

Pentalpha

May 25, 2008

Pentalpha's Plan To Reduce Conflict Concerns In the Hiring of a Rating Agency in a Public Bond Issuance

For all new public bond issuances where ratings are desired by the issuer, Pentalpha recommends that two or more rating agencies are hired to provide a rating on each class. One (or more) agency is selected by the Issuer; the other (or more) is selected by Investors through the voting process outlined herein. This process would apply to corporates, municipals and structured finance bonds.

Background

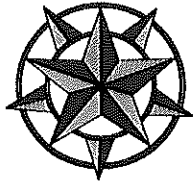
Historically, corporate bonds were issued using a syndicate of Dealers hired by the Issuer. In that process, it was common for an Investor to receive a solicitation call from each selling Dealer almost simultaneously, once the deal was announced. In order to be efficient, the Investor usually called one Dealer and placed an order to buy the bonds with instructions to give a "sales credit" to some or all of the placement agents hired by the Issuer. When the deal was settled, the lead manager distributed the sales concession to the other placement agents based on those votes. In this instance, the Investor was rewarding the Dealer for their service level on that bond issue as well as general market coverage. Instead of the Issuer saying which Dealers got compensated, the Investors got to say so.

Pentalpha's operational process below uses that same voting process. For this application, the Investors are hiring a rating agency as opposed to rewarding a Dealer for research and trading coverage. Additionally, it is common that structured finance deals do not have syndicates. As such, there is just one lead manager.

The following process assumes that the Issuer hires a placement agent (Dealer) to underwrite or distribute the deal and provide deal closing resources. In the case of the vertically integrated Dealers who issue mortgage and other structured finance bonds, the Issuer and placement divisions of that firm would work independently to follow these procedures.

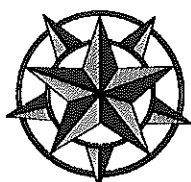
Sample timeline

| Day | Action | Relevant issue |
|------------|--|---|
| 1 | <p>The placement agent ("Dealer") will approach the rating agencies it is aware of and ask how much they will charge for ratings. This is based on a general description of the deal (including size) but the issuer's name will be revealed.</p> <p>Based on feedback from the Dealer concerning recent discussions with Investors and their desired rating agencies of choice, as well as the Issuer's preferences, the Issuer and Dealer agree which rating agencies will be solicited to provide ratings. No matter what the feedback is below, the list of agencies is "selected" at this time.</p> | <p>Pentalpha recommends that a minimum of three agencies will be solicited and the Issuer can invite more if they think Investor demand warrants it. If the Investors like more than three Dealers to select from, they may pay a higher price for the bonds so the Issuer/Dealer is motivated to deal with the aggravation of working with more rating agency firms. Hypothetically, there could</p> |



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| | | <p>be 10+ rating agencies solicited.</p> <p>If a new rating agency comes along, they must convince either the Issuer or Investors to get them on the list of considered agencies in the future.</p> |
| 2-10 | <p>The Issuer, Dealer and each selected rating agency discuss the merits and risks of the deal and each agency presents a preliminary credit enhancement level to the Issuer for their consideration. This is an iterative process where the Issuer may adjust the collateral or deal structure to make the risk look better to each agency. Based on the final feedback, (subject to final pool features) the Issuer and Dealer restructure the deal accordingly.</p> | |
| 11 | <p>The Issuer selects a rating agency that it wishes to use. This agency is referred to as the “Issuer’s agency” herein. (Some Investors may question the relevance of an Issuer agency but that is the Issuer’s discretion.)</p> | <p>The Issuer may want to reward the agency for their good research, overall coverage of the client or the fact that they are the lowest on that deal etc.</p> <p>In this process, the Issuer will only select one rating agency. IF the Issuer wishes to select a second, that is OK. Technically, the Issuer could select all three but that would eliminate the Investor participation that is intended herein.</p> |
| 12 | <p>The “losing” agencies are asked to post their presale report on their web site for Investors to review.</p> <p>The Dealer announces the deal to the Investors, the name of the Issuer’s rating agency and the list of agencies that have done research work so far. Investors approach each agency as they see fit.</p> | |
| 13-15 | <p>The deal is officially launched and the Investors are told that they can vote on one (or more) of the rating agencies on the day before the pricing date.</p> <p>In order to appease investor interests due to their position on the capital stack, there will be three voting groups.</p> <p>AAA AA,A,BBB BBB- or lower</p> <p>It is contemplated that the private placement investors will have access to private information and will interact with the agencies to address their specific questions. (This is actively done in CMBS.) As part of that, the agencies may re evaluate their ratings position. If they do, it is their obligation to communicate with the dealer to have their new structure made available to all potential investors.</p> | <p>To facilitate the Investors in their decision, the Dealer would offer the capital structure in three versions:</p> <ul style="list-style-type: none"> • Retained agency + agency number 1 • Retained agency + agency number 2 • Retained agency + agency number 3 <p>Additionally, as part of this process, the Dealer would contact the most active modeling vendors and provide each structure so that an Investor can stress</p> |



