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S&P Global
55 Water Street
New York, NY 10041

Re: Request for Comment: Global Methodology and Assumptions for CLOs and Corporate CDOs (10 Apr 2019)

Ladies and Gentlemen:

This is in reply to your publication, *Request for Comment: Global Methodology and Assumptions for CLOs and Corporate CDOs*, which was released on April 10, 2019 (the "RfC"). The proposed change to the criteria would reduce the necessary credit support levels for CLO tranches at all rating levels. Both the RfC (¶ 1) and its companion FAQ article[1] indicate that the key basis for proposing to make the criteria more lenient is that CLOs performed well during the 2008 downturn and in the period since then. However, the rationale for the proposed change to the criteria appears strained in at least three respects.

First, the performance of CLOs and their underlying loans over the past decade (or even over the past several decades) provides no new insight into how they would perform under conditions of "severe" or "extreme" stress, corresponding to "AA" and "AAA" stress scenarios, respectively.[2]

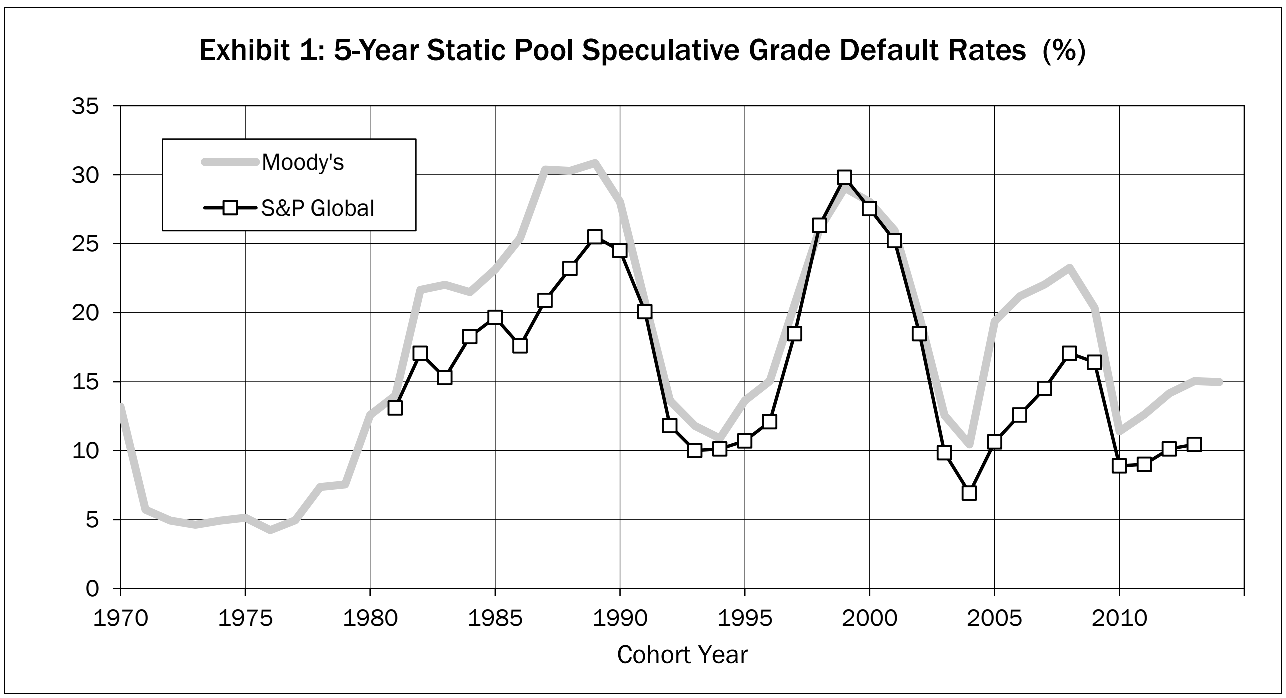
Second, the benchmark used for calibrating the criteria for "BBB"-rated tranches appears inconsistent with previously published materials. Paragraph 29 of the RfC states that "the parameters are calibrated such that 'BBB' rated CDO tranches can withstand a moderate stress that is informed by the post-1981 maximum observed corporate default rates." Table 1 of the RfC reports the post-1981 maximum observed corporate default rates. However, some of the values in that table are *lower* than the

[1] *Credit FAQ: Understanding S&P Global Ratings' Request for Comment on Proposed Changes to Its CLO and Corporate CDO Criteria* (Apr. 11, 2019).

