

# Unsolicited Comments Favoured Over Unsolicited Ratings

The “Credit Crisis 4 Years On” Series

## Special Report

This report is part of a series of comments marking the fourth anniversary of the global credit crisis. While the exact timing of the beginning of the crisis is subject to debate, July 2007 marked an acceleration of the globalisation of the crisis, as concerns over US mortgage losses spread to European financial institutions. While the repercussions of the crisis continue to affect the global economy, the passage of four years is sufficient to begin to assess the true impact of the crisis on the securitisation market from actual losses to the future shape of the industry.

**Rating or Commentary?:** Essentially, two key requirements drive the issuance of unsolicited commentaries or ratings: first, there should be strong investor interest; and second, Fitch has a materially different credit opinion on the transaction compared to the mandated agencies. Fitch Ratings’ approach to issuing unsolicited commentaries and ratings remains as per its press release “*Fitch Outlines Approach to Initiated Ratings in Global Structured Finance*”, dated 28 July 2010 (issued after the introduction of the SEC’s Rule 17g-5).

**Defining “Material”:** While there can be no precise definition of “materiality” as it will vary between transactions, instances may include where Fitch could not rate the top tranche of a transaction ‘AAA’, and/or where the rating it would assign would be at least one rating category lower than the assigned rating(s). Note this latter “rule” could apply to any tranche in the capital structure.

**Timing of Commentary:** Fitch aims to issue any such commentary or rating before investors are required to commit to purchase a security, ie typically after an offering circular has been published, but before pricing/closing. While this may be potentially disruptive for an issuer, it is clear from feedback from investors that the value of unsolicited ratings/commentary is maximised during this period. In extremis, Fitch may publish a commentary after pricing if the circumstances warrant it, for example, to comment on emerging sector or country trends.

**Growth of Unsolicited Commentary:** In recent months, Fitch has published a number of comments on specific structured finance transactions. Philosophically, Fitch has always been keen to publish its credit views on transactions it was not engaged on, subject to the parameters detailed in the first paragraph above. Historically, however, this has not always been possible, due to poor disclosure and transparency standards within the industry.

As a result, such initiatives were usually confined to broader sector level pieces, for example, Fitch’s critique of the constant proportion debt obligations (CPDO) sector published in April 2007. However, as industry disclosure standards have improved in response to the credit crisis – often spurred on by regulatory initiatives – the ability of Fitch (and other rating agencies) to issue transaction-level commentaries or ratings has significantly improved.

**Likelihood of Future Commentaries:** Although the number of unsolicited commentaries published by the major rating agencies has been relatively modest, this is partly due to the continued depressed state of the primary markets. As a more broad-based recovery becomes established, the volume of commentary is likely to increase. In addition, unsolicited commentary may become one of the primary mechanisms by which rating agencies – including new entrants – compete.

This will be further encouraged by the requirement for investors to carry out more of their own analysis, as this will increase the value of alternative views to those offered by mandated agencies. All these trends have been significantly facilitated by regulatory initiatives, such as Rule 17g-5 in the US. A similar rule is already being considered for the EU and other regulators may follow.

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## Ratings Versus Commentaries

While the amount of unsolicited commentary has increased substantially, no agency has yet to assign an actual unsolicited rating to a structured finance transaction. This reflects a number of factors, as detailed below.

**Timing:** As already noted, the value of an unsolicited commentary is severely diminished if it is published after a deal has priced. In practice this only gives a short window of opportunity for an agency to complete the rating process. This may be adequate to identify differences of opinion on key credit issues, but insufficient to complete the full rating process. For example, a typical transaction takes between six to eight weeks to rate, while information disclosed may only be made available a few days before pricing.

**Information:** Although initiatives like Rule 17g-5 have materially increased the information available to non-mandated rating agencies, the fact that one agency has enough information to rate a transaction does not necessarily mean that all agencies will have such information. For example, for most transactions, a key part of the Fitch rating process is the originator and servicer review and insufficient disclosure on this issue will prevent Fitch from assigning a rating. Although taping of phone calls and even filming of originator and servicer reviews can overcome this in part, there is no substitute for on-site visits, as well as file reviews.

**Cost:** By definition, unsolicited ratings are free. Given the significant investment that goes into assigning a rating and the growing compliance costs of developing and maintaining ratings — due to the significant increase in regulatory polices governing credit ratings (particularly in structured finance) — it may be simply uneconomic for rating agencies to assign even relatively modest numbers of unsolicited ratings.

**Effectiveness:** A significant difference of opinion as regards the assigned ratings can often be conveyed via an unsolicited commentary, without the necessity of assigning traditional notch-specific credit ratings. A commentary can focus on the key risks that an agency believes have not been adequately addressed or mitigated in a transaction, or can simply highlight for investors the issues on which they may wish to focus when conducting their own analysis. This allows investors to readily assess whether they agree or disagree with the agency concerned and factor that assessment into the investment decision process.

**Increasing Regulatory Focus on “Rating Shopping”:** The growth of unsolicited commentary also reflects concern amongst regulators about the practice of “rating shopping”. Rating shopping is typically defined as consciously appointing those agencies that are known to have the most liberal credit criteria in a particular sector, or engaging several agencies and subsequently dropping the agency with the least favourable rating outcome or implied capital structure from the transaction. This is a particular concern in structured finance, where transparency has traditionally been weak.

