Rating Agencies and Their Methodologies

Seminar, Senior Bank Supervisors from Emerging Economies, World Bank/IMF/Federal Reserve System

Washington D.C.,
October 21, 2008

Laura Feinland Katz
Managing Director, Regional Chief Credit Officer
Latin America Ratings, Standard & Poor’s
Agenda

- Role of ratings in the capital markets
- Overview of Standard & Poor’s ratings methodology, including:
  - Corporate / Industrial
  - Financial Institutions
  - Insurance Companies
  - Sovereign
  - Structured
Standard & Poor’s Role in the Financial Markets

Historic milestones

- 1966: S&P acquired by The McGraw-Hill Companies

Today

- Rating activity for securities issues valued over US$30 trillion
- Obligors in over 100 countries
- Approximately 1,000 ratings analysts
- Offices in 20 countries
Standard & Poor’s Role in the Financial Markets

➢ Full range of issuers
  – Corporate (industrials, financial institutions)
  – State and Local Governments
  – Sovereigns
  – Structured Transactions
Users of debt ratings…

- **Investors in public debt securities (notes and bonds)**
  - Institutional investors
    - Mutual funds
    - Pension funds
    - Insurance companies
  - Individual investors

- **Investors/lenders, bank loans**
  - Banks
  - Institutional buyers of bank loans

- **Regulators**
  - Banks
  - Insurance
Value Of A Credit Rating

- Independent & Objective Analysis Of Credit
- Benchmarked On A Global Basis
- Provides Value To All Stakeholders
- Measure Of Default Risk
- Not A Measure Of Asset Value
- Not A Buy / Sell Recommendation
- Not A Guarantee Of Future Events
How do ratings add value?

**Intermediaries (Bankers)**
- Facilitates pricing against other benchmark deals

**Issuers (Borrowers)**
- Anticipate cost of debt
- Expand potential investor universe
- Compare to others

**Investors (Lenders)**
- Can “benchmark” credit against other issues
- Supplements in-house credit resources
Basic principles…

– Independence
– Objectivity
– Credibility
– Transparency
Ratings Definitions and Ratings Scales
Credit Risk Dimensions

- **Risk of Default …**
  - The failure by a borrower to make timely payment of principal or interest

- **Risk of Loss Given Default …**
  - The difference between a borrower’s contractual obligation, and the amount ultimately recovered by a lender
Standard & Poor’s
Credit Ratings

- Issuer Credit Ratings –
  - Overall credit worthiness of an obligor

- Issue Credit Ratings –
  - Credit characteristics of specific debt instruments/transactions
Issuer Ratings

Issuer ratings assess:

– Capacity & willingness of an obligor to meet financial commitments

– Default baselines expressed variously as …
  • Issuer Credit Rating, Corporate Credit Rating
  • Counterparty ratings
  • Sovereign ratings
### Long-Term Debt Rating Scale

...as applied to **Issuers**

<table>
<thead>
<tr>
<th>Rating</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>Highest Credit Quality</td>
</tr>
<tr>
<td>AA</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
</tr>
<tr>
<td>BBB</td>
<td>↑ Investment Grade</td>
</tr>
<tr>
<td>BB</td>
<td>↓ Non-Investment Grade</td>
</tr>
<tr>
<td>B</td>
<td></td>
</tr>
<tr>
<td>CCC</td>
<td></td>
</tr>
<tr>
<td>CC</td>
<td></td>
</tr>
<tr>
<td>SD/D</td>
<td>Debt in Selective Default / Default</td>
</tr>
</tbody>
</table>

“+” and “–” modifiers apply to ‘AA’ through ‘CCC’ ratings
Long Term Debt Rating Scale
Selected Rating Definitions

“AAA” – “Highest rating …. obligor’s capacity to meet financial commitment is extremely strong.”

“AA” “…very strong. It differs…only in a very small degree.”

“A” – “Somewhat more susceptible to adverse changes in economic conditions …. capacity to meet financial commitment is still strong.”

