Article Title: ARCHIVE | Criteria | Financial Institutions | General: Rating Secured Lines Of Credit To Financial Institutions Data: Standard & Poor's Financial Institutions Ratings Group has begun to assign ratings to secured lines of credit granted to financial institutions. While the rating criteria developed by Standard & Poor's can have broad application to a variety of secured issuances by a wide range of issuers, to date, the secured lines of credit that the Financial Institutions Ratings Group has reviewed have mostly been revolving facilities extended to specialty finance companies, such as subprime mortgage lenders and real estate investment trusts. Specifically, the facilities rated have been warehouse lines used to fund mortgages or other related financial assets, with the loans funded by the facility serving as collateral. In most cases, proceeds arising from securitization or sale of the loans are then used to repay the advances from the facility. In many cases, a portion of the facility can also be drawn upon to fund longer-term portfolio investments of the borrower. Relationship To Counterparty Ratings Ratings on secured lines of credit begin with the counterparty credit rating of the creditor. While a counterparty credit rating addresses the risk of full and timely payment on all obligations of that entity, a rating for a secured line of credit also incorporates an analysis of ultimate recovery based on collateral protection. Consequently, a rating on a secured line of credit can be higher than the counterparty credit rating. The incorporation of ultimate recovery consideration is not new in Standard & Poor's analysis as reflected by the convention of rating subordinated debt below senior debt, given the former's weaker standing in postbankruptcy liquidation. The logic of ultimate recovery analysis has been extended to permit the enhancement of a rating through the offering of security. Key Rating Factors A rating above the counterparty credit rating would be given only if Standard & Poor's were to conclude that full recovery—100% or virtually 100% of principal—can be anticipated, albeit delayed—in the event of default. The degree to which a secured rating can be placed above the counterparty rating depends on four considerations: Counterparty credit rating; Value of the collateral; Length of the delay in recovering and liquidating collateral; and Advance rate against the collateral's value. Counterparty credit rating. The higher the counterparty credit rating, the more weight given to timeliness in determining a rating for a secured line of credit. Conversely, the lower the rating, the more it incorporates a postdefault perspective. By way of analogy, the same principle is used in rating subordinated debt of investment grade issuers one notch below the senior unsecured rating, though differentiating subordinated debt of speculative grade borrowers by two notches. Since an enhanced position in a liquidation scenario is being considered, the adjustment above the counterparty credit rating would widen in the speculative rating category. The quality of the collateral. The collateral securing a line of credit made to a financial institution is represented in the main by financial assets. Examples of the type of financial assets offered as security in the facilities Standard & Poor's has been asked to rate include: First lien home mortgages; Second lien home mortgages (home equity loans); Manufactured housing loans; Manufactured housing dealer inventory loans; Commercial mortgages; Home construction loans; Commercial construction loans; Bond call loans; Warehouse lines; and Excess servicing receivable. As this list illustrates, the majority of financial assets offered as security are themselves secured loans. Standard & Poor's assessment of the quality of these loans as security is determined by credit-risk considerations and by market-risk considerations. In most instances, the underwriting of the securing loans is standardized, facilitating the analysis of their credit quality. Standard & Poor's would, for example, be able to form an opinion of the credit quality of a class of loans by examining the qualifying criteria for a borrower as measured by credit scores or credit history. The purpose for which the loan was extended also would be considered in assessing the degree of credit risk. For example, a home mortgage loan made for the purchase of a home and underwritten to conform to the guidelines of FannieMae or FreddieMac would be of higher credit quality than a home mortgage loan extended to a borrower for purposes of debt consolidation and underwritten with debt servicing ratios below FannieMae or FreddieMac standards. Standard & Poor's also considers market risk in its analysis. The two types of risk can be related, as the market or sales value of a loan could, as suggested above, be impaired by a perception that it is of poor credit quality. However, market risk is primarily a function of interest rates, and is most relevant when rating fixed-rate assets or byproducts of the securitization process, such as interest-only strips and other types of excess servicing receivables. Whether the securing asset is being warehoused for sale or securitization, or is being funded as a long-term portfolio investment, Standard & Poor's would expect to see that any hedges associated with the securing asset to protect it against market risk be assigned to the provider of the credit facility. The length of the delay in recovering and liquidating collateral. If collateral can be liquidated quickly, e.g. within 60 days, opportunity costs are minimized and recovery potential is assigned a high value in Standard & Poor's analysis. The longer the delay in recovering what is owed a lender under a secured line of credit, the less the value accorded the protection offered by collateral. If full principal recovery cannot be achieved within two years of a default, no recovery potential is recognized. In estimating the length of delay, the analysis would focus upon how readily the legal system gives the lender access to collateral and how quickly the collateral could be turned into cash. In the U.S., 18-24 months is the typical time needed to resolve a Chapter 11 filing. (The analysis would identify and differentiate cases that might take longer because of litigation and other complexities.) Since the security is represented typically by loans, liquidation can be achieved through repayment, securitization or an outright sale. However, unless the securing asset is of short tenor or is in the form of a bullet loan, repayment may not occur quickly enough to qualify for credit enhancement recognition. Therefore, Standard & Poor's would expect a securing loan to be sold or securitized by the provider(s) of the facility to recover what is owed in the event of a