[2] You identify the characteristics of stress scenarios of differing intensity in *Understanding S&P Global Rating Definitions* (3 Jun 2009, republished 18 Dec 2018).

corresponding values in a similar table that appeared in the 2009 criteria.[3] It does not seem possible that the maximum observed default rate can have *decreased* with the passage of time. The difference is not explained and the lower values in Table 1 of the RfC indicate a lower "BBB" benchmark for the proposed change to the criteria.

Third, the RfC and the companion FAQ appear to ignore the fact that speculative-grade corporate default rates were generally lower in the 2008 downturn than in previous episodes of stress. The FAQ, in particular, misses this key fact in comparing the observed default rates of loans backing CLOs with the default rate "predicted" by the CDO Evaluator computer model. The FAQ incorrectly implies that the model is predicting an excessively high level of defaults on the loans backing CLOs. On the contrary, the effects of the 2008 downturn were concentrated in the finance in real estate sectors rather than in the corporate sector. This is confirmed by the 5-year speculative grade default rates reported in S&P's annual corporate bond default studies. The static pool cohorts for the years 2007-2009 display somewhat elevated default rates but those rates are well below the 5-year speculative grade default rates associated with prior episodes of stress. Moody's data shows a similar pattern (Exhibit 1).

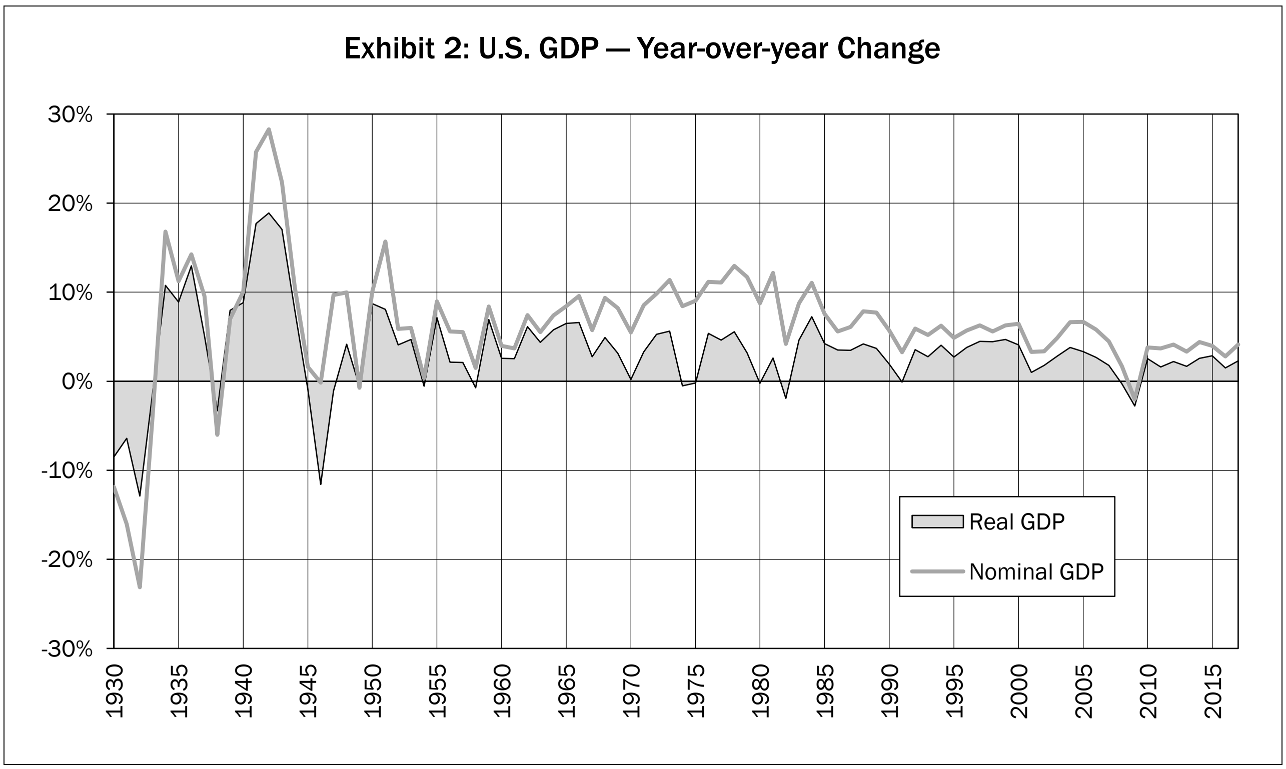



Sources: S&P Global Ratings, *2017 Annual Global Corporate Default Study and Rating Transitions* (5 Apr 2018) (Table 32); Moody's Investors Service, *Annual Default Study: Defaults Will Rise Modestly in 2019 Amid Higher Volatility* (1 Feb 2019) (Exhibit 53).

[3] *Update to Global Methodologies and Assumptions for Corporate Cash Flow and Synthetic CDOs* (17 Sep 2009).

The FAQ article seeks to characterize the 2008 downturn as one of either "modest" (*i.e.*, "BB") or "moderate" (*i.e.*, "BBB") severity for purposes of showing that the observed default rates on the loans underlying CLOs were lower than would be predicted by the simulation model for scenarios of such severities. The FAQ seems to take the stance that the 2008 downturn was at least "modest" and possibly "moderate."

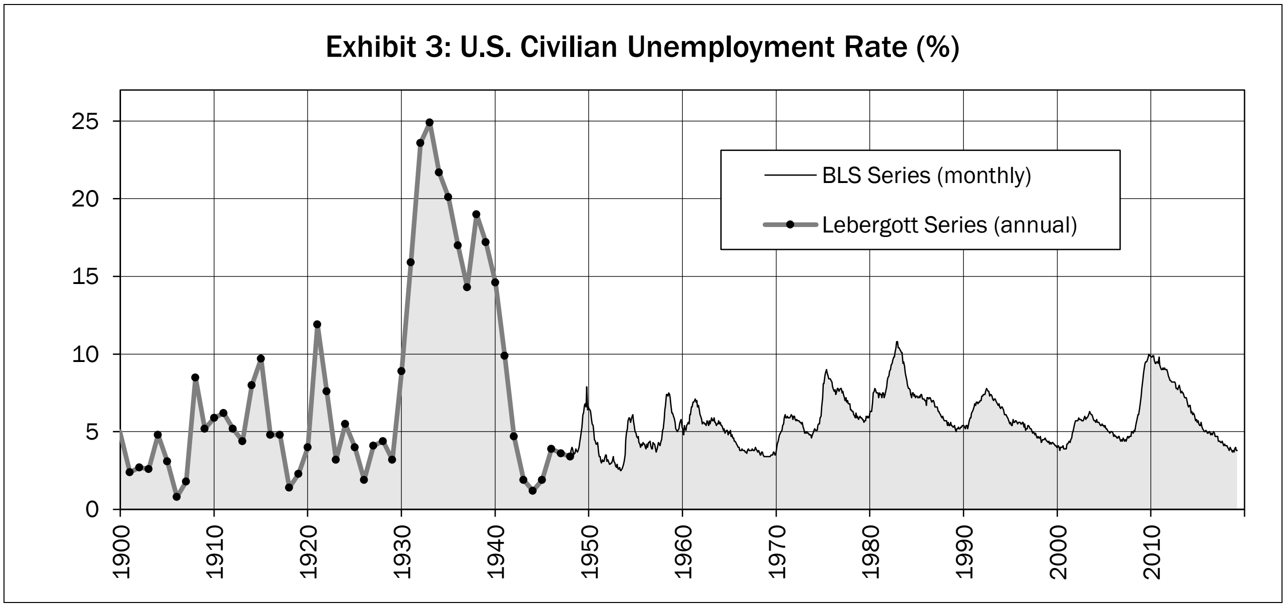
At first blush and based purely on gross macroeconomic variables—change in GDP, unemployment, and stock market performance—the 2008 downturn looks like an episode of "moderate" (*i.e.*, "BBB") stress.[4] For example, according to the National Bureau of Economic Research, the downturn ran from December 2007 to June 2009. U.S. real GDP contracted by 4% from 2007Q4 through 2009Q2. It recovered to its pre-recession peak two years later, in 2011Q2 (Exhibit 2).