“BBB” – “Adequate protection …. but changes in economic conditions could lead to weakened capacity…”

“BB” – “Faces uncertainties during adverse economic conditions…”

“B” – “Possesses current capacity …. but likely to be impaired…”

“CCC” – “Vulnerable to non-payment …. needs favorable business climate to meet obligations…”
Ratings And Their Interrelationships

➢ Global comparability
  – S&P’s rating scale used on a global basis
  – Facilitates comparability across sovereigns and corporate ratings

➢ National Scale Ratings
  – Alternative to S&P’s standard rating scale
  – Confined to 13 selected national markets…
    • ADEF (France) ‘fr’
    • Argentina ‘ar’
    • Brazil ‘br’
    • Canada (Short Term)
    • CaVal (Mexico) ‘mx’
    • Kazakhstan ‘kz’
    • Nordic (Short Term)
      – Denmark, Finland, and Sweden
    • Russia ‘ru’
    • South Africa ‘za’
    • Taiwan ‘tw’
    • Turkey ‘tr’
    • Ukraine ‘ua’
    • Uruguay ‘uy’
Sample Ratings:  (ratings as of October 19, 2008)

<table>
<thead>
<tr>
<th>NAME</th>
<th>RATING</th>
<th>OUTLOOK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands</td>
<td>AAA</td>
<td>Stable</td>
</tr>
<tr>
<td>Singapore</td>
<td>AAA</td>
<td>Stable</td>
</tr>
<tr>
<td>Toyota Motor Corp.</td>
<td>AAA</td>
<td>Stable</td>
</tr>
<tr>
<td>Belgium</td>
<td>AA+</td>
<td>Stable</td>
</tr>
<tr>
<td>New Zealand</td>
<td>AA+</td>
<td>Stable</td>
</tr>
<tr>
<td>Kuwait</td>
<td>AA-</td>
<td>Stable</td>
</tr>
<tr>
<td>Italy</td>
<td>A+</td>
<td>Stable</td>
</tr>
<tr>
<td>IBM</td>
<td>A+</td>
<td>Stable</td>
</tr>
<tr>
<td>Chile</td>
<td>A+</td>
<td>Stable</td>
</tr>
<tr>
<td>Telefonica S.A. (Spain)</td>
<td>BBB+</td>
<td>Positive</td>
</tr>
<tr>
<td>Mexico</td>
<td>BBB+</td>
<td>Stable</td>
</tr>
<tr>
<td>Telefonos de Mexico</td>
<td>BBB+</td>
<td>Stable</td>
</tr>
<tr>
<td>Russia</td>
<td>BBB+</td>
<td>Stable</td>
</tr>
<tr>
<td>Reliance Industries (India)</td>
<td>BBB</td>
<td>Stable</td>
</tr>
<tr>
<td>Brazil</td>
<td>BBB-</td>
<td>Stable</td>
</tr>
<tr>
<td>Fiat SpA</td>
<td>BBB-</td>
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<tr>
<td>Venezuela</td>
<td>BB-</td>
<td>Stable</td>
</tr>
<tr>
<td>Telefonica de Argentina</td>
<td>B+</td>
<td>Stable</td>
</tr>
<tr>
<td>General Motors</td>
<td>B-</td>
<td>CreditWatch-Negative</td>
</tr>
<tr>
<td>United Air Lines</td>
<td>B-</td>
<td>Negative</td>
</tr>
<tr>
<td>Belvedere S.A. (France)</td>
<td>D</td>
<td></td>
</tr>
</tbody>
</table>
Corporate Default Rate  (Percent of All Outstanding Issues)

Sources: Standard & Poor's Global Fixed Income Research; Standard & Poor's Credit Pro®.
## Historical Default Risk by Rating Category
### Cumulative Default Rates 1981-2007

