



# Is Rating an Efficient Response to the Challenges of the Structured Finance Market?

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# Summary

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This analysis focuses on the role of rating agencies in the structured finance market, and especially in the CDO market. It aims at completing the "2007 Risk and Trend Mapping for Financial Markets and Savings" published by the AMF in October 2006.

The European securitization market reached €450 billion of issues in 2006, within a framework which appears to be sufficiently secure to attract a growing number of investors. Agencies have developed their human and technical resources to meet this demand, as can be seen by the increasing resources allocated to this activity, particularly for Paris-based operations. The present analysis points out the level of market concentration, with only 12 banks accounting for more than 70% of the European market, as well as the cornerstone role of the main rating agencies in this area. The preponderant percentage of securitization in rating agencies' income, which accounts for almost 50% of their revenues, is also noted. The analysis reviews the potential conflicts of interest which might arise from this situation, especially with regards to rating agencies' ancillary business and with the participation of analysts in the negotiation of rating fees. It also questions the limits inherent to rating agencies' models in a context where products are constantly evolving technologically. The analysis highlights the potential asymmetries of information in the secondary market between market participants and rating agencies/transaction sponsors.

The regulator's intent, in order to maintain and strengthen agencies' credibility in this area, is to ensure that the growth of agencies' means corresponds to market needs in terms of size and complexity. In addition, it must ascertain that market participants receive adequate information. This study contemplates the regulatory actions to be implemented at the European level to ensure a better functioning of the securitization market. It suggests two main proposals :

- the need for clarification of the underlying methodologies of securitization ratings, especially in comparison with more traditional corporate ratings;
- and review of applicable regulations regarding permanent and periodic disclosure obligations over the course of the products' life cycle.

# Description of the structured finance market

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Structured finance instruments can be defined through three key characteristics: (1) the *pooling* of identified and legally isolated assets (either cash-based or synthetically created) ; (2) a debt issue backed by this pool of assets, with a limited recourse to those assets in case of default; (3) the *tranching* of liabilities. This structure allows the de-linking of the credit risk of the collateral (pool of assets) from the credit risk of the originator, usually through the use of a finite-lived, stand-alone special purpose vehicle (SPV), or FCC under French law<sup>1</sup>, with an average life equal to that of the assets transferred to it.

Liabilities are structured along a technique called subordination, which consists of creating an order of seniority between different categories of investors. Generally, an equity tranche absorbs most of the risk attached to the securitized asset portfolio. If a credit event occurs, equity tranche holders are first in line to bear any losses (loss of principal, interruption of interest payments). Next comes the mezzanine tranche (or several junior tranches), which offers middling risk exposure. The final tranche is made up of senior debt, which has very low exposure to credit risk. Mezzanine and senior debt are rated by agencies. By virtue of its special position, senior debt generally receives the highest rating, i.e. AAA/Aaa, sometimes with the participation of a guarantor such as monoline insurance, a technique called "credit enhancement."

A key goal of the tranching process is to create securities whose risk/return profiles are sufficiently diverse to correspond to different types of market investors.

Example of tranching:

Issuer	Seller	Class	currency	Mdy	S&P	Fitch	Size (Eur mn)	WAL (Yrs)	Launch spread	credit support (%)
SPV XXX	bank YYY	A	Eur	Aaa	AAA	AAA	254	8.4	3mE+24	29.1
		B	Eur	Aa2	AA	AA	22	11.2	3mE+41	22.9
		C	Eur	A2	A	A	21	11.8	3mE+63	13.13
		D	Eur	Baa2	BBB	BBB	14	12.2	3mE+166	9.5
		E	Eur	Ba2	BB	BB	13	12.6	3mE+375	7.82
		F	Eur	-	-	-	-	27.5	-	-

A credit support of 7.82 means that tranche E will be affected once SPV asset losses reach 7.82% of the total liability (the attachment point). The detachment point is when the full tranche E has been used to cover the SPV asset losses (i.e. when the SPV asset losses reach more than 9.5%)<sup>2</sup>.

<sup>1</sup> Certain funds and SPV are "rechargeable", ie can be used for several transactions over time.

<sup>2</sup> Potential excess spread has not been accounted for this example.

## Types of assets

Market practice is to talk about mortgage-backed securities (MBS) when the securitized claims are mortgage loans, reserving the term ABS for other types of arrangements like consumer and auto loan securitizations. MBS are further subdivided into commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS).

