THE NEW RATING REGIME FOR STRUCTURED FINANCE INVESTMENTS IN EUROPE (AS PUBLISHED IN THE JOURNAL OF STRUCTURED FINANCE – OCTOBER 2009)

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Introduction

Few doubt that the loss of investor confidence in ratings is linked to the recent mistakes made by credit rating agencies ("CRAs") when rating structured finance investments. A wave of defaults in U.S. sub-prime mortgages in the summer of 2007 caused the market for mortgage-backed securities to tank. The crisis quickly spread to other structured finance investments and, inevitably, to other credit markets worldwide. CRAs reacted by downgrading structured finance investments and tightening their rating criteria and methodologies. However, this did not prevent credit markets from continuing to fall and liquidity from drying-up almost completely. More rating downgrades exacerbated the problem by forcing investors to fire-sell assets, pushing asset prices down further.

In response to the criticism levied at CRAs for having contributed to the recent market turmoil, there has been pressure on regulators both in the U.S. and in Europe to implement initiatives designed to reform the way in which CRAs do business. As part of these initiatives, the European Parliament recently adopted a new regulation (the "Regulation") on CRAs and their rating activities in Europe. The Regulation adopts a prescriptive, rules-based approach to the regulation of CRAs, including (a) new registration requirements, (b) strengthened supervision by EU and national authorities over CRAs and their activities in Europe, (c) new conduct-of-business rules and operational duties, and (d) a new rating regime for structured finance investments. Although not yet in force, if enacted in its current form, the Regulation will have a significant impact on the credit rating business in Europe.

This article examines some of the more significant changes proposed by the Regulation to the rating business for structured finance investments and considers whether such changes are likely to assist in regaining investor confidence in the market for structured finance investments.

Presentation of credit ratings for structured finance investments

In the late 1990s, structured finance developed rapidly. Investors were able to tap new asset classes for the first time while the structure of transactions became more and more complicated. CRAs were entering unchartered territory and had to adapt quickly. In rating structured

finance investments, CRAs continued to use the same rating categories that were applied to corporate bonds, even though the rating methodologies and statistical data were altogether different. As a result, investors assumed that an AAA-rated bond issued by a U.S.-listed corporation carried the same risk as an AAA-rated bond backed by consumer receivables.

In recognition that in "*certain circumstances structured finance investments may have effects which are different from traditional corporate debt instruments*" and that "*it could be misleading for investors to apply the same rating categories to both types of instruments without further explanation*,"[1] the Regulation requires CRAs when issuing credit ratings for structured finance instruments to use rating categories that are "*clearly differentiated using an additional symbol which distinguishes them from rating categories used for any other entities, financial instruments or financial obligations.*"[2]

By choosing to identify structured finance investments as the sole category of investments to which this new requirement applies, the regulators appear to have taken the view that all types of investments that can be rated (other than structured finance investments) will operate in the same way as traditional corporate debt instruments. However, it can hardly be the case that corporate debt instruments will operate in the same way as, for example, syndicated bank loans, sovereign nations, and infrastructure projects. For this reason, a number of market participants have criticized this new requirement as having the potential to generate confusion. In addition, there does not appear to be a sound basis to single out structured finance investments. Many market participants are of the view that isolating structured finance investments in this way will not help investors return to the market and improve liquidity—structured finance investments now having the unredeemable stigma of special rating categories. Investment criteria for banks, pension and mutual funds, insurance companies, and other financial institutions will likely remain the same with no amendments being made to accommodate the new rating categories.

This new requirement is also difficult to justify on the basis that "further explanation" is required when applying corporate debt rating categories to structured finance investments. Each structured finance investment has risks peculiar to that investment and should be accompanied with its own disclosure document drawing investors' attention to all risks relevant to the investment decision.

A number of market participants have also criticized this new requirement on the basis that it is unlikely to prevent rating mistakes for structured finance investments. The rating mistakes made in the current crisis were

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1 See recital 18 to the Regulation

2 See article 8(3) of the Regulation

likely caused by the lack of reliable historical data and wrong rating assumptions by CRAs on default probabilities, correlation coefficients, recovery rates and expected losses in respect of the underlying assets, not by the use of then-existing rating categories. Perhaps it would have been preferable to limit regulatory intervention to the substance of the rating process rather than ratings presentation.

