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Criteria | Structured Finance | Request for Comment: Methodology For Rating Interest-Only Certificates

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Methodology For Rating Interest-Only Certificates

Standard & Poor's Ratings Services is requesting comments on its proposal to directly link the rating on an interest-only (IO) certificate to the credit quality of the referenced assets that serve as its notional balance. Specifically, we propose to limit 'AAA' ratings to those IOs that reference a 'AAA' rated asset. Under our current criteria, we may assign 'AAA' ratings to IOs that reference the notional balance of the entire securitized asset pool, regardless of the ratings assigned to the related assets, so long as the IOs are senior to or rank pari passu with the issuer's other securities.

If adopted, these proposed criteria would supersede "Interest-Only Rating Methodology For U.S. Assets Reviewed" (see "Related Research" below).

This request for comment discusses the "credit quality of the securitized assets," principle, described in "Principles-Based Rating Methodology For Global Structured Finance Securities" (see "Related Research"). It is part of a broad series of measures that we announced last year intended to enhance our governance, analytics, dissemination of information, and investor education. Those measures are aimed at augmenting our independence, strengthening the rating process, and increasing transparency to better serve the global markets.

Proposal Summary

The structure and payment terms of IOs are fundamentally different from those of conventional securitized debt. IOs represent securities backed by the excess interest payments generated from the pool of assets underlying a securitization transaction. An IO security has no principal balance that is returned to investors. The amount of interest payable to the IO investors is usually a specified percentage of a reference notional balance that is typically tied to the outstanding principal balance of the securitized assets or to specific certificate or note classes that are issued through the securitization. The IO interest payment amount varies over time depending on the speed and magnitude of reductions to the notional balance.

Our ratings on IOs address the credit risk related to the contractual promise to pay. Under our current criteria, however, IO ratings do not address the credit risk that realized losses due to collateral-level defaults will reduce the outstanding notional amount. If this happens, holders of the IO securities may receive less interest and therefore a lower-than-expected investment return. In addition, IO ratings do not address certain non-credit risks that could adversely affect the return on investment. Specifically, the ratings do not address the risk that asset prepayments may be higher than expected and/or more front-loaded (i.e., they occur earlier in the transaction's life). These prepayments can reduce the amount of excess spread available to pay the IOs, which could result in a lower-than-expected investment return. Under the current proposal, our IO ratings would explicitly address the aforementioned credit risk posed by collateral defaults but would not address the risk of lower returns that would result from higher-than-expected asset prepayments.

Many IOs that we have seen issued from commercial mortgage-backed securities (CMBS), residential mortgage-backed securities (RMBS), and to a lesser extent asset-backed securities (ABS) transactions, were sized

based on the notional balance of the securitized assets. These IOs are paid interest at or near the top of the transaction's payment priority waterfall based on the notional balance of the assets multiplied by a specified interest rate. In transactions we have rated, the structure typically seeks to mitigate the risk of potential payment shortfalls to IO investors in two ways: First, by the high priority of the IOs in the payment waterfall and, second, by the common practice for loan servicers to advance for delinquent payments on loans that have not been charged-off. Additionally, the risk of payment shortfalls due to adverse asset selection—where progressively poorer quality assets remain in the pool as the better quality assets pay down—causing the collateral to pay down to a small number of loans may be mitigated to the extent the issuer exercises a clean-up call option. This option typically involves the issuer paying down the transaction early once the pool amortizes to a trigger percentage, usually 10%, of its original pool balance. However, there have been instances where 'AAA' rated IO securities experienced missed payments because of adverse selection, the servicers' unwillingness to advance against nonperforming collateral, and the issuer's failure to exercise a clean-up call.

For example, a CMBS transaction with 5% of its original balance outstanding may consist of two or three remaining loans. While, in a typical transaction, it may be highly likely that the issuer will ultimately receive sufficient interest collections to repay the IO securities, the receipt of these payments is subject to interruption if one or more of the loans becomes delinquent. In this situation, under our current and proposed criteria, we would deem a missed payment for one or more months to be a default.

Therefore, we propose to link new and existing IO ratings to the lowest rating associated with the notional balance of the collateral that the IO references. IOs that reference 'AAA' rated securities would continue, all else being equal, to be rated 'AAA'. IOs that reference the full notional balance of the collateral pool would be assigned either (i) the same rating as the lowest rated class that is owed both principal and interest or (ii) a 'B' rating because of our view regarding the low likelihood that the full reference notional balance will be repaid in a full and timely manner.

