

Read This Before Your Borrowers Do — What Loan Rating Refinements Mean to Lenders

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By Tod Trabocco

Credit markets are growing in sophistication as lenders desire and regulators require greater clarity of the risks surrounding bonds and loans. Ratings agencies have taken a big stride toward better discerning the different risks inherent in bank loans and bonds through its new updated bank loan methodology. In particular, Moody's Investors Service's new methodology is an important attempt to reconcile the complexity inherent in capturing two factors with one rating and is very likely to have important ramifications for the asset-based and middle-market lending communities.

Before embarking on an analysis of what the new methodology means for asset-based and middle-market lenders, it may first be helpful to briefly review the new approach. Moody's has historically tried to reflect loss given default and default probability through one rating per instrument. These are the familiar ratings that range from AAA down to C and the 1, 2, 3 refinements within each category. A rating across all asset classes indicates the same combined probability of loss and loss given default.

Moody's has now refined this process with the addition of a separate loss given default rating (LGD) that will be combined with a probability of default rating (PDR) to determine an overall loss rating. LGD ratings will range from 1 to 6 will have corresponding recovery rates. The six LGD ratings will span recovery from 0% to 100%, although the bands will not be identical. For example, the lowest band, LGD1, will reflect a recovery rate of 0% to 9% and the highest band, LGD6, will reflect recovery of 90% to 100%. The bands in between will have recovery rates of 20%. The PDR will be driven by the corporate family rating (CFR), which is determined through the standard credit scorecard and application of metrics that Moody's has published for most of its industries. The CFR is really the foundation for the PDR as cross default clauses generally equalize default rates across asset classes.

The true innovation to this methodology, the LGD portion, is derived first by determining the net assets available to be distributed in liquidation. This valuation is then applied the LGD percentage corresponding to the LGD rating to determine the recoverable assets. The recoverable assets are then apportioned according to the priority of claims. Moody's does not take into account debtor-in-possession facilities or administrative fees, as these are difficult to predict and require too many distorting assumptions.

One key to this recovery analysis valuation of net available assets depends on the issuer's proximity to default. A company closer to default will be valued according to standard industry enterprise valuation metrics. A company further from default will be assumed to have an enterprise value equal to 100% of its liabilities. (Moody's recognizes that standard metrics for a healthy company are poor indicators for enterprise value in distress.) The assumed recoverable assets for a healthy company (apart from utilities) will fall along a truncated normal distribution with a standard deviation of 20% and a mean of 50%. This distribution curve reflects Moody's empirical research findings.

LGC Recovery Probabilities

LGD1	0%–9%
LGD2	10%–29%
LGD3	30%–49%
LGD4	50%–69%
LGD5	70%–89%
LGD6	90%–100%

Source: Moody's Investors Service

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This all sounds rather complicated, and it can be. However, such a refinement is extremely powerful because it codifies what senior lenders have known for some time: security attributes, collateral and voting rights in a loan often yield far better recovery rates for loans than for bonds. Moody's own research has revealed that loans tend to default at approximately 80% the rate of bonds and recover from two to four times that of bondholders. Bond ratings and loan ratings were historically different, but this empirical research shows mounting evidence of a greater difference in default rates and recovery values between bonds and loans than was previously believed.

In general, this new approach comports with the type of credit analysis performed by senior and second lien lenders. The use of a waterfall is a

tested method for understanding recovery. Nevertheless, certain aspects of this new methodology will need to be tested in practice. The first of these aspects involves the use of two different valuation techniques. The use of EBITDA multiples for firms closer to financial distress is understandable and reflects standard restructuring practice. Given the depth of analysis that Moody's will perform on firms in distress, the accuracy of recovery estimates is likely to be greater than for firms that are further from distress. Moreover, firms that hover around default may have ratings of varying accuracy and quality.

For healthy firms, it appears that Moody's will use a standard enterprise value (EV) of 100% of liabilities and a LGD range based on the truncated normal distribution mentioned above. While this assumption may be statistically defensible, it will likely offer little comfort to lenders struggling to cope with a healthy borrower's idiosyncratic risk. From what Moody's has offered in its published methodologies, it sounds as though most borrowers in most sectors will have a very similar LGD when healthy. The insight that loan ratings provide may be more limited and useful for companies not in financial distress.