A duty not to rate

One of the causes of the loss of investor confidence in ratings was the extending of ratings to instruments where there was limited historical experience. Not only were sub-prime mortgages a relatively new asset class in relation to which there was limited experience, historically there had been few cases of widespread declines in residential real estate assets. These problems were further exacerbated as transactions became more and more complicated. Many market participants have concluded that CRAs simply did not understand the enormous complexity of the structured finance investments they rated.

In answer to these shortcomings, the Regulation provides that CRAs shall refrain from rating or withdraw an existing rating where "*the lack of reliable data or the complexity of the structure ... or the quality of information available is not satisfactory or raises serious questions as to whether a credit rating agency can provide a credible credit rating.*"[3]

It is difficult to see how this requirement will be enforced in practice. It is unlikely, at the time CRAs were assigning AAA ratings to complex structures such as CDOs of ABS, CDO squareds, and CPDOs, that CRAs thought the structures were too complex to rate. It was only with the benefit of hindsight that CRAs and regulators have been able to determine that some of the assumptions on which ratings were assigned were incorrect. Would a regulator have been able to determine this in the pre-2007 environment?

It has also been argued that the mischief that this requirement seeks to remedy is, by its nature, self-correcting. The argument is that the consequences of getting it wrong are such as to sufficiently incentivize CRAs to ensure the accuracy and quality of their ratings. If a CRA gets it wrong, it is likely that such CRA will lose credibility resulting in a loss of business and market share. If all CRAs get it wrong in respect of a particular product, it is likely that investor demand for that product will cease. For example, as a result of the recent rating mistakes, it is unlikely that in the near future there will be strong investor demand for sub-prime mortgage backed securities and other complicated and opaque structured finance investments. For these reasons, a number of market participants are of the view that the decision of whether a product is rateable should be left to CRAs. This new requirement has also been criticized as being

[3] See article 8(2) and annex I, section D, part I, item 3 of the Regulation

likely to force CRAs to err on the side of caution and take an overly conservative approach to structured finance investments thereby impeding innovation.

Disclosure, more disclosure

The Regulation introduces a comprehensive disclosure regime. The requirements include disclosure of (a) "*methodologies, models and key rating assumptions*" used in credit rating activities[4] and any material changes to any of these,[5] together with guidance that explains assumptions, parameters, limits, and uncertainties surrounding the models and rating methodologies including simulations of stress scenarios,[6] (b) the likely scope of credit ratings to be affected by any changes to rating methodologies, models or key rating assumptions,[7] and (c) all information about loss and cash-flow analysis performed by the CRA.[8]

Full disclosure of the "building blocks" of ratings is to be welcomed as a step towards better transparency and market efficiency. However, this may not necessarily prevent the same rating mistakes from happening again, as many investors will not have the ability to thoroughly understand rating methodologies, dissect modelling assumptions, and second-guess ratings if necessary. Rating methodologies and models are technical statistically based tools that are typically well beyond the comprehension of many investors. Investors are likely to continue to rely on the rating itself, rather than on their own analysis. In addition, full public disclosure of proprietary models and methodologies has caused concerns for CRAs and arranging banks because it may prevent innovation. Striking the right balance between the desire to have a transparent and efficient market and the concerns associated with disclosing sensitive information is likely to cause practical difficulties. The Regulation itself acknowledges this problem[9] but gives no guidance as to how it should be resolved.

It should also be noted that the Regulation does not apply to "*private credit ratings produced on an individual order ... which are not intended*

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[4] See article 7(1) of the Regulation

[5] See article 9(1) and annex I, section E, part I, item 5 of the Regulation

[6] See article 8(2) and annex I, section D, part II, item 3 of the Regulation

[7] See article 7(5) of the Regulation

[8] See article 8(2) and annex I, section D, part II, item 1 of the Regulation

[9] See recital 7(c) of the Regulation which provides that the level of detail concerning the disclosure of information concerning models should be such as to give adequate information to the users of credit ratings in order to perform their own due diligence in order to assess whether to rely or not on those credit ratings. On the other hand, disclosure of information concerning models should be such as not to reveal sensitive business information or seriously impede innovation

for public disclosure,"[10] which may well reduce any benefits derived from the new disclosure regime. Some market participants have argued that if private ratings are not publicly disclosed, there is a risk that CRAs will not apply their rating methodologies and models consistently when issuing them. In addition, as long as private ratings are not made public, credit information will be unevenly distributed creating arbitrage opportunities for few and leaving the rest to play catch up.