<table>
<thead>
<tr>
<th>Year</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>Rating</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC/CC</th>
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<tbody>
<tr>
<td>1</td>
<td>0.00</td>
<td>0.01</td>
<td>0.06</td>
<td>0.23</td>
<td>1.00</td>
<td>4.57</td>
<td>25.59</td>
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<tr>
<td>2</td>
<td>0.00</td>
<td>0.05</td>
<td>0.16</td>
<td>0.65</td>
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<tr>
<td>3</td>
<td>0.09</td>
<td>0.09</td>
<td>0.29</td>
<td>1.13</td>
<td>5.19</td>
<td>14.72</td>
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<tr>
<td>4</td>
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<td>0.19</td>
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<td>0.29</td>
<td>0.64</td>
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<td>21.08</td>
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<td>0.62</td>
<td>1.32</td>
<td>3.96</td>
<td>14.05</td>
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<tr>
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<td>0.71</td>
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<td>4.42</td>
<td>15.27</td>
<td>27.55</td>
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<td>10</td>
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<td>0.81</td>
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<td>28.74</td>
<td>49.76</td>
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<tr>
<td>11</td>
<td>0.67</td>
<td>0.91</td>
<td>1.95</td>
<td>5.37</td>
<td>17.13</td>
<td>29.80</td>
<td>50.50</td>
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<tr>
<td>12</td>
<td>0.67</td>
<td>0.99</td>
<td>2.11</td>
<td>5.75</td>
<td>17.87</td>
<td>30.70</td>
<td>51.26</td>
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<tr>
<td>13</td>
<td>0.67</td>
<td>1.09</td>
<td>2.26</td>
<td>6.22</td>
<td>18.51</td>
<td>31.61</td>
<td>51.87</td>
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<tr>
<td>14</td>
<td>0.73</td>
<td>1.17</td>
<td>2.39</td>
<td>6.68</td>
<td>18.96</td>
<td>32.47</td>
<td>52.50</td>
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<tr>
<td>15</td>
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<td>1.21</td>
<td>2.61</td>
<td>7.20</td>
<td>19.43</td>
<td>33.26</td>
<td>52.50</td>
<td></td>
</tr>
</tbody>
</table>

*Sources: Standard & Poor’s Global Fixed Income Research; Standard & Poor’s CreditPro®.*
Historical Default Risk by Rating Category
Cumulative Default Rates 1981-2007

Sources: Standard & Poor's Global Fixed Income Research; Standard & Poor's CreditPro®.
Short-Term Debt Rating Scale
Correlation with Long-Term Debt Rating Scale

- Debt with a maturity of one-year or less, e.g. commercial paper.
- Only the A-1 category is modified by a “+”.
- Note to illustration: Short-Term Rating Scale extends to “C” and “D”
“OUTLOOK” –

- Assigned to all long-term Issuer ratings
- Assesses potential long-term direction
- Time horizon: up to 2 years
- Not necessarily a precursor to
  - Rating change
  - “Credit Watch” listing
- Options: Positive, Negative, Stable, Developing
“CREDIT WATCH” –

- Assigned to long-term Issuer ratings, as appropriate
- Focus on short-term direction
  - Fundamentals driven
  - Driven by identifiable events or circumstances
- Time Horizon: targeted for 90 days or less
- Additional information necessary
- Options: Positive, Negative, Developing
Issuer Count by Region
(Through 2007)

Sources: Standard & Poor's Global Fixed Income Research; Standard & Poor's CreditPro®.

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Distribution of Corporate Issuers by Industry (December 31, 2007)

- Financial Institutions: 19%
- Telecommunications: 5%
- Leisure time / media: 8%
- Consumer / service sector: 13%
- Aerospace / automotive / capital goods / metal: 11%
- Transportation: 4%
- Forest and building products / homebuilders: 4%
- Energy and natural resources: 6%
- Health care / chemicals: 6%
- High technology / computers / office equipment: 4%
- Real estate: 3%
- Insurance: 9%
- Utility: 8%
Global Corporate Rating Distribution:
December 31, 2007

Investment Grade: 57%
Speculative Grade: 43%

Sources: Standard & Poor's Global Fixed Income Research; Standard & Poor's CreditPro®.
U.S. Corporate Rating Distribution
December 31, 2007

Sources: Standard & Poor's Global Fixed Income Research; Standard & Poor's CreditPro®.
Corporate Rating Methodology
Corporate Rating Analysis Methodology Profile ("RAMP")

