INNOVATIVE CAPITAL MARKETS INSTRUMENTS

Peter Gibson
Managing Director & Associate General Counsel
Standard & Poor's Rating Services

Maintaining the Benchmark – How a Credit Rating Agency responds to innovation in the debt capital markets

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As a global leader in the provision of financial market information, Standard & Poor's Rating Services must constantly adapt to developments in the needs and expectations of the debt capital markets – these changing needs can be driven by regulation, funding, or investor needs.

In order to stay abreast of, or hopefully ahead of the market, Standard & Poor's have established a global body, the "New Instruments Committee" which has the charter of reviewing, commenting on and developing rating methodologies for new instruments being issued by Financial Institutions, Corporates and Governments.

In Structured Finance, Standard & Poor's need to be able to apply consistent core principles to the analysis of assets of any type and in any jurisdiction. To ensure structured finance ratings can be benchmarked against their global cohorts we have built up a strong global network of experienced analysts, with open communication lines and effective quality oversight.

Global Benchmarks for New Instruments – Hybrid Capital.

Hybrid Capital Instruments are a rich focus of innovation as these instruments are structured to achieve multiple aims (namely positive equity treatment, favourable tax treatment, flexibility and high rating aspirations) and meet the expectations of various stakeholders (investors, issuers, regulators, and rating agency). More often than not, the development of a hybrid instrument becomes a balancing act emphasizing various features and attributes to attain the best results for the particular circumstances. As a consequence we see a wide variety of hybrid instruments with various 'bells and whistles'. Standard and Poor's assesses the terms and conditions of each instrument along with the regulatory treatment afforded to the instrument. If the regulator does not recognise the instrument as part of equity neither will Standard &Poor's (as the instrument would be less likely to forestall regulatory intervention), conversely if the instrument does not have loss absorption features we will not ascribe equity credit regardless of any favourable regulatory treatment.

Investors, issuers, and market intermediaries increasingly seek clarification of the value of specific hybrid securities in Standard & Poor's analysis of a bank or insurance group's capital. Our approach closely resembles that of financial regulators, since they have the power to intervene in the operations of a financial services company, and determine whether to do so based on their own perceptions of capital adequacy, as reflected in their definitions of capital. Even so, Standard & Poor's has developed generalized guidelines that vary somewhat from regulators' to facilitate cross-border comparisons. We differentiate the capital value of hybrid securities by their equity-like characteristics, and classify them as follows:

- Category 1: High Equity Content
- Category 2: Intermediate Equity Content (divided into two levels: Category 2: Strong and Category 2: Adequate)
- Category 3: Minimal Equity Content

This streamlined approach is coordinated across Standard & Poor's Financial Services and Corporates Ratings groups. The approach allows for the different regulatory environments facing many issuers of hybrid securities. Standard & Poor's includes qualifying hybrid securities in its published total capital measures for banks and insurers up to limits that are the highest for Category 1 (High Equity Content) hybrids, but that exclude Category 3 (Minimal Equity Content) hybrids. Standard & Poor's applies limits for the inclusion of hybrids in its capital measures. These limits vary by category and broadly reflect the regulatory policy of capping the inclusion of hybrids in regulatory capital. Standard & Poor's capital measures and classification of hybrid securities by category complement measures based strictly on regulatory capital. At the very least, qualification as Tier 1 or Tier 2 regulatory capital by national bank regulators is necessary for Standard & Poor's to include a hybrid security in its published total capital measures. For regulated insurance companies, qualification as regulatory capital by the national insurance regulator is necessary. When insurance regulators express no views on specific hybrid securities, Standard & Poor's establishes its own stance on likely regulatory policy with respect to the instrument. The regulatory treatment of hybrids issued by regulated financial services companies matters because regulators typically have the legal authority to intervene in operations to stop or suspend coupon payments on hybrid securities of troubled entities. Standard & Poor's considers that regulators will intervene to suspend hybrid coupon payments at an earlier point than an unregulated corporate would decide to suspend coupons on its hybrids. This has been demonstrated most clearly in the U.S. banking sector. Standard & Poor's treatment of hybrid securities issued by non-regulated financial services companies is likely to increasingly mirror the treatment for other unregulated corporate issuers. Standard & Poor's includes hybrid securities in capital analysis when it concludes that the hybrids can act like equity when the issuer is under stress: for example, they preserve cash and to some degree bear the downside risk of poor performance. We limit hybrids in capital because:

