

HOW EFFECTIVE IS YOUR SECURITY — THE IMPACT OF RECENT CASES

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INTRODUCTION

I wish to respond to David Wetherell's paper on the **Welsh Development Agency** case by:

- commenting briefly on the case from a ratings agency perspective;
- I thought it may be useful to explain what a credit rating implies; and
- finally, sketch some of the legal issues, we as a rating agency, focus upon in assigning ratings in structured finance transaction.

For those not familiar with Standard & Poor's, we are the largest credit rating agency operating in Australia and New Zealand following the acquisition of Australian Ratings in 1990. Whilst credit ratings have been a common feature of the United States capital markets for many years, it is only in the last decade Australian and New Zealand investors have sought an independent assessment of securities issued in our domestic capital markets. The increased use of credit ratings has arisen from a number of factors:

- the heightened concern about creditworthiness by investors;
- the continued globalisation of capital markets; and
- increased secondary trading of debt which has required a common standard for assessing creditworthiness.

In this region Standard & Poor's assigns over 1,000 ratings to debt securities issued by over 275 issuers, including:

- governments and other public sector enterprises;
- banks and financial institutions;
- corporates; and
- securitisation programs.

WELSH DEVELOPMENT AGENCY

As David noted in his paper, it is in the rating of bonds and commercial paper issued by securitisation and structured finance vehicles that cases such as **Welsh Development Agency** have most relevance for a ratings agency.

The significance of this case, from our perspective, is that it provides a cautionary reminder that structured finance and securitisation transactions should always be carefully structured, in a legal sense, to ensure that security is, in fact, being obtained over the assets which are intended to be covered.

Investors are dependent upon the cash flows of the assets for the payment of interest and repayment of principal and it is important that they have a first ranking and perfected interest in the assets to protect against any competing claim by the originator, seller of any other third party.

Also the confirmation by the Court of Appeal that the transaction was a true sale and not a secured financing is of comfort to us, as the true sale question is the first hurdle that must be cleaved in rating any securitisation program.

CREDIT RATINGS

To place credit ratings in their proper perspective it is important to remember that the rating of a debt security is but one of the many factors that should be taken into consideration in making an investment decision. Other factors investors will evaluate include:

- the investor's risk preference;
- yield offered on the securities; and
- liquidity of the secondary market for the securities.

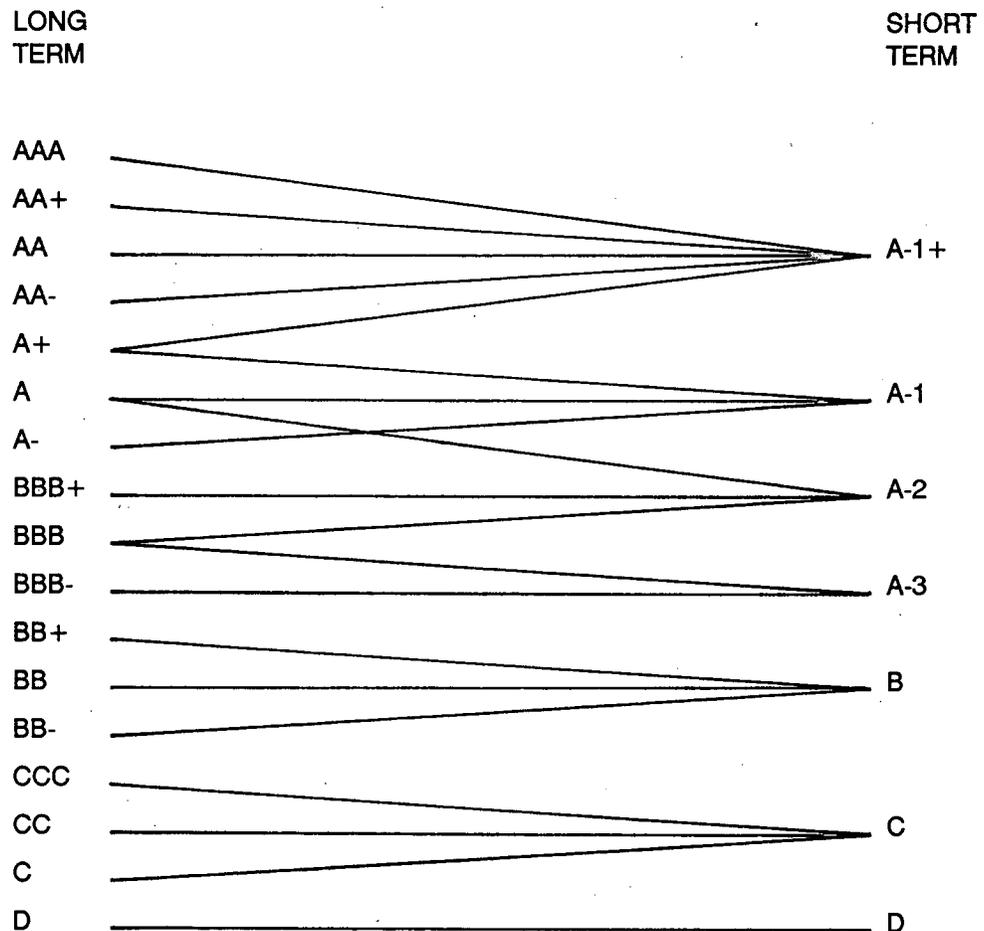
These factors are usually key consideration in the investment decisions.

A rating from Standard & Poor's reflects the capacity and willingness of an issuer to make a full and timely payment of interest and repayment of principal in accordance with the terms and conditions of the issue of the security.