- Country Risk
- Industry Characteristics
- Company Position
- Profitability / Peer Group Comparisons
- Accounting
- Governance, Risk Tolerance, Financial Policy
- Cash Flow Adequacy
- Capital Structure
- Liquidity/Short Term Factors

Business Risk

Financial Risk

RATING
Standard & Poor’s
Corporate Rating Analysis: Key Factors

Country Risk
Industry Characteristics
Company Position
Profitability / Peer Comparison

OVERALL BUSINESS RISK

Accounting
Governance / Risk / Financial Policy Score
Cash Flow Adequacy Score
Capital Structure / Asset Protection Score
Liquidity / Short Term Factors Score

OVERALL FINANCIAL RISK

CORPORATE CREDIT RATING
Business Risk Analysis

As it applies to the Issuer...

- Country Risk
- Industry Characteristics
- Competitive Position
- Profitability / Peer Comparison

How volatile is the Issuer’s business and its related profits → operating cash flows?
Financial Risk Analysis

The Issuer’s…

- Accounting Practices
- Financial Policy / Risk Tolerance
- Cash Flow Protection & Adequacy
- Capital Structure / Leverage & Asset protection
- Liquidity

How much risk does the Issuer possess in terms of the magnitude, timing, and character of its financial obligations?
Balancing the risks: The overall rating...

- Linking the business with its capital...

Balancing the risk of the business with the risk imposed by the borrower’s financial structure

What is the relationship between the operating cash flows and its need to service its financial obligations (i.e., risk of default)?

Conclusion: Corporate Credit Rating (“CCR”)
Financial Institutions Rating Methodology
### S&P Financial Institution Rating Analysis: Key Factors

<table>
<thead>
<tr>
<th>OVERALL BUSINESS RISK ASSESSMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Risk</td>
</tr>
<tr>
<td>Industry Risk</td>
</tr>
<tr>
<td>Management / Strategy</td>
</tr>
<tr>
<td>Market Position</td>
</tr>
<tr>
<td>Diversification</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OVERALL FINANCIAL RISK ASSESSMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Reporting &amp; Accounting</td>
</tr>
<tr>
<td>Analysis</td>
</tr>
<tr>
<td>Earnings</td>
</tr>
<tr>
<td>Financial Flexibility</td>
</tr>
<tr>
<td>Capitalization</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OVERALL ENTERPRISE RISK MANAGEMENT ASSESSMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market and Interest Rate Risk</td>
</tr>
<tr>
<td>Credit Risk</td>
</tr>
<tr>
<td>Liquidity and Funding Risk</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OVERALL RATING</th>
</tr>
</thead>
</table>

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Insurance Company Rating Methodology
Standard & Poor’s Insurance Rating Analysis Methodology: Key Factors

**Industry and Country Risk Assessment**
- Competitive Position
- Diversification
- Market Share
- Growth Rates
- Distribution Channels
- Products Offered vs. Market Demand

**OVERALL BUSINESS PROFILE**

**MANAGEMENT AND CORPORATE STRATEGY**

**Enterprise Risk Management Assessment**
- Operating Performance
- Investments
- Liquidity
- Capitalization
- Financial Flexibility

**OVERALL FINANCIAL PROFILE**

**Overall CREDIT RATING**
Sovereign Rating Methodology
Definitions: What A Rating Is And Is Not

A Standard & Poor’s sovereign rating is:

- Our assessment of a sovereign government’s ability and willingness to service its debt on time and in full.
- A globally comparable, independent, objective, forward-looking estimate of default probability.
- A reflection of medium-term fundamentals -- through economic and political cycles.

