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# Request For Comment: Planned Changes To Provision Of Ratings And Credit Estimates For Europe's Leveraged Finance Market

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# Request For Comment: Planned Changes To Provision Of Ratings And Credit Estimates For Europe's Leveraged Finance Market

Standard & Poor's Ratings Services in Europe requests comments from market participants on a proposal of six measures (the Proposal) designed to help improve the transparency and efficiency of the European leveraged finance market.

Responses are requested by May 16, 2008.

The period of rapid market growth culminating in the liquidity crunch in July 2007 and subsequent market dislocation has prompted significant market demand for improved transparency with regard to the underlying asset composition and credit quality in structured finance transactions.

Investors in the underlying asset class have reason to be focused on both "probability of default" as well as "post default recovery" analysis. Briefly, probability of default addresses the likelihood of an obligation paying principal and interest according to its terms, while post default recovery addresses the likely recovery after default (please see Appendix for full explanations). This is equally relevant for investors with direct exposure to leveraged loans and bonds through the cash and derivatives markets and investors with indirect exposure through collateralized loan obligations (CLOs). The latter are obligations issued by vehicles, which themselves invest in leveraged loans and bonds.

Standard & Poor's expects that if the Proposal were implemented, it could benefit the European leveraged finance market by:

- Increasing collateral level transparency in CLO structures;
- Supporting secondary market trading activity in leveraged loans and countering excessive price volatility;
- Benefiting CLO investors and issuers wanting to trade out of positions;
- Facilitating the development of relative value pricing for senior debt;
- Ensuring the market distinguishes appropriately between credit ratings and Credit Estimates (CEs);
- Providing added value through recovery analysis on debt obligations;
- Supporting the development of the nascent credit default swaps market referencing leveraged loans; and
- Attracting an even wider pool of investors to the market.

## The Proposal includes:

- Placing restrictions on the provision of CEs for newly originated CLOs;
- Conducting additional analysis on certain underlying assets that are not publicly rated;
- Expanding the sphere of Standard & Poor's recovery ratings;
- Assigning ratings throughout the capital structure of rated issuers;

- Providing the option to choose between recovery ratings and average class level recovery assumptions; and
- Requiring arrangers of leveraged synthetic structures to provide more extensive information.

## Detailed Proposals

Although individually described, the measures comprising the Proposal should be viewed as a package. Standard & Poor's believes that in this way the Proposal will best deliver the above-described benefits to the European leveraged finance market.

### 1. Restrictions on the assignment of CEs

To encourage private equity sponsors to have transactions rated publicly, Standard & Poor's will no longer provide CEs for leveraged finance transactions where the total debt facilities being raised in the transaction is greater than €750 million effective Sept. 1, 2008. The limit of €750 million was selected because we believe it will capture 10%-20% of deals--including the major, more complex transactions.

CEs have been and continue to be an appropriate means of determining the overall probability of default on a portfolio of leveraged finance obligations for the purposes of rating CLOs. However, as leveraged buyouts have increased in size and have become more complex, the limitations of CEs have become more apparent.

These limitations include:

- The often limited information on the structure of transactions;
- No published explanation of the analysis underpinning CEs;
- The large number of market participants, both private and public, requesting access to CEs that are, by definition, nonpublic; and
- Lack of transparency on the aging of CEs as well as a poor understanding in the broader market of the appropriate use of CEs in a portfolio context.

(See Appendix for effect on existing CLOs of leveraged loans.)

### 2. Additional analysis on certain existing CEs

Standard & Poor's will conduct additional analysis on larger and more complex credits, including a seniority ranking that may be factored into CLO surveillance (that is, the post issuance review of a transaction's credit quality). Classification of a specific type of loan or bond and allocating it to the correct "bucket" in the CLO is important as it can affect the ratings on the liabilities of the CLO. For selected, more complex loan transactions, Standard & Poor's will inform relevant CLO managers of its recommended seniority ranking for these loans.

### 3. Expansion of the sphere of recovery ratings

Standard & Poor's has been publishing recovery ratings in Europe on secured loans and bonds rated lower than 'BBB-' for almost four years. As more fully explained in the Appendix below, a recovery rating is an opinion that considers the likelihood of ultimate repayment on an obligation post default. As previously announced, from March 19, 2008, Standard & Poor's started publishing recovery ratings on existing and new unsecured obligations of

corporate entities rated lower than 'BBB-'. Designated recovery rating analysts will determine issue-specific ratings to be assigned by Standard & Poor's. This expansion of recovery ratings to unsecured debt rated lower than 'BBB-' will enhance the information content of our ratings provided to the leveraged finance market.

#### **4. Assignment of recovery ratings throughout the capital structure**

In Europe, Standard & Poor's now proposes to publish its ratings and analyses as a matter of course on all debt obligations throughout the capital structure of corporate issuers rated lower than 'BBB-'. Such publication would give investors access to our opinion on post default recovery prospects without the need to second-guess or infer what the unpublished recovery rating on any segment of the capital structure might be. New issuers would, as a condition of receiving a rating, be required to agree to have Standard & Poor's ratings applied throughout the capital structure.

