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Big Changes In Standard & Poor's Rating Criteria

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Chief Credit Officer's Note

Standard & Poor's Ratings Services considers the recent changes in our criteria for rating collateralized debt obligations (CDOs) and U.S. residential mortgage-backed securities (RMBS) to be significant. Overall, their effect should be to make it more difficult for securities in the sectors that have displayed poor credit performance during the current financial crisis to receive high ratings. The changes are designed to enhance the comparability of ratings on those securities with ratings on credits in other sectors.

Establishing and modifying criteria goes to the very heart of what a rating agency does. Our rating criteria comprise both the fundamental principles of how we analyze credit risk, as well as the specific methodologies and assumptions that we apply in different sectors. The fundamental principles are generally similar to those used by most other market participants. However, our specific methodologies and assumptions may differ markedly from those used by others. The methodologies and assumptions constitute "our way" of analyzing credit.

More than any other kind of institutional change, changes to criteria directly affect our credit analysis and our ratings that result from that analysis. Indeed, criteria is the exact spot where the rubber meets the road for a rating agency. By reading our criteria, investors can gain a deep understanding of the nature and levels of risk expressed in our rating opinions.

The changes are driven by our overarching objective of making ratings comparable across sectors, geographic regions, and over time. The changes reaffirm the long-standing definitions of our ratings. We intend for each rating symbol--for example, 'AAA'--to connote a comparable overall view of creditworthiness wherever and whenever it appears.

To help enhance comparability, we recently embraced the use of stress scenarios as tools for calibrating our criteria. We use a scenario of extreme economic stress--on par with the U.S. Great Depression--as the 'AAA' calibration case. Accordingly, we intend for securities to which we assign 'AAA' ratings under the new criteria to be able to withstand that level of economic stress without defaulting (though, of course, they could suffer downgrades under such stress).

Comparability Is The Key

Comparability of ratings is important because ratings can serve as a common vocabulary to describe credit risk. When ratings are comparable across sectors, investors can better use them to compare the credit risk of securities in different sectors, thereby helping them to assess whether there are potential discrepancies in the pricing of credit risk in different sectors. When ratings are comparable, an investor can more easily assess the yield offered by a bond relative to its risk as compared to other bonds from other sectors.

The recent poor credit performance of many highly rated securities in certain sectors, particularly CDOs and U.S. RMBS, has led us to update our criteria in those sectors in order to improve ratings performance and comparability. The performance of many recent ratings in those sectors has been disappointing and out of line with our historic track record. We aim for the recent criteria changes to produce better ratings performance and comparability going forward.

As noted above, we use specific stress scenarios in the process of associating both qualitative and quantitative factors with different rating categories. Significantly, the scenarios do not supplant consideration of sector-specific and company-specific risk factors in our criteria or in assigning individual ratings. Rather, they apply in addition to these factors. For example, for corporate criteria, we consider the stress scenarios, along with everything else that we consider, in assessing the levels of leverage and profitability that we associate with the different rating categories. Likewise, for structured finance criteria, we consider the stress scenarios in assessing the levels of credit support for the different rating categories.

Broadly, the stress scenarios provide a way for pursuing and maintaining superior calibration of our rating criteria going forward. Superior calibration enhances comparability.

The Criteria Changes

The criteria updates for both CDOs and U.S. RMBS refer to the experience of the Great Depression as the calibration standard for 'AAA' ratings. Both updates utilize historical studies of that period.

U.S. RMBS

The centerpiece of the updated U.S. RMBS criteria is the specification of an "archetypical" prime mortgage pool and its associated credit enhancement level at the 'AAA' rating category. The archetypical pool serves as a benchmark against which investors can compare the actual pools in real transactions. The archetypical pool provides a clear and straightforward vehicle through which market participants can understand our analysis. In addition, it gives investors a simple way for comparing our rating criteria with those of other rating agencies.

The new U.S. RMBS criteria establishes a 'AAA' credit enhancement level of 7.5% for a security backed by the archetypical pool. That level is substantially higher than the credit enhancement level under the previous criteria. Thus, under the updated criteria, investors should generally expect RMBS at each rating level to embody a larger cushion against potential losses.

Naturally, future transactions may present pools that differ markedly from the archetype. Should we be asked to rate U.S. RMBS with borrowers featuring low credit scores, little equity in their homes, or certain other risk features of recent vintage mortgages, the support levels attendant to a 'AAA' rating would be higher than the archetypical pool's 7.5%. The adjustment mechanisms in the criteria are intended to capture the relevant risk sensitivities we see and to result in ratings of 'AAA' only when an RMBS has sufficient credit support to withstand extreme stress.