The range of securitization instruments has recently been extended with the arrival of collateralized debt obligations (CDO). Though they share the basic principles of ABS, CDOs use different underlying asset portfolios. CDOs can be backed by loans, in which case they are referred to as collateralized loan obligations (CLO) or by bonds, in which case they are known as collateralized bond obligations (CBO) or, more recently, credit derivatives (synthetic CDO). Furthermore, while ABS are backed by a portfolio of many standardized assets, CDO work more on the principle of diversification, via mixed portfolios, and generally comprise fewer line items.

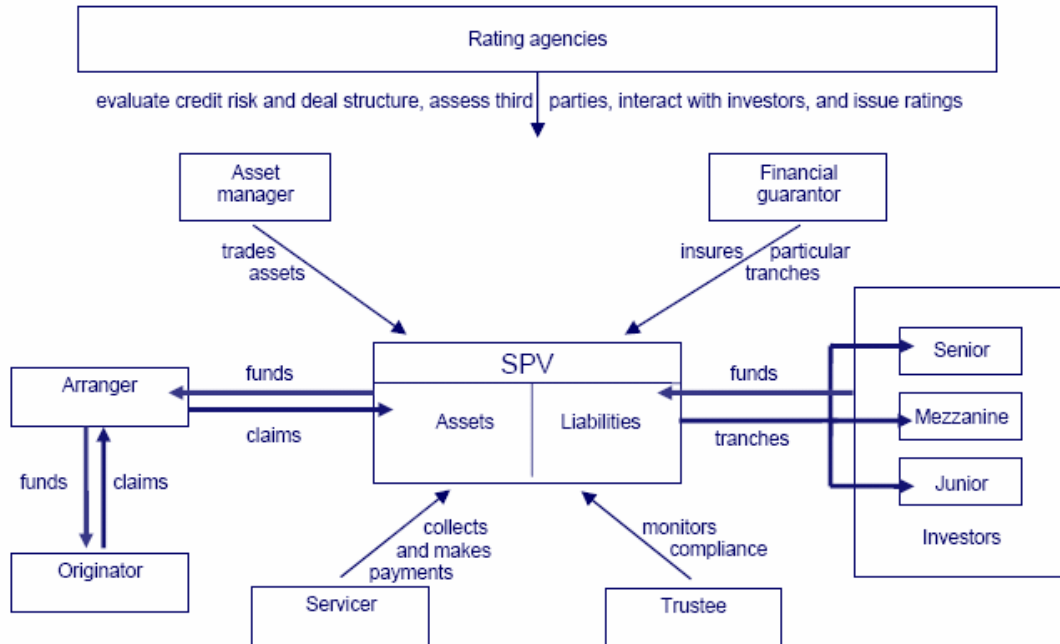
## Market participants

A number of different participants are involved in structured finance markets. These include:

- the arranger, generally a bank, that sets up the structure, tranches the liabilities and markets the tranches;
- one or more originators that originate(s) the underlying assets of the SPV, either in the course of regular business activities (sellers) or by sourcing them in the open market (the originator often is also the arranging bank);
- the servicer tracks and manages the assets of the pool and collects payments (the servicer is often either the seller or one of its subsidiaries, as it is the best-placed to manage assets which often are liabilities granted by the servicer);
- the asset manager (especially with regards to CDO transactions) may assemble the initial pool and subsequently trade in and out of collateralised (swaps or cash) assets;
- the trustee or depositary oversees cash distributions to investors and monitors compliance with deal documentation;
- the lawyers advise participants during negotiations and provide a legal opinion on the sale of assets, often focusing on aspects of bankruptcy law;
- the rating agencies evaluate credit risk and deal structure, and issue ratings for each tranche (except for the junior tranche which is normally unrated).

### Structured finance: key market participants

Stylised overview of the "players" involved in (funded) structured finance transactions and of their roles



Source: "Structured finance : complexity, risk and use of ratings" – BIS Quarterly Review June 2005

#### The role of rating agencies

Due to the complexity of the deals and the diversity of underlying assets involved, most investors (except investors in junior or highly subordinated tranches) do not have dedicated credit analysts to properly assess structured deals. As a result, many investors rely on rating agencies to assess the quality of each structure, both at initiation and throughout the life of the transaction. While the nature of the rating is the same for structured finance and corporate ratings, the agency's role and approach are strikingly different in the two cases. Rating is an integral part of structuring securitization products. The agency is involved at an early stage, and the rating is not an outcome but a target for the arranger, with the agency indicating the factors that need to be addressed to obtain the desired rating. In particular, the agency has an indirect influence on how the tranches are configured to ensure that the senior issue obtains the highest possible rating.