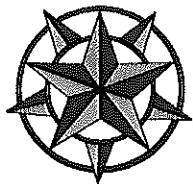
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|----|---|--|
| | | test each potential structure. |
| 16 | <p>Day before the PRICING DATE. 3pm</p> <p>Each Investor who has expressed preliminary interest to buy the bonds is canvassed to vote for their choice of "Investor rating agency" and the amount of bonds they want to buy.</p> <p>The lead Dealer tabulates the votes by rating category and dollar weights them.</p> <p>Assuming two "rating groups" vote on one agency, that agency wins the spot to be the "Investor Rating Agency". (If the subordinate investor does not get his agency that is chosen, he will likely be annoyed but will adjust his bid based on his perception of risk and not the winning agency.)</p> <p>The Dealer tells the client, the winning Investor rating agency and announces it to the public. The Dealer indicates which structure will be used to price.</p> <p>The voting is not audited but an electronic copy of the tabulation is sent to the trustee for record keeping.</p> | <ul style="list-style-type: none"> • The rating agencies will not always agree on enhancement levels etc., As such, there will be split rated bonds. Small split rated bonds could negatively impact liquidity so this process could have a cost. • Seeing that most structured finance bonds are AAA, the AAA Investors will likely have a proportionally higher vote. The result is that conservative credit enhancement levels will likely be utilized. |
| 17 | <p>PRICING DAY 10 am</p> <p>Some Investors may not like the selected agency/structure and choose not to buy. The Dealer will replace them, as needed, or price the class wider. There will not be a new Investor rating agency vote because of the change of invertors.</p> <p>The selected agency and structure is used to price (and hedge) the bonds.</p> | |
| 20 | <p>Consistent with existing practices, the client and selected agencies will close out the deal structure and ratings based on final collateral and deal structure information and then the ratings will become final.</p> | <p>Investors do not participate in this process and could be marginally adversely selected but the impact is not likely to be material.</p> |

Technical comments:

This enhanced process adds delays and cost to the process but it does appease investor needs. These higher costs will drive up borrowing costs to the underlying borrower and add aggregation price risk to the issuer. (In the long run, if investors have more confidence that this conflict issue has been resolved, they will bid higher and offset this marginally.) Specifically, we expect:

1. Delays in lending to bond issuance timing which requires more financing lines by the Issuer
2. More Dealer management of :
 - a. More rating agencies and for a longer period
 - b. Its sales force to manage the auction/voting process
 - c. Syndication desk tabulation



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In this proposed process, the Investors are in the driver seat. They are selecting the rating agency that they believe is the most interested in their perspective. As such, the ratings agencies need to “suck up” to the Investors and serve them more, not the Issuer. If they do not help the Investor to their satisfaction, that agency will not be selected.

Each rating agency is effectively bidding to provide a service. They will do all of the analysis work up front without any confidence of being selected. They are taking risk. Seeing that one participant will likely want lower enhancement percentages (the Issuer) and the Investors will want higher levels, each agency will likely seek to satisfy one of the constituents. Being in the middle may not result in fees to the agency. We should expect more split rated bonds because the opinions of risk could be material, especially in the subordinate classes. Some could say that this would hurt liquidity because of smaller bond classes being issued but at least the Investors got to choose their rating.

It is fair to expect that Investors will “bid to the worst” rating or more conservative agency. For the Issuer, they are usually focused on cumulative issuance proceeds and not ratings. If one agency is particularly conservative and gets the Investor’s vote (and related spreads as well as expense), the Issuer has the option to terminate or restructure the deal. If the Issuer does pull the deal because of the conservative position of one agency, this would likely result in that agency not being considered by the Issuer in future deals. In other words, if one agency is too conservative, they will not be considered again. This check and balance keeps enhancement levels at the “market”. Note that the Investors may revolt in the future deals because their agency is not used and the Issuer will have a liquidity problem. So.. the Investors will still rule.

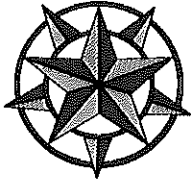
Similar to existing issuance procedures, the Issuer effectively pays for both (or more) rating agencies to be retained. This expense is usually judged as a reduction in their issuance proceeds. If the expense is too high, the Issuer may pull a deal and not issue it. As such, they may be motivated to get the agency to charge the least price. Over time, there is a high probability that some rating agencies will charge more than others. (Currently they charge effectively the same amount because the Issuer drives them to the same price through the awarding process.) The Issuer will simply have to agree to pay the agency’s fee or not issue the deal.