default. While the underlying collateral of a securing loan is not viewed as a direct source of repayment, the value of the collateral relative to the amount of the securing loan is factored into Standard & Poor's analysis. Standard & Poor's incorporates a worst case scenario in its analysis, in which both the borrower under the rated credit facility and the borrower under the securing loan default concurrently. In such an event the likelihood that the foreclosure on, and sale of, the non-financial collateral would proceed efficiently, if at all, is highly uncertain. In essence, two foreclosure processes would have to be carried out in order to realize the cash to repay the line of credit. Under such a scenario, it is not certain, at least within U.S. jurisdictions, that the proceeds could be collected within the two years required to qualify for notching the rating of the line of credit above the counterparty rating. Again, Standard & Poor's assumes that a securing loan which has defaulted will be sold by the provider of the facility rather than directly collected. In which case, once a securing loan defaults, its salability will depend largely on the value of the underlying collateral. The advance rate against the collateral's value. The value of the collateral relative to the amount borrowed is a critical determinant of how quickly the collateral can be liquidated, and whether the proceeds generated would be sufficient to repay the borrowing. Consistent with the above, Standard & Poor's incorporates into its advance rate calculations both the discount rate against the securing loan's face value, and the discount against the value of the loan's underlying collateral. Once the advance rate is calculated, Standard & Poor's assesses whether the advance rate would be sufficient to repay at minimum the outstanding principal within the two year window allowed for notching. This analysis would focus on the quality of the securing loan (in terms of credit and market risk as discussed above), as well as the quality of the underlying collateral (in terms of the factors that would affect its valuation and salability). Under such an analysis, advance rates against loans of a speculative nature, such as to finance the acquisition of undeveloped property, or against loans extended to borrowers with blemished credit records (e.g., a subprime mortgage borrower), would be expected to be significantly more conservative than against loans extended to borrowers conforming to FannieMae or FreddieMac credit standards. Fitting All The Pieces Together The matrix (see table) that follows places the factors discussed above into a systematic framework. To begin, a distinction is made between borrowers whose counterparty rating is in the investment grade and those in the noninvestment grade rating categories. As indicated earlier, notching in the investment grade category is not as great as in the noninvestment grade category. Ultimate Recovery Rating Criteria Framework CONFIDENCE RATING LEVEL WITHIN 18-24 MONTHS WITHIN 6 MONTHS WITHIN 30-60 DAYS ICR RATING LEVEL: BB, B Reasonable confidence of full recovery of principal +1 notch +1 or 2 notches +2 or 3 notches 1.30X - 1.40X Highly confident of full recovery of principal +2 notches +2 or 3 notches +3 or 4 notches 1.40X - 1.65X Highly confident of recovering principal and interest +3 notches +4 notches +4 notches IN EXCESS OF 1.65X ICR RATING LEVEL: A, BBB Reasonable confidence of full recovery of principal +1 notch +1 notch +1 notch 1.30X - 1.40X Highly confident of full recovery of principal. +1 notch +2 notches +2 notches 1.40X - 1.65X Highly confident of recovering principal and interest +2 notches +2 or 3 notches +2 or 3 notches IN EXCESS OF 1.65X Secondly, within each of these two categories, three distinctions are made based on the Standard & Poor's level of confidence that the providers of a rated line of credit will recover either principal or principal and interest. These different levels of confidence are then defined by advance rates that incorporate both the amount that can be borrowed against the value of the loan and the value of the underlying collateral relative to the amount of the securing loan. The range of advance rates in each confidence category reflects the range of credit risk and market risk of the security. For example, Standard & Poor's would be more willing to accept advance rates falling within the lower end of a given range for such low-risk assets as home mortgages underwritten to conform to FreddieMac or FannieMae credit criteria while expecting to see more conservative advance rates for subprime mortgage loans. Finally, the time within which cash proceeds can be realized from the seizure and liquidation of security is laid over the various confidence levels in order to determine the degree of notching. Special Issues "Wet funding." Many mortgage warehouse facilities permit advances against mortgages serving as the facility's collateral in which not all documentation allowing the lender to enforce its claim against the loans has been delivered to the custodial agent. Under such arrangements, complete documentation may not be delivered for several days, in effect leaving unsecured the moneys advanced. Such a practice is known as "wet funding". Standard & Poor's believes the risk to the lender of such a practice is modest. Rarely is full documentation not delivered to the provider of the warehouse line after four to five days. Failure to transfer documentation to the custodial agent in a timely manner usually would trigger an event of default. While Standard & Poor's views as unlikely a declaration of default due to the occasional missed deadline, chronic failures to deliver in time could prompt a lender to exit the facility by threat of enforcing default covenants. Standard & Poor's believes that this threat does provide a strong incentive to the borrower to provide documents promptly to perfect the security. Consequently, no limits are placed on the amount of money advanced under a wet funding arrangement. Unsecured credit. Only secured credit is eligible for a rating higher than the counterparty rating. The counterparty rating would be applied to any unsecured portion of the credit facility. Performance covenants. Performance covenants, especially as they relate to capitalization or interest coverage ratios, are seen as allowing a lender to terminate the facility in the event that the borrower encounters financial problems. Standard & Poor's approaches the rating of secured lines of credit primarily in terms of collateral coverage; however, the rating for the facility may be influenced by the existence of covenants allowing the providers to exit the facility if the borrower's financial condition does begin to deteriorate. Security other than secured loans. Will be evaluated on a case by case basis.