### The figures

The European securitization market grew by 25% in volume in 2005 with an issuance totaling €361 billion. As in 2004, the market was largely dominated by UK deals accounting for about 40% of the total, followed by Spain, the Netherlands, and Italy (about 10% each). As in 2006, RMBS dominated, accounting for more than 44% of the total volume issued, with CDO 24%, ABS 17% and CMBS 15%. CDOs, including synthetic CDOs, largely outnumbered other types of transactions with 72% of the total deals. In 2006, the European securitization market grew by more than 40% to €450 billion including more than €100 billion in CDO notes issued, of which 10% were synthetic CDOs. As an example, CLO issuance approached that of high yield bonds (€23 billion versus €25 billion). For the first time, the outstanding amount of European securitization deals was greater than €1000 billion.

## **Risks and issues in ratings procedures**

### **⇒ Is there enough diversification in the market to provide for a variety of views and opinions about the quality of the deals?**

Concentration is one of the main features of the structured finance market. 12 banks account for more than 70% of European deals, and three rating agencies cover the entire market (two of them accounting for 80%). According to 2005 figures for the French market, three legal firms account for more than 60% of the legal structuring work in the CDO market, and three others account for more than 50% of volume in the MBS market. Most of the bank teams dedicated to CDOs are located in London. This is less true for other types of assets, for which certain teams are located in the country where the seller is established.

Structured finance activity generates between 40% and 50% of overall sales at the mainstream rating agencies. Rating agencies' financial results closely depend on the selection process conducted by a limited number of arrangers.

Due to pressure and competition, rating agencies may be asked to rate complicated and innovative (though well remunerated) deals within a very short time, which despite all the due process can potentially lead to errors or an approximate assessment of the risks involved. In addition, do ratings agencies have enough experienced analysts to face the growing demand, especially given the turnover in such an active market? The same question could be raised for the monitoring of existing transactions. Finally, the lack of buy-side analysts could lead the market to rely only on rating agencies' opinions (except when the transactions are subject to a multi-rating<sup>3</sup>) which is less the case in the corporate bond markets where there are many more analysts.

### **⇒ Do rating agencies manage their various activities in an appropriate way to avoid potential conflicts of interest?**

Due to the complexity of some deals, rating agency analysts themselves may be involved in the negotiation of the rating fees. The CESR report on the compliance of ratings agencies with the IOSCO Code states: "DBRS, Fitch, and Moody's deviate from provision 2.12 of the IOSCO Code concerning the issue of rating staff's involvement in fee discussions with rated entities. These three CRAs adhere to the general principle stated in the IOSCO Code, but they all state that there are exceptions to the general rule. One explanation is

<sup>3</sup> Nonetheless, the more agencies involved, the more investors rely on their analyses.

that language problems and other circumstances in small offices outside the main markets may lead to rating staff occasionally having to take part in fee discussions. Another is that when deals are complicated, in particular in structured finance, rating staff may become involved in discussing the amount of work that has to be done as it also has an impact on fees. These CRAs can therefore not be seen as complying with the IOSCO Code in this respect<sup>4</sup>."

Since 2005, several rating agencies have proposed pricing services for the secondary market of existing deals. To the extent that rating agencies are the sole decision makers for any rating changes and due to the asymmetry of information between rating agencies and market participants in this area where ratings constitute an essential if not exclusive basis for setting a price, such a new service could raise questions about the information used by rating agencies to provide market prices, and the mix of responsibilities this might create between their role as rating entity and their presence in the secondary market for the valuation of the rated paper. Certain agencies have implemented a legal barrier between these activities and state their adherence to the usual corpus of ethical rules. In every case, given the role of agencies in the market, it is essential that at minimum there be no technical or human link, whether formal or informal, between the two activities that could influence the decisions of one or the other.

## ➔ Are there specific issues in the legal structuring of the deals?

Complex securitization transactions come with potentially substantial legal risks, which are a key factor for agencies assessing proposed structures and rating the tranches. Lawyers chiefly advise participants during negotiations and provide a legal opinion on the sale of assets, often focusing on various aspects of bankruptcy law. They are also called on to provide an opinion on particular parts of the transaction. As part of the process of preparing their opinion, which is needed to secure the desired rating and thus the success of the transaction, lawyers have to say at the outset – often at the request of the agencies -- whether there are any impediments, and they must indicate any reserves that might be included in their opinion.

Since rating agencies do not always use outside counsel, they ask, on a regular basis and for information purposes, arranger's lawyers to give them some of the analysis originally destined for the arrangers on questions that concern all parties. There are few lawyers involved in the structured finance sector, and in the event a law firm acts for different participants on the same deal, there could be a potential conflict of interest.

<sup>4</sup> "Code of Conduct Fundamentals for Credit Rating Agencies" IOSCO – December 2004.