A rating is not a recommendation to buy, hold or sell the security, nor does it attest to the suitability for any particular investor.

Standard & Poor's utilises a long term rating scale which runs from 'AAA' to 'CCC' for debt securities with a tenor of greater than 12 months and a short term scale running from 'A.1+' to 'C' for securities which mature within 1 year. The term investment grade is one often spoken about in relation to ratings. This refers to ratings above 'BBB-' on the long term scale and 'A.3' on the short term scale. Ratings in these categories, in our view, could be suitable for a conservative investor. Those below this level are regarded as speculative grade ratings. The correlation between the long and short term ratings is illustrated in the following table.

Correlation Of Short Term Ratings With Long Term Debt Ratings



STANDARD & POOR'S RATINGS GROUP

To elaborate on the distinction between rating categories, in assigning a 'AAA' rating we are stating it is our opinion that the issuer has an **extremely strong** capacity to pay interest and repay principal in a timely manner. At the 'BBB' rating level we are judging the issuer to have an **adequate capacity** to repay principal in a timely manner. At the 'BBB' level protection levels are more likely to be weakened by adverse changes in circumstances and economic conditions than issuers rated more highly.

Turning to what a rating may not address, No doubt you are all well acquainted with the controversy surrounding the New South Wales Homefund scheme which is funded by 'AAA' rated FANMAC mortgage-backed bonds. Whilst some of you may have found it curious that despite the increased level of delinquent loans and losses incurred by the FANMAC trusts and proposals to assist some of the underlying borrowers, the rating of the bonds has not been adjusted. The reason is that the credit quality of the bonds stems from the legally binding support provided by the Government of New South Wales and is dependent on the State's willingness and capacity to provide this support. The 'AAA' rating of the pass through bonds does not, and never did, address the likelihood or timing of principal being passed back to investors as a result of the mortgages which default or repay early. Under the terms and conditions of the issue of the FANMAC bonds the risk of early repayment of principal was always borne by the investors regardless of the factors giving rise to the repayment of principal.

RATING STRUCTURED FINANCINGS

In considering a rating of debt issued out of a securitisation program we are most mindful we are generally assessing a nominally capitalised special purpose company or trust and hence the legal structure of the transaction and the protection available to investors are paramount and fundamental considerations in a rating process.

In assigning a structured finance rating, S&P conducts an in depth credit and legal analysis of the transaction. In completing the latter task we are assisted by S&P's external legal counsel.

The credit analysis focuses on the ability of the assets to generate sufficient cash for meeting the payment of the issuer's expenses, and the full and timely payment of interest and principal due under the securities. If the assets are mortgage receivables we will evaluate amongst other things the past history of delinquencies and defaults exhibited by the portfolio or similar portfolios. Likewise with trade receivables we look at the history of bad debts, credits and returns and the speed of collection of the receivables.

The focus of our legal analysis includes an examination of the legal structure of the issuer, the terms and conditions of any credit and liquidity support facilities and the associated security documentation. To ensure the assets are held for the benefit of investors we seek clarification of any competing rights and interest in those assets, including those of the investors and various third parties. If the receivables of Parrot Corporation were being securitised, the competing interest of parties such as the Welsh Development Agency and Export Finance Company would have needed to be resolved and clarified before a rating could have been considered.

We undertake a review of the documentation from an investor's perspective to ensure what is promised to them can be delivered in a timely manner.

In addressing a forum such as this it is worthwhile to state that S&P views securitisation and structured finance transactions quite differently from other general banking and finance transactions.

To assign a rating the documentation of any third party credit or liquidity support agreements must be constructed in a clear and unambiguous fashion. We are somewhat allergic to many of the usual clauses found in banking type documents, such as material adverse change clauses, clauses relating to increased costs, and the repetition of vague or ambiguous representations and warranties. The premise of our rating is that when times get tough and there is a need for the issuer to draw on the support facilities, that the enhancers do not seek to delay or avoid their obligation by using 'get out' clauses.

Parties providing support in rated structured finance clauses need to be mindful of the commitment that is required, and price their facility accordingly.

The consequence of this attitude is that we view more favourably Letter of Credit type liquidity support or the utilisation of senior/subordinated structures, bond insurance, or over-collateralisation type credit support. These forms of credit and liquidity support avoid many of the documentary risks we organise about in rating securitisation transactions.

As a final part of the rating process we also require the solicitors representing the issuer and others to opine to S&P on matters fundamental to the rating.

Some of the factors that S&P routinely requests confirmation on are:

- the insolvency remoteness of the issuer. We must be clear that the insolvency of the originator of the assets, the shareholders of the issuer or other third parties does not in itself compromise the payment of interest and repayment of principal to investors;

- the issuer has a valid legal interest in the assets which support payments to investors. In a receivables transaction for instance, it needs to be quite clear that the transfer of the assets represents a true sale and not a secured financing;
- we require a trustee, acting on behalf of the investors, to have first ranking security over the assets of the issuer including its bank account and other liquid investments;
- the cash flows of the transactions are clearly documented and can be effected in a timely manner; and
- the transaction documents, including any forms of credit or liquidity enhancements, will be legally valid, binding and enforceable in accordance with their terms.

In conclusion, it is cases such as **Welsh Development Agency** which re-enforce to us that structured finance transactions, because of their dependency upon a particular pool of assets and associated enhancements, need to be structured in a very careful and precise manner to permit an investment grade rating to be assigned.

One final thought is an invitation to you to raise with us at any stage any aspect of the law which you believe we should be considering or reconsidering because, like the law, our rating criteria does evolve and is refined by experience, legislative changes and case law.