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General Criteria:

Methodology: The Interaction Of Bond Insurance And Credit Ratings

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Editor's note:
This article supersedes the following previously published criteria articles:

- Credit FAQ: The Interaction Of Bond Insurance And Credit Ratings, Dec. 19, 2007.
- Credit FAQ: The Interaction Of Bond Insurance And Credit Ratings – Structured Finance Update, Feb. 26, 2008.
- Credit FAQ: Underlying Corporate Ratings Of Insured Debt Remain Strongly Investment Grade, March 11, 2008.
- Credit FAQ: Increased Focus On Credit Quality Of Project Finance Issues After Ratings Changes To Monolines, April 24, 2008.

1. Standard & Poor's Ratings Services is publishing this article to help market participants better understand its methodology regarding the interaction of bond insurance and credit ratings. This article is related to our criteria articles "Principles Of Corporate And Government Ratings," which we published on June 26, 2007 and "Principles-Based Rating Methodology For Global Structured Finance Securities," which we published on May 29, 2007.

SCOPE OF THE CRITERIA

2. Standard & Poor's is publishing this criteria article to summarize and clarify its methodology for rating issues that have credit enhancement in the form of bond insurance. These criteria apply to all sectors.

SUMMARY OF CRITERIA UPDATE

3. This article supersedes the following articles:

- Credit FAQ: The Interaction Of Bond Insurance And Credit Ratings, Dec. 19, 2007.
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4. The main differences compared with the aforementioned articles are:

- This criteria article consolidates the previously published criteria to provide increased transparency; however, there are no methodological changes from previous criteria.
- We have added the section "What consequences does a bond insurer downgrade have on an obligation that does not have a SPUR?," paragraphs 16-17.

IMPACT ON OUTSTANDING RATINGS

5. We do not expect any rating changes as a result of this criteria update, since our methodology has not changed.

EFFECTIVE DATE AND TRANSITION

6. These criteria are effective immediately.

METHODOLOGY

7. In general, the rating on an issue that has credit enhancement in the form of bond insurance will be the higher of the rating on the insurance company providing the enhancement, and, if rated, that of the underlying obligation. Standard & Poor's provides, upon request, a Standard & Poor's underlying rating (SPUR), which addresses the creditworthiness of the underlying entity or obligation (i.e., without considering the potential credit enhancement from bond insurance).

Frequently Asked Questions

What is bond insurance?

8. Bond insurance is a financial commitment by a bond insurance company to make the scheduled principal and interest payments on a bond if the obligor does not. Insurance on a new issue is typically obtained by the issuer with the expectation that the interest rate on the insured bonds will be lower than if they were not insured. Bondholders can also obtain insurance in the secondary market.

What is credit enhancement?

9. Credit enhancement generally refers to a financial instrument or structural feature of a transaction that enables the obligation to be rated higher than the creditworthiness of the obligor (or underlying assets). Letters of credit, reserve accounts, overcollateralization, and bond insurance are all viewed as forms of credit enhancement. Credit enhancement generally operates to absorb all or a portion of credit losses in a transaction, thereby increasing protection for the holders of rated "credit-enhanced" securities.

What is an issue rating?

10. A Standard & Poor's issue credit rating is a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program. It takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation.

What is a SPUR?

11. A SPUR expresses our opinion of the stand-alone creditworthiness of the obligation, the stand-alone capacity to pay debt service on an insured debt issue in accordance with its terms, without taking into account the enhancement that may reduce default risk. Upon request of the issuer, Standard & Poor's will publish a SPUR on an insured bond issue. A SPUR is the same as an issue rating, simply without enhancement. The SPUR is assigned and surveilled in the same manner as an unenhanced issue rating. Making more SPURs publicly available is one of several steps Standard & Poor's is taking to provide greater transparency.

What are the interactions between these ratings?