The new disclosure requirements of the Regulation also extend to disclosure of the level of assessment the CRA has performed concerning the due diligence processes carried out at the level of underlying financial instruments or other assets of structured finance instruments, including whether it has relied on a third-party assessment and indicating how the outcome of such assessment impacts the rating.[11]

In determining the scope of any duty of CRAs to undertake their own due diligence processes, a number of questions arise: What is the level of detail required in their assessment? How independent does the CRA's assessment need to be and to what extent can it rely on information provided by the arranging bank? In practice, it is unlikely that CRAs will be able to perform any extensive due diligence of their own; indeed they would have to re-invent their businesses in order to do so. Instead, it is likely that CRAs will continue to largely rely on due diligence conducted by the arranging bank.

No recommendations on the design of structured finance investments

With a view to avoiding potential conflicts of interest, the Regulation precludes CRAs from making "*proposals or recommendations, either formally or informally, regarding the design of structured finance instruments....*"[12] This is likely to have a significant effect on the way in which arranging banks and CRAs engage with each other. Traditionally, an arranging bank and the CRA worked together closely—exchanging information and ideas—in developing and structuring a transaction to achieve a particular rating. This two-way information flow has given arranging banks the chance to work with the CRAs towards a common goal. At a practical level, the Regulation gives no guidance in determining what are "*proposals or recommendations ... regarding the design of structured finance instruments.*" However, market participants have suggested that the ambit of the prohibition is wide and raise the concern that the prohibition is likely to impede innovation, as CRAs' involvement in the structuring process will be less hands-on, and more distant and one-sided.

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[10] See article 2(2)(a) of the Regulation

[11] See article 8(2) and annex I, section D, part II, item 2 of the Regulation

[12] See article 5(2) and annex I, section B, item 5 of the Regulation

No more rating shopping

The business of rating structured finance investments had become highly competitive—so too had the business of arranging structured finance investments. CRAs wanting to increase or maintain their market share were put under pressure from arranging banks to minimize the level of support[13] required in a particular transaction to achieve the required rating. In this way, the practice of rating shopping developed whereby arranging banks would play off one CRA against another so that the CRA willing to assign the highest rating with the least level of support would ultimately win the rating mandate.

In an effort to avoid this practice and the associated conflicts of interest[14], the Regulation requires a CRA to "*disclose, on an ongoing basis, information about all structured finance products submitted to it for their initial review or for preliminary rating. Such disclosure [to be] made whether or not issuers contract with the credit rating agency for a final rating*"[15]. However, it is difficult to see how this requirement by itself will achieve its stated aim. It has been suggested by some market participants that one solution to the rating shopping problem would be to remove the regulatory bias against unsolicited ratings; if unsolicited ratings were given the same footing as solicited ratings the incentive to shop rating agencies would be reduced. However, the Regulation requires CRAs when issuing an unsolicited credit rating to state prominently in the credit rating whether or not the rated entity participated in the credit rating process,[16] which is likely to add to the existing bias against unsolicited ratings.

Conclusion

The regulatory response by the European Parliament to the loss of confidence in ratings goes some way in assisting to improve transparency and market efficiency with the ultimate goal of restoring investor confidence in structured finance investments. However, a number of the new requirements may in practice be difficult to enforce, may generate confusion and are likely to impede innovation. Prescriptive regulation may not provide a complete fix for all past rating mistakes.

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[13] Such support typically is given through subordination or other structural features

[14] See recital 19 of the Regulation which provides that CRAs should take measures to avoid situations where issuers request the preliminary rating assessment of the structured finance instrument concerned from a number of CRAs in order to identify the one offering the best credit rating for the proposed structure and that issuers should also avoid applying such practices

[15] See article 8(2) and annex I, section D, part II, item 4 of the Regulation

[16] See article 8(5) of the Regulation