- The quasi-fixed cost of most hybrids increases coverage requirements (the servicing cost is usually not linked to the performance of the company),
- The complexity of many hybrids introduces uncertainty of performance under stress, and
- Regulators limit hybrids in regulatory capital.

The growing inclusion of call options with step-up clauses weakens the permanency of hybrid securities. This trend heightens the importance of analysing the regulatory approval of the call and the replacement covenants that commit the issuer to replace the retired security with hybrid capital of equivalent strength. Mandatory, enforceable replacement covenants restore permanency and equity value to hybrid capital securities that have call options and step-up clauses, but clear regulatory policy can also achieve this for regulated financial services companies. In many cases, regulators can prevent a call if unhappy with the company's financial standing, or can insist on the instrument being replaced with one of equivalent strength. The existence of a clause that obligates the issuer to defer or suspend the coupon payment under defined circumstances makes a hybrid capital security more equity-like, all else being equal. Nevertheless, for regulated financial services companies a mandatory coupon deferral clause is not a material factor in the classification as a Category 1, Category 2: Strong, Category 2: Adequate, or Category 3 hybrid security. This is because regulators retain authority over the deferral of coupon. The mandatory deferral clause may be a factor that increases the potential for payment deferral, but the regulatory intent and authority is more important analytically. Furthermore, in the event of a stress at a company, the ability to write down the instrument's principal on a going-concern basis may be a more important signifier of equity content than the coupon deferral clause.

[For more information the following articles are available on www.standardandpoors.com.au and/or our subscription web-site www.ratingsdirect.com

- "*Financial Services Criteria: Equity Credit for Bank and Insurance Hybrid Capital, A Global Perspective*" published 16 February 2006;

- *"Formulas for Including Hybrids in Adjusted Total equity for FIs Is Updated: but Equity Content Unchanged"* published 26 April 2007; and
- *"Ratings on Various Australian Bank and Insurance Hybrids Raised"* published 20 April 2007]

Principles Based Methodologies for Rating Structured Finance Instruments

To accommodate the inherently dynamic and flexible nature of the global structured finance market, Standard & Poor's employs a largely principles-based methodology for assigning and monitoring ratings on structured finance securities around the world. Our approach helps us to respond to the market's evolving needs and enhances the global comparability of the ratings we assign, by considering:

- The constantly changing and innovative nature of structured financings;
- The differences in the maturity and sophistication of global markets, as well as particular sectors and/or participants within those markets;
- The differences and changes in regulatory and legal frameworks among countries and market sectors;
- The differences and changes in market conventions and industry practices;
- The cultural differences among markets that may influence behaviour and performance;
- The unique considerations at the asset, originator and transaction levels;
- The key characteristics of structures or asset classes that may not have been securitised before;
- The interplay of all these factors, which may minimize the significance of each risk in determining default risk for a given transaction relative to another transaction.

[*for more information the following article is available on* www.standardandpoors.com.au *and/or* www.ratingsdirect.com *: "Principles-Based Methodology for Global Structured Finance Securities" published 29 May 2007*]

Securitisation of New Asset Classes – A Rating Approach (illustrated by the CBA Case Study)

One of the benefits of securitisation is the potential for accommodating cash flows of a wide range of asset classes. Though securitisation was first applied to mortgage loans, later, in the 1980s, its techniques were applied to credit card receivables and auto loans. Today, these asset classes have grown into their own mini-markets in which an extensive and subtle array of financial products has developed. In contrast, other once-novel assets, such as time-share loans, exist in market niches despite years of securitisation experience. At some point, every securitised asset class was a "new asset." The adaptability of securitisation to new asset classes is mostly a result of its use as a flexible funding source for issuers and as a diversified source of investment income for bondholders. It goes without saying that the asset-backed market would not have grown nearly as rapidly were it not for the adaptation of securitization techniques and processes to new asset classes and investor demand. Frequently, what suggests promise as a new asset type may ebb after a short time. In Australia and New Zealand, most non-mortgage backed securitisations have unique elements and every year we see transactions which are one-offs.

