



Glass ceiling?

Acceptance of lower-rated securities, different criteria to broaden

Sovereign rating ceilings - once a consideration only for emerging market credit structures - began to matter last year for the first time in European ABS. Given the consequent difficulty of securing a triple-A rating for many issuers, wider acceptance of lower-rated securities and greater acknowledgement of different rating methodologies may become the market norm.

Fitch, Moody's and S&P now explicitly link peripheral European ABS ratings to the rating of the corresponding sovereign (SCI passim), following the disruption caused by the sovereign debt crisis. Rating caps are therefore effectively in place on Greek, Portuguese, Irish and Italian transactions.

Green Street Capital principal Dean Atkins notes that with greater rating agency focus on potential weak links in securitisation structures from the various counterparties providing services to the SPVs and bank ratings under continuing pressure, there will inevitably be downward pressure on ABS ratings as a result. He agrees that sovereign downgrades have become increasingly important now that several eurozone countries are rated in the triple-B area.

However, how much this matters is the relevant point, according to Atkins. "Not many buyers of, for instance, mezzanine CMBS bonds pay much attention to the ratings - especially when downgrades have been driven by counterparty linkage and given that there is often a large disparity between ratings of the same bond. Buyers are increasingly forming their own view of the risk."

Certainly, sovereign linkage is expected to result in more split ratings. Gene Phillips, director at PF2 Securities Evaluations, says it's odd that there appears to be so much agreement on initial ratings between the rating agencies given the ratings mean different things on different scales.

Bifurcation between ratings post-issuance is significant, he adds. "There is little evidence that rating agency performance is regularly monitored, which is compounded by the fact that the agencies don't monitor transactions at the same time."

The impact of sovereign linkage on ratings will depend on the investor and the extent to which they use ratings as an input for regulatory requirements, according to Phillips. "Generally, downgrades aren't good because they result in bank investors having to hold additional capital against the affected assets," he explains. "For example, many funds can only invest in investment grade assets and so downgrades can also impact the number of buyers and sellers in the market in this way. It will take a while for the market to move past this issue: it's not easy to change fund mandates to allow them to invest in sub-investment grade assets."

Atkins notes that while the inability to issue triple-A bonds out of lower-rated countries removes the option of tapping into triple-A investors, pricing made public issuance of PIIGS RMBS unattractive some time ago - and these deals have typically been replaced by bank repo trades with the ECB. "Perception of risk and relative value has front-run the impact of sovereign rating ceilings to a large

extent," he explains. "In other words, it wouldn't do banks much good to have the possibility of issuing triple-A bonds, if they were going to trade at 1000bp over anyway."

However, Phillips suggests that sovereigns perhaps shouldn't be rated in the first place. "Conflicts of interest are created when rating agencies rate sovereigns: governments lobby rating agencies and vice versa. The sovereign linkage only serves to magnify the difficulties in assessing the stability and accuracy of ratings."

In addition, Phillips says, some investors and regulators still don't seem to understand what ratings mean. "But what ratings mean has also changed over the last few years," he notes. "For example, one could confidently say S&P rated to probability of default three years ago, but the language has changed away from a statistical measure, towards a more qualitative measure of relative risk. Default probability became just one input into the final rating assessment."

Phillips continues: "This raises for me the question of how the agency can ensure consistency across product types, given that its ratings aren't explicitly linked to a scale. Can a triple-A in munis be at all comparable to a triple-A in corporates or sovereigns?"

While it's fine for each rating agency to have their own different methodologies, they should advertise their performance in the same standardised way so that investors can differentiate between them, Phillips notes. "Rating agencies should all be forced to consider AIG, Lehman and Fannie as either defaulted, or not. Right now, they're defining what their ratings means, they're defining their scale and they're defining their own consideration of default. Not surprisingly, their definitions of default are sometimes quite narrow, thereby artificially improving the performance of their own ratings."

Phillips suggests that rating agencies haven't been properly dealt with under the Dodd-Frank Act, for example. "The one exciting feature of Dodd-Frank was the creation of the Office of Credit Ratings," he says. "With that office having being postponed and with the liability standard having being removed, Dodd-Frank lacks its teeth."

Separate to Dodd-Frank, it's often said that new rating agencies entering the market encourages flight to quality. But Phillips cautions that having more avenues simply increases the ability to ratings shop.

If well implemented, certain aspects of the Franken amendment have the potential to overcome some of the hurdles around conflicts of interest, however. It proposes to allocate new assignments to the rating agencies depending on their resources, with the aim of making their business quality-oriented.

European asset-backed analysts at RBS suggest that the explicit sovereign linkage will continue to drive ratings instability and create greater bond ratings disparity in 2012, particularly in peripheral jurisdictions. Ultimately, the re-rating of the market could mean that it is no longer feasible for most European securitisations to aim for a triple-A rating for the senior tranche.

The RBS analysts conclude: "We consider it likely that most transactions will evolve to a point where the highest rating is either a low double-A or a high single-A rating, since securing a triple-A rating will be unjustifiably expensive. Such a rating will actually protect the transaction from undue reliance on the originator or other transaction counterparties, while still offering modest capital requirements for bank investors."

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