CMBS, CRAs and CRA3

- A recent CMBS conduit issue by JP Morgan prompted a rather unusual action from Moody's. To 'our' banks – seeking to revive hitherto quiet markets - this may introduce an additional layer of uncertainty.
- The upcoming European 'CRA3' regulation is not likely to help; to us, some of the proposals appear fundamentally flawed.
- In our view, the market is the only proper arbiter of the accuracy of CRA ratings. CRAs could, for example, be required to publish their historical performance in a pre-defined - and harmonised - format, leaving investors to make their own choices.

Moody's aloud

Credit rating agencies (CRAs) are making the competition among investment banks seem positively muted. With the CRA-related regulation being harmonised in Europe and the US, we set out our thoughts on the upcoming 'CRA3'.

This tale harkens back to July-11, when Standard & Poor's pulled its rating on a $1.5bn CMBS deal, forcing Goldman Sachs and Citi to cancel already placed transactions and, according to various sources, compensate buyers[1]. S&P explained that its decision – and the freeze on new issues ratings - was due to inconsistencies in its 'model' (the dreaded m-word again!). Shortly afterwards, S&P announced the errors were not as significant as first feared[2] but the damage was evident: according to Commercial Mortgage Alert, the firm's market share in CMBS dropped from 46% in 2010 to 23% in 2011, and issuers effectively froze S&P out of the market.

Seeking to draw the line under this unfortunate affair, S&P undertook a wide-ranging review of its CMBS rating criteria. In June-12, the firm invited comments on its initial proposals. By Sept-12, the new ratings were finalised; they reportedly incorporated a single model for rating different kinds of CMBS and lower capitalisation rates (which implies higher property value). The new rating approach was not met with universal acclaim, but JP Morgan was interested: in Oct-12, the bank commissioned S&P to rate its new $1.1bn CMBS conduit. Unusually - perhaps seeking to counter investors concerns about S&P's new ratings? – JP Morgan also chose DBRS, Fitch and Kroll Bond Ratings to rate the deal.

Moody's, generally thought the most conservative CRA on new CMBS issues since it started demanding more credit protection on CMBS deals in early 2007, was absent from this deal – for the first time since May-11, noted Credit Suisse's CMBS analysts. Moody's took little time to furnish its opinion of ratings assigned to JPM's CMBS conduit. Reviewing publicly available information, the agency said that several classes of the issue lack sufficient credit enhancement; that one of the classes should be rated 'speculative'; that the market capitalisation rates understate the underlying refinancing risk; and that its analysis of loans comprising 17% of the pool balance suggests most of them are not of investment-grade quality.

CRA3: looking for a problem to solve

Many observers will doubtless hear more than an echo of the pre-Credit Crunch practices – when CRAs often stood accused of buying market share - in this tale. We would not be surprised to hear of the US regulators' renewed interest into whether there is a 'race to the bottom' among CRAs.

European regulators - which agreed, in Oct-12, that the US legal and supervisory framework for CRAs is aligned with European requirements - are doubtless taking notes of the events described above, especially as it happens to be very topical for them. CRA3 – announced in Nov-11, it is the third round of CRA regulation in European Union since 2008 – is scheduled to take effect before the end of 2012. CRA3 attracted criticism from across the market – including money managers, which were meant to benefit from CRA reforms - and to our mind, with good reason: some of the proposals could prove worse than meaningless.

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[1] Citi and Goldman Sachs finally placed the issue in Sept-11, with ratings from Moody's, Fitch Ratings and Morningstar. The size of the offering was increased from $1.5bn to $1.7bn, but with significantly more conservative structure, including 30% credit enhancement for senior investors, far above the level offered in the July-11 deal. Back at S&P, the shake-up of the CMBS z

[2] This was not a happy period for S&P. In addition to the CMBS fiasco, the firm lowered its long-term sovereign credit rating on the USA to AA+. In Nov-11, as the spread between German and French debt widened to a record 1.7%, S&P accidentally announced to some of its subscribers that it has downgraded French sovereign debt. The firm quickly announced this was an error and that the rating of France remains AAA/A-1+, with 'stable' outlook. Or not so stable: two months later; S&P downgraded France and eight other Eurozone countries, and assigned negative outlook to most of the Eurozone.