Seeing that numerous rating agencies will be given material information about the issue upfront, they will be in a position to “shadow rate” a deal if they are not hired by the Issuer or Investors. If they do this, the Investors will benefit from their opinions on an upfront basis and ongoing, if the agency elects to keep the ratings current. Many rating agencies post shadow ratings on their public web sites. (In the future, they may not because it costs money to monitor them and they get no income.)

There could be hundreds of rating agencies popping up in the future. Obviously it would be unwieldy to manage this process with too many agencies. In order to satisfy the Investor community and receive the highest proceeds, it is the Issuer’s responsibility to decide how many to invite to rate. As stated previously, we recommend a minimum of three.

There have been instances where a deal is not completely placed on the pricing date. In this instance, the dealer would underwrite the unsold bonds at the announced price and sell them at a later date. For purposes of voting for the Investor agency, the Dealer’s broker dealer division that is underwriting the bonds would not be entitled to any vote related to the Investor’s rating agency. (If the Dealer’s proprietary investment desk, states to the underwriter that it intends to own the bonds longer than 6 months, or the Dealer’s investment management division intends to purchase the bonds, they will be entitled to vote for the Investor agency as Investors.)

There are numerous instances where the AAA classes of a deal is issued as public securities but the AA and lower are private. In the spirit of consistency, these allocation guidelines would apply to all bonds issued.



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There is a high probability that the AAA Investors, because of their proportionate size, will lead in the selection of the Investor's rating agency. The subordinate investors may think they have been "short changed". As seen in the CMBS market for years where the first loss buyers effectively rejected the rating agency's sizing of the first loss bond and priced the class as they saw fit, that can be done here. Sure the agencies can apply the ratings but the investor with the highest bid can decide if it is important to them or not. Price rules.

In the past, there have been some investors who wanted some specific rating agencies because the ratings were critical to their own financing vehicle. Even if they offer to pay the highest price, this could prove problematic to the AA and lower investors because the AAA investors may get a larger vote in the selection of the Investor's rating agency.

This process assumes that the Issuer and Investor ratings are paid by the Issuer out of the issuance proceeds. If one or more investors have a preference for a specific rating agency, they can buy the additional rating and split the cost. (Only the agencies that were originally approved by the Issuer upfront will be eligible for this. The Issuer does not want to go back and restart the agency management process.) This expense can be done independently or stipulated at the pricing date. In this instance, the investors would approach the Dealer and say "I am disappointed that XYZ was not selected. I, and three other investors I know, will pay for a rating from XYZ. Please split the cost of the XYZ agency proportionally over our purchases. In other words, if we agreed to pay par before, we will now pay par plus a very small amount so that we can get our rating." The non-paying investors will effectively benefit from this special group's needs.

The comments in this section are highly focused on the new issue process. In reality, some investors may reward an agency based on their ongoing surveillance activities as opposed to their upfront ratings.

Subject to complete up front disclosures and no fraud, if the ratings prove to be materially wrong and require ratings action (up or down), neither the Issuer, rating agency nor Investors will be justified in complaining. They were given the opportunity upfront to choose their preferred analysis specialists.

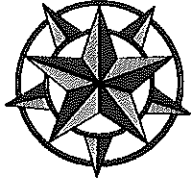
The comments provided herein assume that the Issuer generates the highest issuance proceeds by issuing deals with ratings attached. That is not always the case. There may be instances where an investor(s) does not think the rating agencies are insightful and their expense is a waste. As such, the investor(s) may ask for a lower price if ratings are not hired. The parties can agree to that or not.

This position paper does not advocate the use of rating agencies. It simply outlines a set of guidelines, if the related parties wish to have them involved. This same process could be used for Trustees, custodians and trust oversight advisors.

There is a possibility that some or all of the subordianates will not be sold on the pricing date. As such, investor will only be voting based on the AAA and AA to BBB rating groups.

A note about the Pentalpha Group

Pentalpha is offering this operational process recommendation in the spirit of having a definitive set of rules for industry participants and regulators to discuss as a solution to a significant industry issue. We appreciate the some market participants may find this to be too complicated, costly or not robust enough to address the issue. We believe it is balanced, executable and shows our firms creativity in devising proactive solutions for complex financial problems. We are known for challenging conventional thinking and devising executable alternatives in the finance business. We think this is a simple solution and worthy of consideration.



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In consideration of Pentalpha providing this position paper to you without charge, we would appreciate it if you would reference this concept and operational process as the "Pentalpha plan to reduce rating conflicts". We just ask for recognition related to this proactive approach and your consideration if you ever find yourself in need of a truly independent advisor to help lead in the workout or optimization of a complex finance industry transaction or business practice. We are considered expert negotiators and expert product specialists in the finance industry.

For more information about Pentalpha, please call Ray Redlingshafer at 203 660 6119 or see our web site at www.PentAlphaGlobal.com.