Source: U.S. Bureau of Economic Analysis, file gdplev.xlsx.

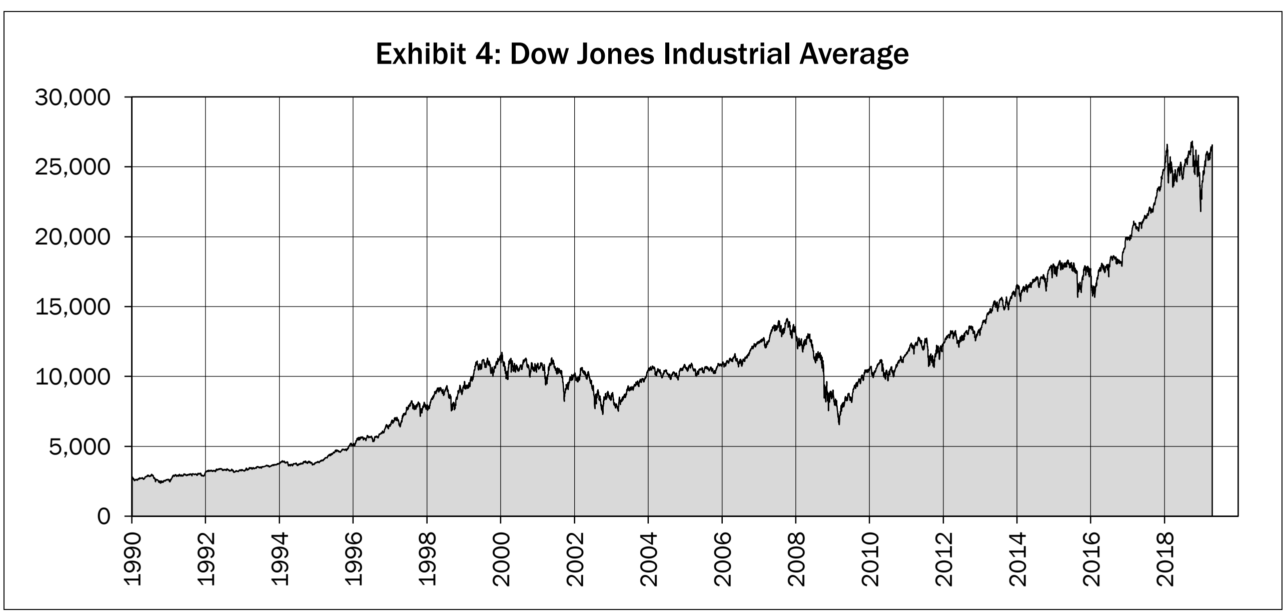
[4] *Understanding S&P Global Rating Definitions* (3 Jun 2009, republished 18 Dec 2018).

Likewise, the civilian unemployment rate reached its cyclical peak of 10% in October 2009. It was at that level for only one month, but it was at or above 9.4% from May 2009 through October 2010. It has been steadily declining since then (Exhibit 3).




Source: U.S. Bureau of Labor Statistics (retrieved from Federal Reserve Bank of St. Louis, date series UNRATE), monthly data 1948 to present; Lebergott, S., *Annual Estimates of Unemployment in the United States, 1900-1954*, in THE MEASUREMENT AND BEHAVIOR OF UNEMPLOYMENT, National Bureau of Economic Research (1957), annual data 1900 to 1948.

