standard & Poor's introduced the application of probability theory to jointly supported obligations 10 years ago. The fundamental concept is now widely accepted by market participants. Our compilation of extensive data on speculative-grade default risk during the past decade—especially our in-depth analysis of default risk correlation—has prompted the proposed criteria refinements. Proposal Summary The proposed criteria contain the following key elements: The rating for the jointly supported obligation will be derived from one of three reference tables, one each for obligor pairs that have high, medium, and low default correlation (see Charts 1, 2, and 3). Under Standard & Poor's current criteria, a single table is used for all eligible obligors. The new tables were generated with a more sophisticated calculation of the joint default probability, including explicit default correlation assumptions. Obligations of very highly correlated entities will remain ineligible for credit enhancement. Application of the criteria will be extended to speculative-grade entities. Presently, the criteria are applicable only to investment-grade obligors. The joint support criteria will not be used to rate issues or issuers that receive less-formal support, such as the benefits enjoyed by many government-owned enterprises. In other words, these issues will continue to be rated no higher than the rating on the government or parent company providing support. Joint Probability Of Default Calculation The joint probability of default (PD) is calculated as follows: Chart 1 For the rating on each obligor, the corresponding 10-year cumulative PD (displayed in Table 1) is used. After the joint PD is calculated, the number is converted back into the closest corresponding rating for the 10-year time horizon. The underlying PDs associated with each rating are consistent with those used by Standard & Poor's for rating CDOs. The following example is illustrative. If a French bank rated 'A+' (PD of 1.525%) guarantees an obligation of an American manufacturing company rated 'BB+' (PD of 13.5%), and the assumed default correlation is 15%, the jointly supported rating would be 'AA' (joint PD of 0.834%). Table 1 Correspondence Between Ratings And Probabilities Of Default RATING PROBABILITY OF DEFAULT (%) AAA 0.365 AA+ 0.523 AA 0.898 AA- 1.164 A+ 1.525 A 1.884 A- 2.606 BBB+ 4.007 BBB 5.885 BBB- 10.737 BB+ 13.500 BB 19.328 BB- 25.619 B+ 33.231 B 44.083 B- 55.632 CCC+ 68.013 CCC 75.506 CCC- 87.498 Under the current joint support criteria, the joint PD was calculated simply by multiplying the stronger obligor's PD (different PDs were used in 1995) by 0.5 to crudely reflect potential default correlation. This is comparable with assuming the weaker obligor is rated 'B-' and default risk of the two obligors is completely independent. The revised, more refined approach reflects our analysis of empirical default correlations. Under the proposed new criteria, default correlations of 25%, 20%, or 15% are explicitly assumed based on the obligors' characteristics, as shown in Table 2. Table 2 Default Correlation Guidelines DEFAULT CORRELATION (%) CHARACTERISTICS Too high No benefit (1) Affiliated companies, (2) government and its owned/supported entities, (3) economically codependent entities, (4) both obligors in the same country, and its sovereign government is rated speculative grade* High 25 Both obligors share two of the following: same industry, same region, speculative grade* Medium 20 Both obligors share one of the following: same industry, same region, speculative grade* Low 15 Obligors are in different industries and regions, and at least one is investment grade* *When rating a jointly supported foreign currency issue, the foreign currency ratings on the obligors and sovereign are relevant, but the result is constrained by the transfer and convertibility limit. In lieu of a single table for all eligible obligors, as under the current criteria (Table 3), three different reference tables for different degrees of correlation are proposed (Charts 1, 2, and 3). To facilitate implementation, relatively simple guidelines are used to determine which table is appropriate. The main factors are whether the obligors are in the same industry, in the same region, or speculative grade. The relevance of these intuitive criteria is supported by Standard & Poor's default correlation research. As sovereign default risk moves through the rating spectrum, default correlation for entities within the country, regardless of industry, typically rises and falls geometrically. The default correlation guidelines take account of this phenomenon, with some smoothing of the ups and downs. No credit enhancement for joint support will be permitted when both obligors are in the same country with a sovereign government rated 'BB+' or lower, and the benefit caps shown below will be used to reduce the credit cliff. When both obligors are in the same country and its government is rated: 'AA-' or higher, there is no benefit cap. In the 'A' category, there is a three-notch benefit cap. In the 'BBB' category, there is a one-notch benefit cap. 