Specifically, we would like market feedback on the following questions:

- Do you believe that linking IO ratings directly to the credit quality of the reference asset balance appropriately captures the credit risk that could affect the IO payment stream?
- Do you believe that IO ratings should address not only the credit risk associated with the underlying referenced assets but also the non-credit related risks (asset prepayments and other termination risks) that affect the investor's return on investment?
- Do you have any other comments or concerns regarding this proposal?

Ratings Impact

We expect the proposal, if adopted, to materially affect outstanding ratings. More than 1,500 IO securities would be subject to downgrades, perhaps by between 10 and 17 notches.

Response Deadline

We encourage all market participants to submit comments on the proposal by June 30, 2009. Please send written comments on this proposal to CriteriaComments@standardandpoors.com. Note that we will only give consideration to written comments that are submitted to this mailbox.

Methodology

We propose to base our rating on an IO certificate on the credit quality of the referenced assets that serve as its notional balance. For example, an IO that promises to pay 0.25% of the notional balance of a \$100 million class A-2 certificate of a CMBS transaction would be rated the same as the rating on the class A-2 certificate. If the class A-2 certificate is rated 'AAA', the IO potentially could be rated 'AAA'. If the class A-2 certificate is rated 'AA', the IO could be rated 'AA'. The rating on the IO would migrate with any changes to the rating on its referenced asset.

For IOs such as PAC-IOs ("planned amortization class") that reference the combined balance of two or more rated classes, we propose to cap the IO rating at the rating on the lowest rated referenced class. For example, if an IO referenced a class A-2 certificate rated 'AAA' and a class B certificate rated 'A', under the proposed criteria we would cap the rating on the IO certificate at 'A'. The IO rating would then migrate along with the credit quality of the lowest rated class.

Under the proposed criteria, those IOs that reference the entire principal balance of a collateral pool supporting many different rated classes would be assigned a rating equal to the lower of: (i) the rating on the lowest rated principal and interest paying class or (ii) 'B' if the credit enhancement in the form of overcollateralization supporting the most junior rated class is greater than 1% of the total notional amount. For example, if the lowest rated principal and interest paying class in a CMBS transaction is rated 'BB-' and the credit enhancement supporting this class is less than 1% of the collateral pool balance, then we would rate an IO that references the entire principal balance of the CMBS asset pool 'BB-'. If the credit enhancement exceeds 1%, we would rate the IO 'B'. While this approach may lead one to conclude that an 'NR' (not rated) designation would apply to the bottom or equity class since a typical pool will have some amount of unrated overcollateralization or equity associated with it, we believe that linking the rating on the IO certificate to the rating on the lowest principal and interest class (or assigning a rating of 'B' in cases where we believe sufficient subordination supports the reference amount) is more representative of the risk. The IO certificate usually represents the most senior claim on the payment waterfall after certain fixed transaction expenses. However, the risk of IO payment curtailments and missed scheduled payments generally increases with defaults and prepayments on the underlying assets—particularly as the pool pays down to a small number of loans.

Scope of the proposed criteria

These proposed criteria, if adopted, would apply to all structured finance IO ratings globally, including those assigned in the following asset classes: ABS (e.g., auto loan, student loan, and manufactured housing loan-backed ABS), RMBS, and CMBS. The criteria would also apply to IO securities that are subject to an "available funds cap"—that is, IOs that are structured to distribute a variable residual amount that is calculated based on the difference between the loan interest received and the note interest payable, but only to the extent this difference produces a positive balance in available funds. The variable and contingent nature of the promised payment does not change the basis of our IO analysis, which is the credit quality of the assets supporting that IO class.

While our IO ratings under this proposal will focus on the credit risk associated with the underlying reference assets, we understand that IO investors typically are more focused on total return, which can be less affected by such credit risk and is likely to be more significantly affected by prepayment and other early termination risks that are outside the scope of the rating.

Related Research

- Interest-Only Rating Methodology For U.S. Assets Reviewed (published April 20, 2005)
- Principles-Based Rating Methodology For Global Structured Finance Securities (published May 29, 2007)

Related articles are available on RatingsDirect. Criteria, presales, servicer evaluations, and ratings information can also be found on Standard & Poor's Web site at www.standardandpoors.com.

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