Amortising Receivables versus Future Flows of Operating Income: A rated new asset transaction is based on either a pool of amortizing receivables or a future flow of operating income from the active employment of transaction assets. An amortising receivable transaction is akin to a traditional securitisation where the assets of the issuer consist of non-executory obligations that liquidate to cash, and where the transaction servicer carries out a related "passive" administrative function. In contrast, a future flow transaction is based on cash flows that must be generated by the active management of assets owned by the issuer. Within the future-flow category exists a degree of operating and market risk not found in an amortizing receivable deal. The degrees of operating and market risk may depend on the nature of the assets.

From a rating perspective, the working premise is that the more involved the processing necessary to achieve the finished product whose sale is necessary to create transaction cash flow, the closer the rating link to the entity that renders that necessary service. These sorts of transactions often include natural resource products such as standing timber, in-ground precious metals, or oil reserves. They also may include securitizations of royalty payments based on products yet to be produced, such as music compact discs, apparel, or pharmaceuticals. The product may have a quantifiable market or liquidation value such as in natural resources, or there may be significant value yet to be contributed, such as production, marketing, and sales, in order to maximize market value. The ratings in many of these transactions are more or less linked to the provider of the essential service necessary to convert the assets to cash.

Operating Risk of Amortising Assets Differs from Future Flows: While all securitizations have some degree of operating risk, amortizing assets, by their self-liquidating nature and the availability of alternative servicers, generally should not suffer to the same extent as future flow transactions in the event of a disruption of the asset servicer-manager.

In the Case Study, the asset is a service provider's right to receive future fee income. In this case the fees earned by members of the Colonial First State group (CFS) from the management of Investment Funds.
This was the first time this type of asset has been securitised, although there have been other transactions which rely on future fee income, generated from closed asset pools.

Rating Analysis of New Assets: A Detailed Process: The rating analysis of a new asset transaction can be challenging because of the lack of precedent. However, the lack of a blueprint enables the analyst to begin each analysis without pre-conceived notions; each case stands on its own. Rating new asset transactions is a detailed process in which the agency analyses relevant aspects of the product and industry. In the analysis of a new-asset transaction, there is often an extensive "borrowing" from corporate finance rating techniques that emphasizes and gives due credit weight to industry sector, economic, management, operational, and market factors. In addition, new asset securitizations often make ample use of covenants in addition to the legal and structural enhancements that are typical of securitization. The rating process begins with a study of the asset itself – in particular, its legal characteristics, its transferability, its ability to generate predictable cash flows, and its ability to survive the replacement of its servicer or manager. The premise of securitization, whether a receivables or a future-flow transaction, is the predictability and volatility of cash flows – the likelihood that investors will recover the scheduled return of principal and interest.

To determine the level of cash flow stability, the analyst reviews appropriate historical performance data from the sponsor or originator. In most instances, this data is available, but occasionally it is not. This is usually because such information is not in a usable form. In other instances, a lack of actual history is the cause; the originator simply has not been around long enough or has not gathered the relevant information. Various approaches can be used to address this latter problem. If the originator operates in an industry that is rated by or otherwise known to the agency, it might utilize information from a company, group of companies, or even an industry database as a reference point. However, if the industry's birth has coincided with the creation of the company and there are no credible "comparables," it may not be possible to rate the transaction. Competition can affect experienced companies as well as newly formed ones. Analysts should assess the competitive landscape for all transactions, particularly for longer-tenured transaction, since the further into the future that cash flows generated are needed to service the transaction, the more likely that unanticipated events can have an impact. The analysis of competition is a complicated process because competition comes in many forms. It may come in the form of a direct competitor with the same or a similar product or an entirely new replacement process or procedure that is more effective, cheaper to produce, or less harmful. Competitors act on many levels in addition to direct product competition. Common themes involve advertising, pricing, and enhanced service, all of which must be considered when analysing the effect of competition. Obsolescence can have the same effect as competition. Obsolescence may be the result of technological enhancements, as happens with computers or pharmaceuticals, or the result of changeable consumer taste for apparel, movie genre, or music style.