## ➤ Is the arbitrage of rating models in the hands of the banks?

Agencies' CDO rating models are subject to potential arbitrages by banks, particularly on the different levels of intra- and inter-correlation used between the agencies' and the banks' models. Unlike corporate bond analysis, structured finance rating methodologies are essentially based on statistical models. Arbitrage opportunities are therefore easier and more numerous than those concerning corporate bond ratings, which are mainly based on a more traditional credit analysis. Arrangers might be tempted to choose the "less demanding model" in terms of the amount of subordinated tranches required, when investors have no particular preference. As a consequence, rating agencies have a difficult task of balancing the risk of their reputation with the marketing of their models to their banking clients.

## ➤ Have the present methodologies proved their robustness over time?

Changes of rating for CDOs are statistically larger and more frequent than those for corporate ratings or ABS. Indeed, in terms of the magnitude of transitions from 1998 to 2004, CDO ratings varied more than corporate ratings: for example, in the case of downgrades, 2.8 versus 1.8<sup>5</sup> notches on average. There were a total of 878 upgrades compared to 376 downgrades in 2006. The CDO rating actions accounted for 46% of the upgrades and 80% of the downgrades, most of them coming from synthetic CDOs. This situation questions the volatility<sup>6</sup> of securitization rating, and especially the rating stability of synthetic CDOs.

## ➤ Are rating agencies' methodologies applicable to all types of structured deals?

Agencies' methodologies are based on the estimated risk of loss linked<sup>7</sup> to the assets transferred to the securitization vehicle, using a probabilistic model with historical data, assumptions of market scenarios, and the correlation of default between underlying assets. Are these models suitable for all type of deals such as CPDO (Constant Proportion Debt Obligations), especially when rating agencies take into consideration, in calculating "expected loss" or the probability of default of the issue's tranches, not only the default probability but also the high leverage effect on spread scenarios? This situation may raise the question of the extent to which such ratings may be compared to corporate and cash CDO ratings. Furthermore, one might ask how comparable the consequences of defaulted issues, between securitizations and corporate debt, really are, particularly concerning the subordinated and bespoke tranches?

<sup>5</sup> CDO rating models are based on a largely "mechanical" approach. CDO ratings are probably more sensitive to a market event affecting one or more of its assets.

<sup>6</sup> which can be increased, *inter alia*, by the underlying leverage in these products.

<sup>7</sup> Agency methodologies differ in principle and in content. Moody's has a method based on expected loss, whereas Standard & Poor's and Fitch have a method based on default probability, with loss risk, in both cases, a function of tranche size and subordination.

## ➤ Does a AAA rating for CDOs have the same meaning as for all other types of products?

Two identically-sized AAA tranches of the same issue can have different attachment points. A similar observation may be made with super-senior tranches, which are supposed to rank above the AAA tranche.

If we consider only standardized structured products such as CLO/CDO, at year-end 2006 the AAA CLO/CDO spread on Euribor 3-month was about 22 bp, while the AAA Prime MBS reached 10 bp and the AAA corporate<sup>8</sup> spread was only 2 bp. For a BBB tranche, the corporate spread was about 70 bp, the Prime MBS 47 bp and the CLO/CDO 140 bp. These differences could bring into question the significance of the AAA rating. Can specific structured finance products with a AAA credit rating produce a return of up to 200 bp for investors, while a AAA corporate or a AAA MBS tranche produces only a 10/20 bp return? What does that mean? A market imperfection, a new product premium, a liquidity premium? Or the market perception that the risk attached to this AAA tranche, especially in terms of volatility, is higher than for a "standard" transaction?

We know, furthermore, that a rating change can put a fund manager in an extremely delicate situation, either because he risks having to sell the security, or because the price volatility linked to the change in rating might lead to booking reserves or capital losses, even if the tranche initially subscribed was AAA. In this case, can we really consider sufficient the current information of default probability of CLO/CDO within a given timeframe? Is a specific measure of risk missing for investors, one that only agencies, with their detailed knowledge of the deals, can produce? For CDOs, and more especially synthetic CDOs and CPDOs, isn't a rating sensitivity measure indispensable?

## ➤ Is it sufficiently clear how changes in the methodologies apply to past transactions?

Agencies have different approaches when updating ratings for past transactions. Some of the agencies do not review the old ratings but use the new method in their surveillance. In this case, the surveillance process is based on both the old and the new methodologies. In addition, it is sometimes difficult for external parties to appreciate whether rating actions are attributable to methodological changes or if they actually reflect a deterioration in the underlying assets. The changes are sometimes masked by other factors, such as the time value, or the sale of an underlying asset, or the repayment of loans, or more generally a variable economic environment. Some market observers also point out that statistics concerning rating changes should be clarified in cases where arranging banks have anticipated foreseeable rating downgrades by adding a subordinated tranche to the program, which increases the credit quality of the existing tranches by as much. All these aspects indicate a certain level of perfectibility of the rating agencies' approach to rating monitoring.