12. When we have assigned a SPUR, the issue credit rating on a fully insured bond issue is the higher of the bond insurance provider's rating or the SPUR. For example, an issue, with a SPUR of 'BBB+', would be rated 'A' based on the support of an 'A' rated bond insurer. If the bond insurer's rating was lowered to 'A-', then the issue rating would also be lowered to 'A-'. But if the bond insurer's rating was lowered to, say, 'BBB-', while the SPUR remained 'BBB+', then the issue would be lowered only to 'BBB+', because the underlying creditworthiness of the obligor or obligation is higher than the bond insurer's. Note that the SPUR remains in place regardless of what happens to the bond insurer's rating and is subject to surveillance by Standard & Poor's. If the bond insurer's rating and the SPUR are the same, the issue outlook or CreditWatch status is assigned based on our assessment of the possible outcomes for the issue rating. For example, a stable outlook on the SPUR and a developing outlook on the bond insurer would result, if both are rated the same, in a positive outlook on the issue.

When are SPURs withdrawn?

13. Like other ratings, if we no longer receive adequate information to maintain surveillance on the underlying obligation, Standard & Poor's withdraws the SPUR. In such a case, our practice is to rate the issue based solely on the bond insurance--at the then current rating of the bond insurer, except as noted below, in the section "What consequences does a bond insurer downgrade have on an obligation that does not have a SPUR?"

What are the consequences of a bond insurer downgrade on an obligation that has a confidential SPUR?

14. In the event that we lower the rating on a bond insurer to a level below the confidential SPUR on a corporate or government obligation, then, Standard & Poor's will likely suspend or withdraw the issue rating, unless the issuer requests the SPUR to be made public, in which case paragraph 12, "What are the interactions between these ratings?," would apply. The rating is withdrawn or suspended because it no longer reflects our opinion of the issue's credit quality.

15. Historically, Standard & Poor's public SPURs were not requested for most fully bond insured structured finance issues. However, typically we maintain a SPUR on the obligation for purposes of determining capital charges for the bond insurer. We generally do not publish these SPURs unless specifically requested to do so by the issuer or the bond insurer. However, if the bond insurer's rating falls below the level of the SPUR, Standard & Poor's practice has been to lower the structured finance issue rating to the level of the SPUR.

What consequences does a bond insurer downgrade have on an obligation that does not have a SPUR?

16. The answer to this question depends on Standard & Poor's general assessment of credit quality within a given sector. The issue rating on a transaction without a SPUR will reflect that of the relevant bond insurer, until the bond insurer's rating declines below a given level whereby we no longer regard the bond insurer rating as reflective of credit quality of the obligation. At this point, the issue rating would be suspended or withdrawn.

17. For example, in the case of public finance, we generally suspend or withdraw ratings on bond insured transactions that do not have a SPUR if the relevant bond insurer's rating is lowered below 'BBB-'. This is because we generally assess credit quality as 'BBB-' or higher for the underlying entities/obligations in this sector. However, in the case of other sectors, including structured finance, we generally suspend or withdraw ratings on bond insured transactions that do not have a SPUR if the relevant bond insurer's rating is lowered below 'B+'. This is because we expect there may be many transactions in these sectors with underlying creditworthiness below 'BBB-'.

Does the lowering of the insured rating have any impact on the SPUR?
18. In most cases, the SPUR and the bond-insured issue rating operate independently of each other. That said, there may be some effect on the SPUR as a result of the downgrade of a bond insurer in cases where the downgrade may have adverse credit consequences for the underlying entity and/or transaction, for example, by triggering a risk premium payable on the entity hitting certain performance covenants. Standard & Poor's will assess the potential effect of a bond insurer downgrade on an entity's SPUR depending on relevant provisions in the issue's documentation.

RELATED RESEARCH

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- Principles Of Corporate And Government Ratings, June 26, 2007
- Principles-Based Rating Methodology For Global Structured Finance Securities, May 29, 2007

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.