'BB+' or lower, there is no joint support benefit. Table 3 Current Criteria For Jointly Supported Ratings AAA AA+ AA AA- A+ A A- BBB+ BBB BBB- AAA AAA AAA AAA AAA AAA AAA AAA AAA AAA AAA AA+ AAA AAA AAA AAA AAA AAA AAA AAA AAA AAA AA AAA AAA AAA AAA AAA AAA AAA AA+ AA+ AA+ AA- AAA AAA AAA AA+ AA+ AA+ AA+ AA+ AA+ AA A+ AAA AAA AAA AA+ AA+ AA+ AA+ AA AA AA- A AAA AAA AAA AA+ AA+ AA AA AA- AA- A+ A- AAA AAA AAA AA+ AA+ AA AA- A+ A+ A BBB+ AAA AAA AA+ AA+ AA AA- A+ A A A- BBB AAA AAA AA+ AA+ AA AA- A+ A A- BBB+ BBB- AAA AAA AA+ AA AA- A+ A A- BBB+ BBB Chart 1 Chart 2 The colors in Charts 1, 2, and 3 illustrate a comparison of the proposed criteria to Standard & Poor's current criteria. Yellow indicates that the proposed rating is lower, light blue indicates that the proposed rating is one notch higher, and dark blue indicates that the proposed rating is more than one notch higher. Chart 3 Analysts will exercise judgment to determine whether the joint support criteria should be applied if the obligation is unusual or unpredictable, such as a GIC. Entities To Which The Criteria Are Applicable The main applications of the joint support criteria to date have been for LOC-backed issues and structured finance transaction components, such as guarantees of swap agreements and liquidity facilities. An estimated 300-400 issues are currently rated based on Standard & Poor's joint support criteria, of which about two-thirds are obligations backed by LOCs—all of these sold in the U.S. The LOC-backed issues are split between those for which the primary obligor is a U.S. public finance (tax-exempt) entity and those with a corporate primary obligor. Banks providing the LOCs range from local U.S. commercial banks to large multinational institutions. Virtually all transactions to which the criteria are applied include at least one financial institution obligor. Most eligible jointly supported issues are expected to fall in the medium or low correlation categories. Under the proposed criteria, Standard & Poor's will continue to exclude very highly correlated entities—such as affiliated companies—from any joint support benefit. This approach remains inappropriate for obligations that are insured by the monoline bond insurers and for U.S. public finance double-barreled bonds, which are backed by economically codependent payment sources (e.g., a general obligation pledge and revenue from water and sewer charges). Nor should it be applied to obligations of government-owned or -supported enterprises when the joint obligors are the issuer and its government owner/supporter. Government-supported entities When rating a government-supported entity (GSE) and its obligations, Standard & Poor's has long recognized the benefits afforded to them, originating from the supporting government. (See "Revised Rating Methodology for Government-Supported Entities," published on RatingsDirect on June 5, 2001.) Based on government support, GSEs are often rated above their stand-alone credit quality, sometimes as high as the government providing support, even in the absence of an explicit guarantee. Standard & Poor's does not plan to apply a probabilistic approach to GSE ratings. After appropriately elevating the ratings on the GSE to account for support, it would be double counting to raise the rating further, above the rating on the government, in an attempt to incorporate the GSE's independent ability to continue paying its obligations when the government is in default. The more likely scenarios are that they will both default or the GSE will default and the government will not. Although default risk might not be identical, there is clearly a very high degree of default correlation between a government and a GSE that is owned by and depends on meaningful support from it. For the proposed joint support criteria, the high correlation category assumes default correlation of only 25%, well below the correlation of a GSE and its government benefactor. Short-Term Ratings Jointly supported short-term obligations will remain eligible for credit enhancement. This is accomplished by converting the indicated long-term rating into the corresponding short-term rating. Dual Ratings There are some issues—mainly U.S. tax-exempt obligations—that have a short-term put or demand feature. Standard & Poor's assigns a dual rating (e.g., 'AA/A-1+') to them. Technically, both the LOC provider and the primary obligor are obligated to meet both the scheduled long-term payments and the put feature. However, only the LOC provider has the ability to meet a put on seven days' notice (even if the primary obligor has a high investment-grade rating). For these issues, we will continue to recognize joint support for the long-term component but not for the short-term rating. Legal Considerations Both the proposed and current joint support criteria are only applicable when the obligation is legal, valid, and enforceable against both obligors. Any preference payment or clawback risk must be addressed in the structure of the transaction. Implementation Following the conclusion of the comment period, Standard & Poor's will publish its new criteria for rating jointly supported obligations. Assuming market reaction to this proposal is positive, our current plan is to begin applying the refined criteria to outstanding and new issues in mid-January 2006. To ensure transparency of Standard & Poor's public ratings, the joint support approach will only be applied when both obligors have a public long-term or short-term rating, unless the joint support criteria affect only one element of a complex transaction. If the rating on a supporting obligor is placed on CreditWatch, Standard & Poor's will either place the rating on the jointly supported issue on CreditWatch or state publicly that the latter rating will be unaffected by the obligor's rating review. Comments on this proposal may be sent through Jan. 6, 2006, to criteriacomments@standardandpoors.com or by contacting any of the individuals listed at the top of the article.