<sup>8</sup> Essentially public or semi-public entities.

## ➤ Is the secondary market for structured transactions provided with regular, sufficient and appropriate flows of information<sup>9</sup>?

Structured finance reports are available free of charge on rating agencies' website for a short period of time, in most cases a few days, after they have been released. Further access is only possible upon payment of a fee.

The information published by CDO issuers may be less precise, more heterogeneous, and difficult to obtain, which could in the end contribute to the asymmetry of information between issuers, investors, and rating agencies. With regards to CDOs, information in certain cases is accessible only to note holders; for the same deal, investors with junior tranches may contractually obtain more information than senior investors.

Finally, once assets have been transferred, the seller may be less keen to provide information which could have a significant impact on the securities issued. The entity responsible for sensitive information may also not be clearly identified: is it the trustee or the servicer? As an example, if a bank which has securitized part of its portfolio decides to change its litigation policy (e.g. changing the policy for when unpaid loans are sent to the litigation department), it may not necessarily publish this information. As a result, the level of unrecoverable assets may rise and lead rating agencies to decide to downgrade the deal. In theory, the change of rating should not create any surprises in the market if the bank's decision to change its policy has been released to the market as material information. This might not always be the case, however, due to the sensitivity of the information in terms of competition, or because the initial participants (arrangers, sellers) have no further interest in the assets and are therefore no longer concerned by the deal.

<sup>9</sup> Cf. *Market Impact of Rating Agencies' Decisions - Study by Evguenia Iankova, Florent Pochon and Jérôme Teiletche, AMF 2005 Rating Agencies report.*

## Conclusions/ Regulatory actions

- As was confirmed in the report published by the CESR in January 2007, over the past two years rating agencies have implemented the IOSCO's Code of Conduct principals in a generally satisfying manner. However, it would be useful to raise specific questions at the European level, regarding structured finance market concentration and the potential conflicts of interest it may generate for ratings, particularly in cases where rating agencies develop ancillary activities. The goal would be to examine whether any particular recommendations beyond IOSCO's present Code of Conduct, might be needed in this respect.
- For several years, agencies have significantly increased the resources dedicated to structured finance ratings, as can be seen by the increased means allocated to this activity, particularly for Paris-based operations. However, in light of the constant flow of new innovative structured products, questions should be raised at the European level concerning the potential limitations of agencies' models - can everything really be rated ? – and the meaning of ratings. This should be done in close cooperation with the prudential authorities in charge of the implementation of Basle II and of the OEEC regime<sup>10</sup>, with the principal objective of encouraging understanding among the participants and strengthening the market's credibility. It is also necessary to determine if a structured finance rating is equivalent to a corporate rating and, within securitization ratings, whether or not the rating of a cash CDO is equivalent to the rating of a synthetic CDO. In this respect, is there a need for either differentiating structured finance and corporate ratings or for requiring additional information regarding the volatility or sensitivity attached to each structured finance rating, which, for certain products like CDOs, seems indispensable? Can these products benefit from the same level of eligibility to retail funds as corporate bonds, ratings and rating sensitivities being equal? In every case, the responses to these questions do not preempt further thoughts about existing regulations concerning fund managers' level of due diligence in assessing such products.
- Structured finance transactions that are subject to a listing on a regulated market are covered by existing directives. However periodic and ongoing disclosure obligations for issuers should be adapted to include special features for structured finance transactions. With the goal of providing the market with more appropriately detailed information on structures and assets, issuers should publish not only financial statement reports but also reports concentrating on the underlying asset behavior (level of delinquencies, level of prepayment, etc.) and the evolution of the key financial elements specific to this type of product. It is worth mentioning that while the Prospectus directive has provided for a dedicated scheme regarding structured finance, the Transparency directive has not. From the point of

<sup>10</sup> External credit rating organisation.

view of the Market Abuse directive, there is a need at the European level to clarify the concept of “sensitive information” with regards to structured finance deals. In this respect, the AMF welcomes the European Securitization Forum's (ESF) latest initiatives to establish guidelines concerning the content of periodic reports, and the definitions of key words to be used in structured finance. Issuers should also clearly identify responsibilities between trustee, servicer, paying agent and other transaction participants for collecting and assembling relevant market data.

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