The most significant regulatory development to combat rating shopping has been in the US, with the introduction of Rule 17g-5 by the SEC last summer (see below for details). As noted, while Rule 17g-5 has yet to produce an unsolicited rating, it has made the process of issuing unsolicited commentary easier, by providing advanced detailed information on specific transactions. A potential EU equivalent of Rule 17g-5 is currently under consideration. If implemented, the universe of transactions that would be captured by these initiatives would be increased substantially.

**Further Regulatory Developments:** As well as the European discussions, in July 2011, the SEC issued a “solicitation of comment” paper on the selection of credit ratings in the structured finance rating process. The paper was issued in response to the Dodd-Frank Act and essentially outlined a proposal to create a body, overseen by the SEC, which would assign credit rating agencies to provide ratings for asset-backed securities and structured financial

products on a rotating basis (commonly referred to as “the Franken amendment”). In addition to this proposal, the paper also listed five alternatives, including the continued use of Rule 17g-5. Fitch’s response, which can be found on the SEC’s web site, was supportive of Rule 17g-5. Indeed, the agency suggested strengthening the Rule by having all agencies publicly disclose the 17g-5 transactions they have been engaged on, regardless of whether they provided the final rating or not.

At the moment, this information is shared only between other nationally recognised statistical rating organisations (NRSROs). In this way, an investor would be able to directly compare which NRSRO reviewed the transaction, versus which NRSRO ultimately rated it. Indeed, Fitch has already started publishing this information on its web site on a monthly basis, partly in response to EU rules on the authorisation of rating agencies. The comment period for the SEC paper ended 13 September. Final proposals are not expected until the first half of next year.

**TFCs Provide Greater Transparency:** Transaction Filtering Committees (TFCs) have been progressively introduced by Fitch in response to the credit crisis. Essentially, TFCs are held on most transactions in order to screen out those that are unsuitable for a rating, require specific credit issues to be addressed, or should be subject to a ratings cap. The outcome of a TFC is categorised using a simple traffic light system: green is defined as proceed; amber is defined as potentially rateable but some issue(s) needs to be resolved; red is defined as rejected; and black is defined as requiring referral to Fitch’s Transaction Screening Committee, a senior interdepartmental committee which reviews complex or innovative transactions. The results of Fitch’s TFCs are published quarterly in the agency’s various Structured Finance Snapshots. Since the system was introduced in 2009, around 40% of all transactions have either been rejected or classified as amber. Fitch will publish a separate report on TFC results shortly.

### SEC Rule 17g-5

SEC Rule 17g-5 came into force in the US, and for non-US transactions placed into the US, on 2 June 2010. Under the Rule, issuers of structured finance transactions are required to maintain a password-protected web site containing all data, documents and transcripts of interactions with mandated rating agencies in order to allow non-mandated agencies access to such materials as would enable them to assign a rating to the transaction.

An agency wishing to review the data on the issuer’s web site may do so at will. However, any agency which accesses data from 10 different sites is required to assign at least one full, public rating which it will then need to maintain (the “one in ten” rule). To date, this access has not been used to assign a full rating; however, Fitch is aware of a total of nine unsolicited commentaries issued by the major rating agencies, either off the back of publicly available information and/or by an agency which was at one point mandated but whose rating was no longer required.

### Fitch’s Unsolicited Comments to Date

Fitch has issued three unsolicited comments in the spirit of Rule 17g-5, as follows.

#### **AHM SART 2011-1 (May 2011)**

Fitch issued a commentary on the above servicer advance transaction, originated by American Home Mortgage, to the effect that the reserve fund amount was more consistent with a mid-investment-grade rating than the ‘AAAsf’ rating assigned by another agency. Fitch updated its servicer advance receivables criteria in December 2010 to better reflect the extended property liquidation timelines seen across the mortgage industry, leading to a more conservative view on these transactions. Under the new methodology, Fitch ‘AAAsf’ rated notes are expected to have sufficient liquidity (usually in the form of a reserve fund) to meet a minimum of 13 months debt service and fees. The AHM SART 2011-1 transaction provided a reserve fund equivalent to nine months of collections.

**DECO 2011-CSPK (June 2011)**

This UK CMBS transaction was considered by Fitch to be too highly leveraged to be awarded the agency's 'AAAsf' rating; its likely rating would be mid-to-high investment grade. Although a high quality, well-let modern business park, the asset is located outside an established office submarket and runs the risk of losing its appeal to its current international media and other boutique tenants; in Fitch's view, this renders it vulnerable to severe stress scenarios. Certain structural features (eg the existence of a class X note, the holder(s) of which are able to veto certain loan modifications) and unsatisfactory loan level legal opinions on enforceability of security — more akin to pre-crisis standards — also contributed to the agency's credit view.

**City Center Trust 2011-CCHP (July 2011)**

Fitch determined that it could not assign an investment-grade rating to the most junior class of this transaction, based on its analysis of hotel properties. In order to achieve the desired rating, Fitch would have needed to include projections of higher future cash flow. In the agency's view, the risk of future growth should be borne by property owners, not investment-grade bondholders. Alternatively, the agency would have needed to apply a 9.5% cap rate on in-place cash flows, far below the historical mean for hotels (in the range of 10.5% - 12% depending on property characteristics). Even at the low end of the historic cap rate range — probably appropriate given the quality of the portfolio — only a rating as high as 'BBsf' could be achieved.

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