A Standard & Poor’s sovereign rating is not:

- A country risk rating or country investment ranking.
- A recommendation to buy or sell a security, or a prediction of the stability or volatility of a security’s price.
Primer: Rating Methodology Profile

Sovereign Credit Risk Factors:

- Political Risk
- Income and Economic Structure
- Economic Growth Prospects
- Fiscal Flexibility
- General Government Debt Burden
- Off-budget and Contingent Liabilities
- Monetary Stability
- External Liquidity
- External Debt Burden
Distribution of Sovereign Ratings

Distribution Of Foreign Currency Sovereign Credit Ratings
1975-2007

Distinctions Between Issuer and Issue Ratings
Issue Ratings

- Issue ratings assess the creditworthiness of a specific financial obligation:
  - Bank Loans, Secured Notes, Bonds, Debentures, Unsecured Notes, Subordinated Debentures, Preferred Stock

- Default risk—the capacity and willingness of the issuer to make timely payment, and

- Ultimate recovery prospects
  - Relative positioning (seniority) in capital structure
  - Guarantees
  - Collateral
  - Covenants
  - Legal environment
Hierarchy of Debt Securities

**Types of Debt Securities**

- Debt sec. w/higher-quality op. assets  
- Debt sec. w/lower-quality op. assets

- Senior unsec. debt of the op. company
- Senior liabilities (pari passu w/sr. debt)

- **Subordinated debt**
  - Junior subordinated debt

- **Senior debt of the holding co.**
  - Subordinated debt of the holding co.

**Seniority**

- **Most Senior**
- **Most Junior**

---

The more senior, the greater the recovery prospects
### Long-Term Debt Rating Scale

*...as applied to Issues*

<table>
<thead>
<tr>
<th>Rating</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>Highest Credit Quality</td>
</tr>
<tr>
<td>AA</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
</tr>
<tr>
<td>BBB</td>
<td>↑ Investment Grade</td>
</tr>
<tr>
<td>BB</td>
<td>↓ Non-Investment Grade</td>
</tr>
<tr>
<td>CCC</td>
<td></td>
</tr>
<tr>
<td>CC</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
</tr>
<tr>
<td>D</td>
<td>Default</td>
</tr>
</tbody>
</table>

“+” and “–” modifiers apply to ‘AA’ through ‘CCC’ ratings.
Issue Rating Notching and Recovery Ratings

➢ Ratings on specific issues are based on the prospects for recovery associated with the specific issue assuming that a default has occurred. Issue ratings may be rated above or below the issuer credit rating.

➢ *Investment grade* issue ratings reflect relative seniority and subordination.

➢ *Speculative grade* issue ratings (industrials) reflect more extensive default and recovery modeling.

➢ Country-specific bankruptcy laws can affect application of recovery analytics.
Issue Ratings
Traditional Framework
Issue Ratings: Traditional Framework

- **Issuer rating**
  - Benchmark for indicating Issue Rating adjustments

- **Recovery expectations:**
  - Relative advantage/disadvantage among debt obligations
  - Threshold tests, based upon relationships between
    - “Priority Liabilities”
    - Total Assets
  - Guidelines for application
    - Investment grade companies
    - Non-investment grade companies
### Issue Ratings: Traditional Framework

<table>
<thead>
<tr>
<th>CCR = Investment Grade</th>
<th>≥ 20% of assets</th>
<th>Lower priority debt is reduced 1 notch below ICR</th>
</tr>
</thead>
<tbody>
<tr>
<td>CCR = Non-Investment Grade</td>
<td>≥ 15% of assets</td>
<td>Lower priority debt is reduced 1 notch below ICR</td>
</tr>
<tr>
<td>CCR = Non-Investment Grade</td>
<td>≥ 30% of assets</td>
<td>Lower priority debt is reduced 2 notches below ICR</td>
</tr>
</tbody>
</table>

**Note:** Subordinated debt of Speculative Grade issuers is generally reduced by two notches.
Issue Ratings

Enhanced Framework: Recovery Ratings
Issue Ratings: Enhanced Framework

What are Recovery Ratings?