> *Case Study:*
> *The fundamental driver of the long-term performance of the funds management industry is the ongoing flow of superannuation contributions, as required by the Australian Government superannuation guarantee levy, which is currently 9%. The industry is also driven by discretionary and personally-funded superannuation contributions from investors, the amount of which may vary from time to time, depending on the performance of different asset classes*
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> *The future fee income may vary because of external factors, such as general market performance, revised asset allocation, or changes to investment and superannuation structures. It may also vary because of internal factors, such as poor corporate and investment performance or negative market sentiment, which could result in a net outflow of funds under management. Internal and external factors could affect the fees earned, and this, in turn, may affect payments to investors.*
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> *Standard & Poor's were provided with historical performance data, evidence to support fluctuations and reasoned forward projections. The rating relied on the substantial cash flow coverage of the fees earned at current levels. When compared with the expected coupons to be paid on securities, these fees provide a substantial buffer. In addition, Standard & Poor's considered the transaction timeframes and the interaction of the historical fee-earning performance with the transaction cash flow lock-up triggers, and concluded that the interaction of these factors supported the issuance volume and the rating levels assigned*

Servicing a New Asset Securitization Often Requires Specialized Functions: Servicing (or, in some cases, management of the assets) can include many components. In its simplest form, servicing consists primarily of performing billing and collection activities and, generally, there are many qualified servicers able to perform this function for a securitized portfolio. However, even billing and collection can be troubled if the servicer is inexperienced, does not understand the class, or is insufficiently capitalized or compensated. But servicing for new assets often incorporates many other functions in addition to billing and collecting, and those functions may be quite specialized. These are often linked to the viability of the servicer to such a degree that, if the servicer itself cannot perform, investors may be at risk. Because management plays a pivotal role, special consideration must be given to the retention or replacement of a management team. A future flow in which the asset is a royalty stream from a product that has a high degree of "fashion obsolescence" is much more dependent on creativity, marketing, advertising, and sales activities performed by the company than is an amortizing transaction involving automobile receivables. A future flow involving manufacturing or equipment use also may be jeopardized by insufficient capital expenditures. Because of the critical nature of such additional operational capabilities, the rating analyst often places a high degree of importance on the creditworthiness of the company.

> *Case Study:*
> *The transaction relies on the CFS group remaining in business for the full term of the transaction, continuing to perform within benchmark ranges, and continuing to be major players in the Australian funds management market. Because of this reliance, the rating on the securities could not exceed the credit quality of the members of the CFS group. Standard & Poor's considered the CFS group to have credit characteristics sufficient to support the rating assigned to the securities;*