Key areas of concern include:

- Mandatory rotation of CRAs. The European regulators' drive to increase the competition among CRAs is likely driven by their desire to avoid the dangers inherent in the oligopolistic NRSROs[3] model which was inadvertently established by the Securities and Exchange Commission (SEC). Mandating the rotation, however, seems a wrong way to achieve that goal. CRAs have proprietary ratings models: in the real-world CMBS example above, Moody's and S&P have a different view of the risks and valuation implied in different capitalisation rates, which resulted in very different ratings. (Frequent?) 're-ratings' may trigger portfolio rebalancing by investment managers not due to the issuer's worsening credit position, but the change in the rating model, a problem particularly acute for long-term securities.
- Further, the 'regulated' increase in competition among CRAs may well lower the quality of the rating advice. At end-July-12, there were 31 registered/certified CRAs in Europe, 16 of which are subsidiaries of S&P, Moody's or Fitch, and 5 of which are barely a year old. Ratings models are refined/back-tested over the years: there is a very strong possibility that the sheer number of newcomers may lower the overall standards of analysis. Even if not, what incentive would CRAs have to improve their analysis, if they only have to wait for their turn with an issuer – especially if CRAs are effectively limited to 10 ratings per issuer?
- The civil liability regime being imposed on CRAs could well exacerbate the negative impact of the mandatory rotation. The problems with this proposal are legion. CRAs can only offer opinions and will occasionally prove wrong; Warren Buffett himself does not get it right all of the time. Further, this stipulation will likely encourage the 'claims culture' by investors and issuers which could pursue CRAs in national courts, especially if the burden of proof is on CRAs[4]. To us, this seems exactly the opposite of the regulators' stated aim of reducing the reliance on ratings.
- CRAs may need European Securities and Markets Authority's (ESMA) approval before making changes to their ratings methodology. Leaving aside ESMA's implied – and yet hitherto unknown - special ratings expertise, the time these approvals would take (during which investors could, of course, sue CRAs for 'erroneous' advice), and doubts regarding the independence of CRAs, this may well result in harmful convergence of ratings models.
- A number of other proposals which we cannot see the need for include a requirement of disclosure of all relevant deal information on a public website (we think this should be limited to public issues only and should take into account the extensive existing disclosures regulation); CRAs being rotated out of an issuer hands over their company files to the incoming CRA ("With or without proprietary models and [formerly] confidential information, sir?"); analysts of sovereign credit must disclose their physical location (?!?!); and other.

In sum, CRA3 Nov-11 proposals, as they stand, appear fundamentally flawed. In our view, the market is the only proper arbiter of the accuracy of CRA ratings. Our in-market sources generally agree that CRA ratings are lagging indicators, a starting point for investment consideration and no real substitute for own research; and that credit spreads are strong complement.

EU/ESMA's enthusiasm would, in our view, be better directed at establishing a harmonised method for scoring CRAs' historical performance. CRAs could, for example, be required to publish their asset class-specific ratings-vs-issuer historical performance in a table defined by a regulator – thus leaving investors to add their own 'risk premium' on basis of a CRAs track record.

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[3] The handy acronym stands for Nationally Recognised Statistical Ratings Organizations. The NRSRO designation was not a legal requirement for CRAs, but not having it was a significant disadvantage, because large investors (e.g. pension funds) were legally obliged to follow NRSRO ratings. The first NRSROs were S&P, Moody's and Fitch. SEC granted several NRSROs designations in 1980s and 1990s (to Duff & Phelps, MCM, IBCA, among others) but mergers and takeover between NRSROs quickly re-concentrated the market in the hands of the few leaders.

[4] In Nov-12, prosecutors in Train, in southern Italy, launched a case against former and current employees of S&P and Fitch, claiming that analysts' reports were inaccurate and may have manipulated the markets. The case is hardly representative - magistrates in Milan and Rome turned the case down in 2011 – but, to our non-legal minds at least - illustrates how operating in some markets could become increasingly expensive for CRAs.

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