- An assessment of the likelihood of recovery of principal in the event of default
- Independent of the Issuer Rating
- Expressed using S&P’s Recovery Rating scale
Methodology for Recovery Analysis

- Business & Financial Risk Analysis
- Simulated Payment Default Scenario
  - Liquidation Analysis
  - Enterprise Value Analysis
    - Market Multiples
    - DCF Analysis

Recovery Value

- Priority Liabilities
- Capital Structure
- Intercreditor Terms
- Security Package
- Covenant Package
- Legal Regime

Distribution of Recovery Value

Assignment of Recovery Rating
## Recovery Scale and Issue Rating Guidelines

### Revised Recovery Scale  *(Speculative-grade issuers / Effective June 7, 2007)*

<table>
<thead>
<tr>
<th>Recovery Rating</th>
<th>Description of Recovery</th>
<th>Recovery Range</th>
<th>Issue Rating vs. Issuer Rating*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1+</td>
<td>High expectation, Full recovery</td>
<td>100%</td>
<td>+3</td>
</tr>
<tr>
<td>1</td>
<td>Very high recovery</td>
<td>90-100%</td>
<td>+2</td>
</tr>
<tr>
<td>2</td>
<td>Substantial recovery</td>
<td>70-90%</td>
<td>+1</td>
</tr>
<tr>
<td>3</td>
<td>Meaningful recovery</td>
<td>50-70%</td>
<td>0</td>
</tr>
<tr>
<td>4</td>
<td>Average recovery</td>
<td>30-50%</td>
<td>0</td>
</tr>
<tr>
<td>5</td>
<td>Modest recovery</td>
<td>10-30%</td>
<td>-1</td>
</tr>
<tr>
<td>6</td>
<td>Negligible recovery</td>
<td>0-10%</td>
<td>-2</td>
</tr>
</tbody>
</table>

* Indicates number of grades, or “notches” relative to Standard & Poor’s issuer credit rating.
Structured Finance Primer
What is “structured finance”?  

Various financing techniques that allow entities to raise funds at a lower cost by:

– Issuing securities that are guaranteed by a more creditworthy entity
   
   ▪ “Credit substitution” transactions

– Selling assets to a special purpose vehicle which then issues securities designed to be repaid using the cash flow generated by the underlying assets
   
   ▪ “Securitizations”
How does a securitization work?

For example auto loans...

Securitization Issuer

Assets

Liabilities

Senior ‘AAA’-rated Class

‘AA’-rated Class

‘A’-rated Class

‘BBB’-rated Class

‘BB’-rated Class

‘B’-rated Class

Unrated Class

Subordinate Classes
Major categories of structured transactions

- Residential mortgage-backed securities (RMBS)
- Asset-backed securities (ABS)
- Asset-backed commercial paper (ABCP)
- Commercial mortgage-backed securities (CMBS)
- Collateralized debt obligations (CDOs)
Why is structured finance so important?

1990
$7.7 trillion

- Agency mortgage-backed securities: 16%
- Municipal debt: 15%
- Securitizations: 3%
- Money-market instruments: 15%
- Federal agency debt: 6%
- Corporate debt: 17%
- Treasury securities: 28%

2006
$27.4 trillion

- Agency mortgage-backed securities: 19%
- Municipal debt: 9%
- Securitizations: 11%
- Money-market instruments: 15%
- Federal agency debt: 10%
- Corporate debt: 20%
- Treasury securities: 16%
Securitizations: examples

Examples include

- Banks that issue credit cards to consumers;
- Financing subsidiaries of auto makers that lend to buyers of new and used cars;
- Residential and commercial mortgage lenders; and
- Finance companies that make loans to finance the acquisition or lease of capital equipment such as airplanes and shipping containers

“Conduits” which aggregate assets from entities that provide direct financing
Why securitize?

- Lower cost of funds
- Higher return on equity
- Opportunity to re-deploy assets
- Balance sheet management
- Capitalization management
- Transfer of interest-rate risk associated with fixed-rate assets
- Asset-liability management
- Alternative source of financing
- Transfer of credit risk
How is a structured transaction analyzed?

- Reviewing the legal structure of the issuer
- Examining the transfer of assets from originator/sponsor to issuer
- Evaluating asset credit risk
- Testing the adequacy of cash flow and/or credit enhancement mechanisms
- Reviewing documents that describe the detailed terms of the transaction
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