Structured Credit Ratings Commentary:
Rating Shopping Persists in Asset Securitization Markets

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Morningstar Perspective: Rating shopping is alive and well in the U.S. securitization markets notwithstanding the implementation of regulatory and legislative actions intended to curb the practice and promote competition among credit rating agencies, or CRAs. It is important to note, however, that the rating shopping following the financial crisis has not led to a “race to the bottom” scenario with respect to rating standards that some congressional lawmakers and other critics of the issuer-paid model believe was prevalent during the years leading up to the crisis.

Introduction
Arrangers and issuers of structured debt including asset-backed securities, residential mortgage-backed securities, and commercial mortgage-backed securities continue to control the selection of credit rating agencies, and their hiring decisions are based primarily, although not solely, on which CRAs offer the highest ratings or demand the least stringent requirements for attaining a specified rating level. Rating shopping is most prevalent in the CMBS market, where the arranger/issuer for a typical transaction will invite up to six of the CRAs that are active in CMBS to conduct a preliminary review of an initial asset pool and transaction structure. This review results in a full underwriting analysis of the underlying properties and ultimately, the required credit-enhancement levels for each rated class within the capital structure. In most cases, the arranger/issuer will hire only the two or three CRAs requiring the lowest enhancement levels or generally the least onerous terms. In some instances, however, the arranger/issuer will hire a CRA based on investor preferences, mandated investment-management guidelines, or for other business reasons. Furthermore, a selected CRA may rate only certain classes of a given CMBS transaction. As arrangers/issuers seek to optimize execution costs, they may designate different agencies to rate different classes.

Rating Standards Not Compromised
While it is rational for issuers and arrangers to choose the CRA with the least onerous terms, CRAs generally have held their ground by adhering to their analytical methodologies notwithstanding the constant threat of losing business. This observation is evidenced by the
higher credit-enhancement levels seen in recent CMBS deals as compared to precrisis levels. The CRAs’ unwillingness to lower their standards in the midst of reviewing a transaction is attributable in part to strong regulatory oversight from the SEC, which has focused heavily on holding nationally recognized statistical rating organizations, or NRSROs, accountable for following their published methodologies. The recently enacted SEC credit rating reform rules will further strengthen this oversight regime and thereby mitigate some of the potential negative consequences of rating shopping.

**Limitations of Rule 17g-5**

SEC Rule 17g-5, which was intended to curb rating shopping and promote rating agency competition by providing access to all deal-related information to every NRSRO, thus far has failed to either curb rating shopping, level the playing field for smaller or newer NRSROs, or raise competition in a way that benefits investors. This is primarily because the CRAs have chosen to not issue unsolicited ratings prior to a transaction’s closing date. The regulators had hoped that preclosing unsolicited ratings would inform investors of all NRSROs’ viewpoints – whether or not an NRSRO was hired to rate the deal – which in turn would further empower investors to influence NRSRO selection. Instead of enhancing information transparency, the current process actually acts to suppress the release of information that would be helpful to investors.

NRSROs have been reluctant to issue preclosing unsolicited ratings for several reasons. Providing a full rating analysis without compensation can strain the NRSRO’s resources, while the derived benefits are questionable or uncertain. To offer unsolicited new-issue ratings under their methodologies, most NRSROs would need to incur the costs associated with property inspections, originator and servicer site visits, and face-to-face meetings with the key transaction parties, which most NRSROs, particularly the smaller ones, are not inclined to do. Thus, rating analysis based solely on information provided on the 17g-5 website generally is not as complete as what a selected NRSRO can produce. And finally, a reality that any NRSRO must consider is the risk – whether real or perceived -- that the arranger/issuer may exclude the NRSRO from future ratings business, particularly if the unsolicited rating undermines the marketing and pricing of a transaction.

**Irreconcilable Differences?**

Rating shopping affects the key stakeholders in profoundly different ways. On one hand, smaller NRSROs like Morningstar Credit Ratings, LLC have benefited somewhat because the process enables them to showcase the quality of their analytics and thus win a share of rating mandates. Over the long-term, however, the process still favors the larger agencies that are better positioned to absorb the costs of providing preliminary analyses without compensation. A more significant downside to the current process for the smaller NRSRO, however, is the lost opportunity to have its voice heard on transactions it is not hired to rate, which in turn stifles its efforts to build its franchise and differentiate itself from other NRSROs. Rating shopping also results in investors being denied access to important
information regarding how the nonselected NRSRO has analyzed the transaction they are looking to buy. Investors who do their own analysis are also frustrated by their lack of access to the information on the 17g-5 website, which was established exclusively for the NRSROs’ use. Arrangers and issuers, to be fair, are acting rationally from a business standpoint by using rating shopping as a means to eliminate some of the uncertainty associated with the timing and expense of deal execution. Preclosing unsolicited ratings and the information they convey may be helpful to investors but potentially disruptive to deal execution. Attempts to reconcile these competing interests of the key stakeholders to date have fallen short.

The proposal by Sen. Al Franken (D-Minn.) to create a board overseen by the SEC that would select qualified NRSROs to offer an initial rating for structured-finance transactions will go into effect unless the SEC develops an alternative mechanism. The Franken scheme, over the near term, could benefit smaller NRSROs by enabling their participation in deals that might otherwise be inaccessible to them. Over the long-term, however, those NRSROs that become more established can best realize their potential under open-market competition.

One alternative to the Franken proposal that balances the interests of the key stakeholders would call for a regulatory requirement to make public the tranche-specific, credit-enhancement levels of all participating rating agencies prior to when a deal is priced. Additionally, investors would be granted access to the information on the 17g-5 website, and NRSROs that are asked to provide preliminary analysis but are ultimately not hired would be entitled to receive partial compensation to cover their costs. These requirements could be in the form of a new SEC rule or an extension of Rule 17g-5. The proposal would address some key investor concerns over information transparency and accessibility. Under this scheme, NRSROs would still provide preliminary ratings and analysis without any assurance of receiving full compensation, but they would benefit from the public dissemination of their conclusions regardless of whether they are ultimately hired. The risk that arrangers and issuers may exclude them from future transactions is mitigated given that the decision to release the preliminary rating information is taken out of the NRSROs’ hands. Arrangers and issuers would still ultimately decide which agencies are hired to rate their transaction, but better-informed investors will likely exert their leverage over the selection process. While this proposal represents a compromise for each stakeholder, it can achieve the same results that regulators had originally hoped for through Rule 17g-5 and unsolicited ratings. Rating shopping may not disappear, but the enhanced checks and balances and information transparency combined with ongoing rating agency regulatory reforms will help sustain ratings quality and integrity.
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