PETER WILLIAMS TALKS TO MOODY'S DAVID STAPLES ABOUT THE IMPACT ON SPECULATIVE-GRADE ISSUERS OF IMPENDING CHANGES IN EUROPE TO THE AGENCY'S LOSS-GIVEN DEFAULT METHODOLOGY.

Moving up a notch

Executive summary

- In the last few months, credit ratings agency Moody's has issued a series of proposals including changing the system of rating transitions for investment-grade issues subject to event risk and proposing a new framework for evaluating bond covenants. The third area where change is certain is in response to the evolving debt capital market. Moody's is attempting to enhance its methodology for speculative-grade corporate ratings, introducing new probability of default and loss-given default rating methodologies.

Leveraged finance transactions are far more complex than they were 10 years ago. The number of investors and investor classes in leverage finance transactions has increased. A transaction today can have multiple layers of debt – senior secured, second lien, unsecured, high yield, payment in kind securities and shareholder loans.

Investors who are looking at these transactions must assess more complicated structures. Continued evolution in the debt capital markets has prompted Moody's to enhance its methodology for speculative-grade corporate ratings. It should be stressed that these changes do not apply to investment-grade rating.

The process is already complete in the US and now Moody's is undertaking the same exercise in Europe, where its recommendations will be the subject of a request for comment due to be published this month (November). The roll-out is set to happen in early 2007.

David Staples, Managing Director of Corporate Finance Europe at Moody's Investors Service, is keen to stress that these are enhancements. He says: "Under the present system Moody's assign a corporate family rating [CFR] to the entity as if there were only one debt capital structure."

The CFR is an estimated loss-based rating where expected loss is defined as the probability of default (PD) multiplied by the loss-given default (LGD), or PD x LGD. The CFR already contained a component of LGD.

Staples says: "Some people in the market wanted us to start disclosing the PD and LGD assumptions." The pressure came from two particular sources – the structured finance market and the imminent arrival of Basel II, due to be introduced in 2007 and 2008.

Staples says: "One of the reasons for doing this is to provide greater transparency to some investors who are looking for more granularity around the assumptions that go into the rating we assign.

"ONE OF THE REASONS FOR DOING THIS IS TO PROVIDE GREATER TRANSPARENCY TO SOME INVESTORS WHO ARE LOOKING FOR MORE GRANULARITY AROUND THE ASSUMPTIONS THAT GO INTO THE RATING WE ASSIGN. PEOPLE ARE STILL LOOKING FOR OUR CORE RATING BUT OTHERS WOULD LIKE TO KNOW THE COMPONENTS."

People are still looking for our core rating but others would like to know the components."

It has to be said that compared with the US, Europe speculative-grade is currently a much smaller market. For example, in September 2006 in the US Moody's had the task of supplementing its EL-based security rating with LGD assessments for more than 1,400 spec-grade corporates in the US and Canada; in Europe, the change will affect just over 200 entities.

RESEARCH REPORT The background to these modifications can be traced back to December 2004 when Moody's published research on the credit loss rates on similarly rated bank loans and bonds. Looking at the recovery rates on bonds and bank loans, the research – based on US data – found that similarly rated bank loans and bonds had different recovery rates.

For a sample consisting of all issuers with both rated loans and bonds outstanding, three-year cumulative loss rates were roughly 1.5 to 2.0 times as great on bonds as on similarly rated loans. Loss rates would have been similar for loans and bonds if the loans had been rated higher by about 0.5 to 1.5 alphanumeric rating notches.

In other words in many cases it was apparent that the loan ratings were too low. So bank loans are being raised by one or two – in some cases even three – notches. The bond ratings have tended to stay the same, although there are some that have moved further out from the two notches down from the CFR. Some second liens have been downgraded by one notch because of insufficient collateral.

Staples, who described some of the differences unearthed by the research as "dramatic", says: "This sparked us into looking at our notching practice. The question Moody's posed was whether it was notching up leveraged loans from the CFR sufficiently for the benefit that they had from collateral."

Moody's decided it needed to revisit how it assigned leveraged loan ratings. "We started looking at notching practices and evolved in looking at LDG." Moody's is keen to emphasise the due process it has been through in implementing these changes with a consultation which started in January 2006 with a request for comment and has been followed up with updates on the proposed rating action.

The methodology is global and involves looking at the priority of claims of different classes of debt and considering the benefit of security to lenders (see *Box 1*). It also puts an enterprise value across the liability structure and looks at the relative positions of different classes of debt from an LDG perspective.

While the methodology may be global, the application has to take account of the different realities in different jurisdictions. Staples and his colleagues have to ascertain whether there are any material differences in Europe which should be reflected either in the priority of claims, or in the estimates of enterprise values. This is one area for which Moody's is requesting comments. Staples says: "The methodology itself works fine. The question is do we need to adjust some of the assumptions or practices going into Europe." (see *Box 2*).

Moody's assign a CFR using the same methodology considering both the corporate's legal structure and the different classes of debt. Once it reaches that position of assigning the instrument ratings, it then considers the mathematical positioning of the debt class against the enterprise value in assigning the instrument rating.

Staples says: "This brings a greater consistency of assignment ratings but in that process we are publishing a PD for the CFR. We are presenting to the market the estimated LGD for the different instruments in addition to saying what the alphanumeric rating would be. Investors will use different components of this information in different ways for their own analysis. But it is ultimately to bring greater information content to our opinions."

Moody's says that the publication of LGD and PD ratings are valuable for some structured finance transactions such as collateralised debt obligations. The structured finance market sees applications for using LDG and PD as part of its own modelling.

Peter Williams is Editor of *The Treasurer*.
editor@treasurers.org

Box 1: Request for comment

Moody's will be seeking comment as to whether differences in insolvency regimes across Europe and other related markets require the agency to modify in any way the implementation plans for applying loss-given default in these markets.

In conjunction with that, Moody's has been considering whether, for instance, a UK court treats security differently from a US court, or whether France treats an unsecured creditor in a priority of claims model differently than the US.

Staples says; "We look at major non-financial debt claims such as pensions, payable and leases, In the US we assume that they are unsecured claims, though there is some priority given to a portion of payables. The question for Europe is whether those obligations should be treated in a different way and will that have a material impact on the outcome."

Box 2: The changes in brief

Moody's is changing its probability of default (PD) and loss-given default (LGD) rating methodology. Its long-term credit ratings are opinions about expected credit loss which incorporate both the likelihood of default and the expected loss in the event of default. The LGD rating methodology will disaggregate the two key assessments in long-term ratings.

PD ratings are only assigned to issuers, not specific debt instruments, and is the standard Moody's alpha-numeric scale expressing Moody's opinion of the likelihood that any entity within a corporate family will default on any of its debt obligations.

LGDs are assigned to individual rated debt issues and are expressed as a percentage of principal and accrued interest at the resolution of the default. Assessment ranges from LGD1 (loss anticipated to be 0%-9%) to LGD6 (loss anticipated to be 90% to 100%).