Credit Support for New Assets: Top Down or Bottom Up? Determining credit support for a liquidating receivable asset can be contrasted with the process of determining an advance rate for a future flow. An amortizing receivable transaction consists of a pool of receivables, most of which should pay on schedule. Credit support for such a transaction is based on an estimate (based on historical losses and other factors) of what percentage of the pool will not pay. As such, it can be considered as being a "top down" approach to credit enhancement. A future flow is often treated as a more complex "bottom up" approach because it is based on a consolidation of many related components which, when considered as a whole, reveal the amount of debt that can be supported by the asset. It is this factor that makes credit analysis for future flows challenging, because it involves the accurate determination of revenues; expenses, including management fees; and an assessment of capital expenditure requirements for the life of the asset. Determining a revenue stream involves a review of historical sales and sales trends and the reasons for any fluctuations, potential market size under best and worst-case scenarios, and the effect of relevant competitive influences, economic changes, regulatory activity, and seasonal fluctuations. The importance of structure in a new asset transaction is much the same as in securitizations of other asset classes. The analyst will determine the extent and availability of over collateralization. Rating future flow securitization is an art as well as a science, particularly as many amortizing new assets have not yet exhibited defined loss curves, the timing of cash inflows and outflows, recessions, etc. Therefore the structure must be reviewed closely to ensure that it is aligned with the risks inherent in the assets in order to mitigate such uncertainties under a variety of scenarios. Credit support need not only be of sufficient size but also of sufficient form. A traditional structured financing purports to isolate the transaction assets from a transferor's insolvency in enabling the bondholder to rely on the creditworthiness of those assets. Typically, such a structure seeks to insulate payment on the rated bonds from unrated or lower-rated entities having some contact with the transaction. The assumption of structural and legal separation is supported by various legal opinions concluding, among other things, that the assets on which the transaction is based would not be affected by the insolvency of these other entities. To a considerable extent, structured finance ratings are based on these principles of structural and legal separation.

Case Study:

Bottom up: *The transaction relies on the CFS group remaining in business for the full term of the transaction, continuing to perform within benchmark ranges, and continuing to be major players in the Australian funds management market. Because of the transaction's reliance on the CFS group continuing in business into the future, the rating on the securities cannot exceed the credit quality of the members of the CFS group. Standard & Poor's considered the group to have credit characteristics sufficient to support the rating assigned to the securities; Significant downgrading of the rating assigned by Standard & Poor's to either CBA or Colonial Holding Company would most likely result in downgrading of the securities;*

Top down: *Standard & Poor's reviewed a number of future performance scenarios in conjunction with CBA and its advisers. Although no explicit stress assumption was considered as a likely stress scenario for the rating, it was noted that the transaction cash flows, when considered with the transaction covenants and triggers, can withstand almost a 10% annual deterioration rate at any point in the transaction term. This analysis excludes any credit for any sale proceeds that may be derived from the sale of ongoing future management fees, if a sale were to take place. Standard & Poor's analysis assumed that all cash flow from the share of the ongoing management fee, even under stressed scenarios, would be sufficient to fully amortize the securities, in full, prior to the final maturity date. As such, no credit was given to any future sale proceeds that may arise from any sale of the secured management fee income*

Legal Analysis of a New Transaction Addresses Insolvency and Security Interest: As part of the rating process for a new asset transaction, the legal analysis considers a number of points. First, there is a determination of whether the documentation sets forth the obligations of the transaction participants. The analyst then evaluates whether the bankruptcy or insolvency of each transaction party could affect the timely payment of principal and interest on the rated securities.

To gain comfort regarding the legal issues presented by a structured finance transaction, rating agencies have developed criteria related to the transaction structure, and, where appropriate, request opinions of counsel that address insolvency as well as security interest and other legal issues. Issuers in a new asset transaction may expect a higher level of legal review. There are various reasons for this heightened scrutiny: Sometimes the nature of the transaction assets is unclear when the transaction first is proposed. There may be a close relationship between the special-purpose entity issuer and the transaction originator or sponsor, which may weaken the presumption of legal and structural separation. Occasionally, the assets themselves may be difficult to transfer or pledge. A new asset transaction often will involve an extensive degree of legal involvement.

Case Study:
Standard & Poor's worked extensively with transaction counsel to understand the legal and regulatory issues that shaped the transaction; and the structural aspects that facilitated it. The legal analysis and the credit analysis were conducted contemporaneously and involved many hours in front of whiteboards, working through the issues. [For an analysis of the legal issues in this transaction, refer to Brian Salter's presentation]

Note:
The rating analysis for the structured finance instruments was conducted independently from the analysis of the impact of the transaction on the credit rating assigned to the CBA itself. Clearly, one of the drivers of the transaction was to deliver a capital efficiency to CBA overall; the analysts responsible for the assigning the rating to CBA were fully briefed on the transaction and concluded the transaction would not in and of itself have any material impact on the rating of CBA.