The implementation of the new criteria resulted in only a small number of downgrades. Many outstanding RMBS had already been downgraded because of poor performance of their underlying loans during the stressful conditions of the past few years.

CDOs

Likewise, the update to the corporate CDO criteria made significant changes. Most important, the updated criteria added both qualitative and quantitative tests to supplement the "Monte Carlo" default simulation model. The simulation model treats the loans or bonds that back a CDO under a mathematical framework, with characteristics and behaviors defined by the laws of probability. The additional tests are intended to address the "model risk" associated with using a probability-based model. We believe this improves the criteria and helps investors by making the analysis more robust than using only a simulation model.

In addition, we recalibrated the simulation model to achieve stresses based on Depression-era experience. The calibration method that we used (as described in the criteria article) makes it easier and more transparent for investors to understand our ratings and to relate them to their investment objectives.

The updated CDO criteria produces a 'AAA' credit enhancement of roughly 42% for a typical nine-year collateralized loan obligation backed by a well-diversified pool of 'B'-rated credits, which is substantially higher than under the prior criteria. Similarly, the 'AAA' credit enhancement level would now be around 18% for a typical five-year synthetic CDO backed by a well-diversified pool of 'BBB'-rated credits, which is substantially higher than under the earlier criteria. Upon the release of the new CDO criteria last month, Standard & Poor's placed more than half a trillion dollars of outstanding CDO securities under review for possible downgrade.

Other changes

Separately, in June, we published updated criteria for rating securities backed by mortgage loans on U.S. commercial real estate (commercial mortgage-backed securities, or CMBS). That update substantially revised the criteria for CMBS to achieve high ratings, again based on a combination of recent performance and comparison to historical examples. As in the other areas, the new criteria generally calls for higher credit enhancement levels, which would reflect less leverage embedded in the securities at each rating category.

In addition, we have taken steps to address what we have observed to be weak stability characteristics of certain types of credits. We accomplished this by adopting criteria that considers credit stability, not just ultimate default risk. Under this criteria, for instance, we may estimate that two securities have a similar default risk, but if we believe one is more prone to sharp deterioration in periods of economic stress, it will be rated lower initially and it is unlikely that it will ever be rated in our highest rating category.

Going Forward

While important changes have been made to the CDO and U.S. RMBS criteria, we continue to examine other areas for potential criteria enhancements. There may be further opportunities to continue incorporating lessons learned over the past two years as well as enhancing the comparability of ratings across sectors. For example, criteria that are based on the criteria for CDOs or U.S. RMBS may present such opportunities.

Conclusion

Standard & Poor's believes that the recent criteria changes are key to restoring confidence in ratings and, by extension, in the capital markets broadly. The updated criteria for CDOs and U.S. RMBS represent significant improvements and should enhance rating comparability. The changes incorporate many lessons from the last few years.

Even though certain market participants may not welcome the changes in the short-run (e.g., because of downgrades or the difficulty of getting high ratings on new issues), Standard & Poor's believes they are important to the long-term performance of its ratings. Improved comparability makes ratings more useful and valuable as benchmarks of credit risk. That, in turn, should help market participants in making informed decisions and help to reenergize the markets.

Very Truly Yours,

Mark Adelson Chief Credit Officer

Related Research

- "Understanding Standard & Poor's Rating Definitions," June 3, 2009
- "Methodology And Assumptions For Rating U.S. RMBS Prime, Alternative-A, And Subprime Loans," Sept. 10, 2009
- "U.S. RMBS Transactions Affected By The Sept. 10, 2009, RMBS Criteria Revisions," Sept. 14, 2009
- "The Potential Magnitude Of Rating Changes Resulting From Our Revised U.S. RMBS Criteria," Sept. 14, 2009
- "Update To Global Methodologies And Assumptions For Corporate Cash Flow And Synthetic CDOs," Sept. 17, 2009
- "Application Of Supplemental Tests For Rating Global Corporate Cash Flow And Synthetic CDOs," Sept. 17, 2009
- "Standard & Poor's Explains Updates To Global Corporate Cash Flow And Synthetic CDOs Criteria," Sept. 17, 2009
- "European Corporate CDO Ratings Placed On Creditwatch Negative In Connection With Revised Corporate CDO Criteria," Sept. 17, 2009
- "U.S. Corporate CDO Rating Actions In Connection With Revised Corporate CDO Criteria," Sept. 17, 2009
- "U.S. CMBS Rating Methodology And Assumptions For Conduit/Fusion Pools," June 26, 2009
- "Standard & Poor's To Explicitly Recognize Credit Stability As An Important Rating Factor," Oct. 15, 2008