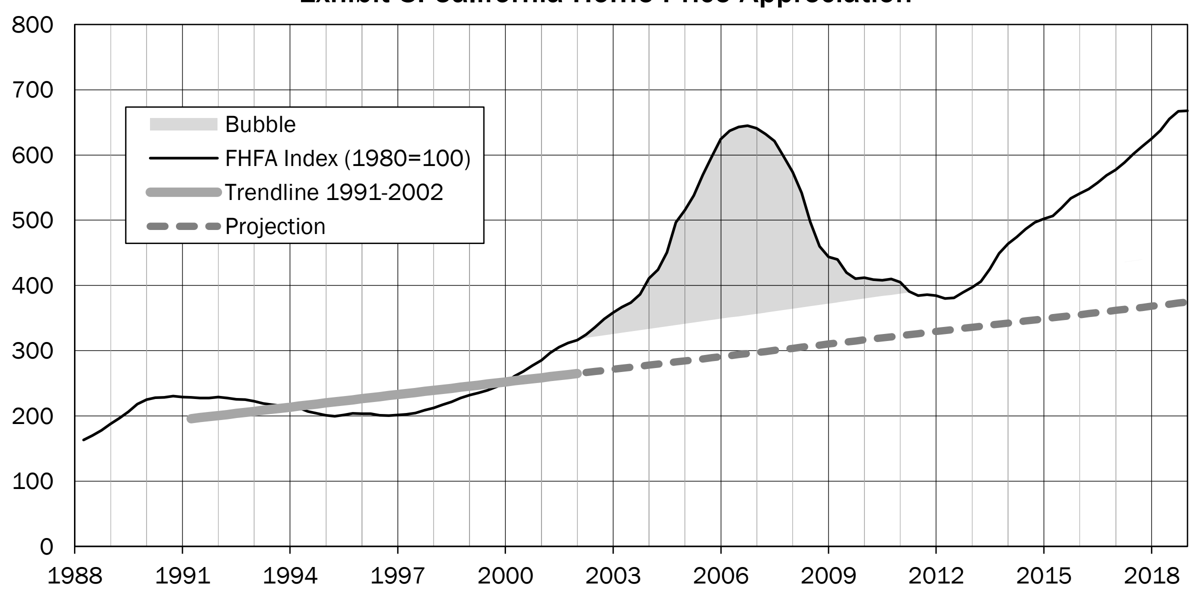
And, following a strong run-up through 2006 and most of 2007, the stock market declined sharply in 2008 and early 2009, losing about half its value. Then, it recovered about half its losses by late 2009 and has been on a generally upward trend since then (Exhibit 4).



However, despite the macroeconomic variables, comparison to past episodes of moderate stress in the U.S. suggest that the better characterization of the 2008 downturn is that of "modest" stress. For example, the 1973 recession was accompanied by major dislocation and hardship for the general population. The OPEC oil embargo triggered gasoline rationing (and even episodes of violence) combined with America's first experience of "stagflation." The effects were extremely widespread and felt directly by most households. Likewise, the recessions of the early 1980s (two of them, punctuated by a year of weak economic expansion) were also felt by most American households. Interest rates and inflation were extremely high in the early 1980s and this created hardship for millions as prices advanced more quickly than wages.

By contrast, the 2008 recession had relatively slight effects on households and most businesses. Before the recession, the bursting of the housing bubble, which hurt household balance sheets, and irresponsible lending practices, which put millions of households into mortgage loans that they could not afford, had profound and widespread effects. But they were not a consequence of the recession; rather they were the sparks that triggered it (Exhibit 5).

**Exhibit 5: California Home Price Appreciation**




Instead, the effects of the 2008 recession were concentrated primarily in the financial sector, with secondary effects in the real estate sector, which had a delayed recovery compared to the rest of the U.S. economy. The corporate sector, as shown above (Exhibit 1), was not among the main victims of the downturn. In fact, the corporate sector may have benefited from the massive liquidity injections into the financial sector that were part of the early policy response to the downturn. Therefore, based on its effects on the household and corporate sectors, the better classification of the 2008 downturn is that it was an episode of "modest" (*i.e.*, "BB") stress, though for the financial and real estate sectors it might fairly be classified as "moderate."

Thank you for your consideration of comments on the proposed criteria change. Please feel free to reply or to call if you would like to discuss these comments.

Very truly yours,

*Mark Adelson*

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