#### **5. The recovery ratings/average class level assumptions option**

Standard & Poor's will continue to give managers of cash flow CLOs (that is, CLOs backed by cash-generating obligations such as leveraged loans) the option to use either instrument-specific recovery scores based on Standard & Poor's recovery ratings, or average class level assumptions. The first option may provide managers somewhat greater flexibility in managing their portfolios and, in certain cases, could lead to a better overall recovery assumption in the CLO. The first option has been sought by many CLO managers in the U.S. since its introduction in October 2006. Standard & Poor's expects this option to gain in popularity in Europe as published loan and recovery ratings in the European leveraged loan market increase.

#### **6. Additional informational requirements for loans**

Standard & Poor's recognizes that the development of a rated synthetic market is problematic where few leveraged loans are publicly rated and where there is insufficient public information available to assign a credit estimate. Standard & Poor's will now require arrangers and third-party managers requesting a Standard & Poor's rating of synthetic CLOs (where the asset pool comprises mainly loan credit default swaps {LCDS} referencing private leveraged loans) to provide all information relevant to the initial assignment and updating of the CEs. Such information should be provided at both origination and at regular three-monthly intervals. In the event that relevant information is not provided, Standard & Poor's will take appropriate credit action, which may include withdrawing the CLO rating or assigning the relevant reference obligation a CE rating of 'CCC-'.

Standard & Poor's expects that these informational requirements will largely be resolved as the larger, traded leveraged loans, including those 75 credits selected as constituents in Markit iTraxx LevX Senior Index for leveraged loan derivatives, become publicly rated. Nevertheless, Standard & Poor's welcomes comments or suggestions as to how these public/private information issues can be resolved in the context of supporting the growth and development of the leveraged loan derivatives market in Europe.

## **Standard & Poor's Seeks Comments On Planned Changes**

In addition to any general comments or questions on the planned changes outlined above, Standard & Poor's would welcome feedback to the following questions:

- In general, does the market believe the Proposal, if implemented, will achieve the aims of improving transparency and efficiency in the leveraged finance market in Europe? Standard & Poor's seeks detailed comments as to how the Proposal or any aspect thereof could be improved.
- Is the threshold of €750 million total debt facilities for the provision of CEs set appropriately, or would a different level better serve the market?
- What are the concerns or reservations relating to the requirement that Standard & Poor's rate all debt in the capital structure of an issuer rated lower than 'BBB-'? Would publishing a recovery rating on secured loans when there is also a published recovery rating on the same issuer's unsecured high-yield bonds in the capital structure assist investors by providing a credit opinion on post default recovery?
- What are the implications of this proposal for CLO managers of existing CLOs?
- Are there other solutions that would enable Standard & Poor's to rate synthetic structures referencing leveraged loans apart from those proposed?
- How valuable would recovery ratings be in facilitating the development of the LCDS market?

## Background To Proposals

To date, the criteria Standard & Poor's uses to rate CLOs evaluates the credit quality of leveraged loans that comprise a CLO's asset pool or base. Certain obligations may be publicly rated, whereas others may be either confidentially rated or unrated. If an obligation is unrated, our practice is to perform a CE on the obligation.

Standard & Poor's believes that rating all CLO assets publicly would address the perceived lack of transparency and simultaneously provide investors greater insight as to the credit quality and performance of a CLO's obligations.

## Response Deadline

Please submit your comments on this Proposal by May 16, 2008.

We would like to encourage all market participants to submit written comments on one or more aspects of the proposals. During the consultation period, which will end on May 16, 2008, we will also be meeting with various market participants to solicit their views on this proposal, and reviewing comments received via e-mail. After that time, we will publish a final approach to the issues raised in this request for comment.

Comments on this proposal may be sent until May 16, 2008, to the following email address, [CorporateFinanceEurope@standardandpoors.com](mailto:CorporateFinanceEurope@standardandpoors.com), or by contacting any of the individuals listed at the top of this article.

## Appendix

### Existing CLOs of leveraged loans

Under Proposal 1--Restrictions on the assignment of CEs--existing assets in existing CLOs would be "grandfathered," that is, we would continue to update the CEs on existing deals of more than €750 million total

debt facilities. However, substituted assets would be affected.

### **Credit estimates**

A credit estimate (CE) is a confidential indication of the likely issuer credit rating on an unrated entity commissioned by and provided to a CLO manager to be used only in a portfolio context. The CE is based on input from a variety of sources and an abbreviated methodology that draws on analytical experience and sector knowledge of Standard & Poor's analysts. CEs do not involve direct contact with management or in-depth insight into operating, financial, or strategic issues that such contact allows.

CEs are an appropriate means to determine the probability of default across a portfolio of issuers. They continue to be used to support various structures. In Europe their use is predominantly across structures investing in syndicated debt, but CEs are also included in financing structures in both the European and U.S. middle markets, in which the collateral manager uses cash flow CDOs to provide "one-stop" financing options for small to midsize so-called "middle-market" entities.

### **Recovery ratings**

These are issue-specific ratings, which consider the likelihood of ultimate repayment post default. They are not linked to, or limited by, the corporate credit rating, which focuses on the risk of a company defaulting. Recovery ratings are expressed on a '1+' to '6' scale, with '1+' the highest level of recovery.

## **Related Research**

For further information on the assignment of recovery ratings to unsecured debt, please refer to the article titled, "Standard & Poor's Extends Recovery Ratings To Unsecured Speculative-Grade Corporate Issues," published March 19, 2008, on RatingsDirect.

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