The second aspect relates to the first and involves the timing of the switch from one valuation method to the other. Moody's will face the challenge of determining a uniform time as to when the EV approach in distress will be triggered. The source of this challenge will arise from Moody's' different approach to credit analysis among industries and the economic peculiarities among industries. In the case of the former, a survey of individual industry methodologies published by Moody's reveals differences in the application of the credit scorecard methodology. In other words, different ratios mean different things in different industries. These differences may create different trigger points for the distressed EV valuation approach. In the case of the latter, industries can move into distress at different rates. Some move quickly when confronted with disruptive competitive threats or severe supply dislocations while others may linger as the individual enterprises wrestle with input costs and pricing pressures. Calibrating the trigger for the EV valuation may take time.

Finally, the assumption of an EV as 100% of total liabilities for companies not in financial distress may fail to account accurately for the equity cushion enjoyed by junior debt holders. As a result, this shortcut valuation for healthy companies, while sensible from the perspective of recovery probability, may overstate the credit risk confronting junior lenders.

Nevertheless, these are challenges that confront all lenders and credit analysts and Moody's will undoubtedly adapt and fine-tune this methodology. But even these first steps will impact senior lenders by potentially triggering widespread upgrades in the syndicated loan sector, changing bank capital allocation decisions, increasing available assets for major alternative/synthetic players, improving transparency in pricing and creating greater liquidity in the syndicated loan market. Not all of these developments will be favorable and asset-based and middle market lenders will be forced to emphasize credit rigor and partnership with borrowers.

Moody's has long acknowledged that loan ratings have been below levels supported by empirical research, so the market should not be surprised that widespread upgrades are in the offing. Bloomberg reported that \$1.2 trillion in bank loans rated by Moody's will be upgraded. Moody's puts that figure at closer to \$500 billion in North America. This "upgrade

parade," as a colleague has called it, will impact lenders of all stripes. For example, secured lenders may revisit RAROC allocations, depending on the prominence of Moody's ratings in risk capital budgeting. Pricing may further tighten, although spreads are already quite tight, leaving little practical room for further narrowing. The upgrades may also create new borrowers for important alternative lenders like CDOs and CLOs, whose covenants may prohibit lending below a certain credit rating threshold. Moody's reports that the smaller and lower rated loans will see upgrades of 1 to 2 notches. This means that previously prohibited Caa1 loans, for example, may now be perfectly eligible B3 or B2 rated credits. This also means that middle market firms, which have experienced abundant attention in recent years, may become even more attractive to yield hungry alternative lenders.

Naturally, smaller firms that previously could not justify an expectedly lower rating may now see the benefit in having their loans rated. In addition to generating earnings for ratings agencies, this will increase transparency and liquidity in the broader loan market and the middle market, whose firms tend to find bond markets more inaccessible. While liquidity and transparency are important virtues for any financial market, they can undermine some lenders' strategies. For example, arbitrage opportunities for alternative lenders and private equity vehicles may grow less common. Even secured asset-based lenders may find themselves under the withering stares of long-time clients pleasantly surprised by a new rating.

But it is premature to conclude that the upgrades and potentially greater transparency will erase good lending opportunities. First, price discovery is driven less by ratings and more by liquidity. While trading in some names may increase, many loans, particularly those issued by middle market firms, will be too small to trade widely. Second, credit rigor will rise in importance if lenders begin to rely more heavily on the proxy analysis of the ratings agencies. Industry knowledge and familiarity with individual names resulting from deep due diligence will continue to be the best means of identifying credits that offer a good risk/reward trade-off. Even now the bond markets, which are vastly more transparent, liquid and better covered by analysts than the leveraged loan market, afford ample opportunities for investors to find quality credits at attractive yields. Finally, borrowers will quickly realize that liquidity and transparency are a double-edged sword. While borrowers may see lower debt costs as a result of the new attention Moody's and others are turning to their markets, they will also realize that greater transparency and liquidity will attract more casual lenders who may be less inclined to show patience in the event of financial distress. The same lender eager to lend at a lower rate thanks to the new ratings and upgrades may be just as eager to trade out of a loan, perhaps selling to a vulture or loan-to-own investor. In the end, relationships have been the bedrock of loan markets and the ratings agencies' new methodologies are unlikely to undo that in the near future. **abfj**

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