Structured Finance
Exposure Drafts

Fitch Seeks Comment on Structured Finance Proposals

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Executive Summary

Fitch Ratings has recently published two reports seeking comments on the agency's proposals for new rating scales and indicators to enhance the meaning and usefulness of existing structured finance ratings, as well as proposals for increased transparency.

Feedback on the proposals is being sought from market participants over the next month - any comments should be sent to sffeedback@fitchratings.com by 1 August 2008.

The proposals focus on:

- the addition of new rating scales or indicators reflecting various risks in structured finance; and
- disclosure of key transaction parties' retention of equity tranche risk within structured finance transactions.

This report gives an overview of each of the proposals and the scope of feedback sought by Fitch. For more information please refer to the original reports, which can be found at www.fitchratings.com:

- "*Fitch Proposals for Complementary Ratings and Indicators to Structured Finance Ratings*", published 1 July 2008; and
- "*Exposure Draft: Retaining Equity Piece Risk - Enhancing Transparency*", published 24 June 2008.

Background

Structured Finance Ratings and Market Scrutiny

In recent months there has been increased scrutiny with respect to the nature, integrity and meaning of structured finance ratings. Fitch Ratings has consulted extensively with interested parties - including investors, issuers, bankers and regulators - to assess what changes might be made to enhance existing rating scales, what supplementary measures might be introduced to complement them and other means of enhancing transparency with respect to structured finance risks.

Feedback with respect to changing the structured finance scale - for example, via the addition of a modifier to distinguish the rating as structured finance-specific - has been mixed. Most industry participants that Fitch has consulted are not convinced as to the value of adding an identifying modifier to ratings of structured finance securities. Additional discussion is expected on this issue, particularly with the regulatory community. The US Securities and Exchange Commission (SEC) recently proposed that ratings for structured finance products be differentiated, perhaps by the use of different rating symbols. Fitch continues to examine the merit of individual sector rating scales as part of this discussion, and may make further proposals in this arena as the dialogue progresses. Investors can offer feedback directly to the SEC on this issue at http://www.sec.gov/rules/proposed.shtml

The agency is mindful that some of the discussion surrounding structured finance ratings relates to a misunderstanding among some of the nature and limitations of ratings themselves. Fitch does not wish to add to any confusion surrounding structured finance ratings by proliferating the number of scales and measures it makes available to the market. However, following internal and external discussion, the agency has decided to offer for investors' consideration a number of new, simple additional indicators and scales which it believes can add value.

Transparency regarding Securitisation Exposures

Market participants across the industry - including rating agencies - have been urged by regulators to foster greater transparency within the structured finance markets generally.

Retaining the economic risks of securitisation exposures is an area that has been highlighted by some commentators as lacking in transparency, thereby impacting the ability to form a view with respect to the relative alignment of - as opposed to conflict of - interests between key transaction parties and investors. This issue is gaining in importance as potential amendments to the Capital Requirements Directive (CRD) proposed by the European Commission, would if implemented, effectively require originators to hold 10% positions in their securitisations where these are offered to bank investors, with a view to forcing alignment of interests between investor and originator.

A prescriptive proposal of this nature is controversial. Equity retention brings its own risks for senior investors, as highlighted in Fitch's report. The alternative of a formalised disclosure regime for securitisation exposures retained would allow investors to form their own judgement as to alignments and conflicts of their interests with those of key transaction parties. With a view to increased transparency in this area, Fitch is making proposals regarding disclosure by key transaction parties (such as the originator, servicer or asset manager) which would appear on the agency's surveillance pages for Fitch-rated transactions and would highlight whether they continued to retain the economic risk of the equity piece. A recent report by the European Securities Market Expert Group (ESME) "*Role of Credit Rating Agencies*" published in June 2008, also recommended that credit rating agencies seek to disclose information regarding an originator or sponsor's retained interest in the transaction.

Proposals

Complementary Ratings and Indicators to Structured Finance Ratings

Fitch has examined the case for potential separate complementary indicators and ratings that may be offered in three areas to enhance the meaning and usefulness of existing structured finance ratings. These areas are outlined below.

1. **Loss Given Default/Loss Severity** - Fitch's ratings traditionally address the probability that a security will default prior to its legal final maturity. They do not address the extent of loss that might occur if a security defaults (loss given default or loss severity).

   This paper proposes a complementary Loss Severity Rating scale at the security level to accompany traditional ratings. Fitch believes additional disclosure in this area would offer most value-added given the inherent difference in loss given default between traditional corporate debt and most structured finance debt. In structured finance, given the different priorities of payment and the relative 'thickness' of tranches, the extent of loss given default can vary significantly. It is an important consideration for investors which Fitch's structured finance ratings do not traditionally address.

2. **Collateral Quality Assessment** - Fitch generally conducts a periodic originator review visit as part of the rating process to assess the quality of origination and underwriting processes for the underlying assets. The portfolio profile, in terms of borrower and product types for example, will also be examined to form a

view on the collateral. Historical performance data will also be analysed to assess collateral performance. The result of this analysis is considered by the rating committee when assessing collateral quality and determining transaction ratings. No separate opinion on collateral quality is generally published, however.

This paper proposes that an opinion scale be adopted for individual asset classes and sub-sectors. At the time of rating a new transaction, the agency would assign the underlying collateral an opinion grade alongside the rating of the transaction securities.

3. **Rating Transition Probability and Volatility** - Fitch believes that meaningful scales giving indications of the potential for a particular security to suffer rating transition or volatility would be difficult to develop in isolation from factors captured by traditional debt ratings. However, the agency agrees that additional transparency regarding the likely medium-term path of a credit rating would be useful information for investors.

   To address this, Fitch has recently committed to an extension of "Rating Outlooks" to all structured finance areas globally. Rating Outlooks are intended to give a forward-looking opinion about the medium-term prospective direction of a tranche rating, generally over the next 12–24 months. Fitch believes this would give the market greater information about prospective future individual tranche performance than an explicit rating volatility indicator.

Further detail on each of these three proposals is available in the report, "*Fitch Proposals for Complementary Ratings and Indicators to Structured Finance Ratings*", which is available at www.fitchratings.com.

Feedback Requested

Fitch is seeking industry comment on the following questions.

- Rather than complementary scales and indicators to the existing rating scale, would users prefer to see a separate rating scale for structured finance securities?
- Would a structured finance 'modifier' to the existing rating scale be preferable to devising a separate rating scale for structured finance securities or the proposed complementary scales and indicators?
- Of the three complementary indicator proposals outlined above, which one adds the greatest analytical value?
- Are there other indicators addressing additional risks that could also be considered?
- Are the perceived deficiencies in structured finance ratings best addressed through increased transparency with respect to methodology enhancements and other areas, rather than through additional rating scales?
- Does the provision of more information in addition to ratings increase the risk of 'too much information' and consequently risk-causing confusion?
- Should there be greater co-ordination between the major credit rating agencies to produce broadly comparable, complementary additional rating scales for structured finance transactions rather than developing disparate non-comparable individual scales?

Disclosure of equity tranche risk retention

The second exposure draft focuses on whether Fitch should invite key transaction parties to disclose who bears the economic risk of the equity tranche (or 'first-loss' piece) of a structured finance transaction on transaction surveillance pages.

Before the start of the "credit crunch" in summer 2007, investor appetite for structured finance products was considerable. More and more investors were going further down the credit curve, such that a market for unrated equity (or "first loss") pieces developed. This began to change the situation whereby the equity piece was retained by the transaction originator or sponsor. Investors in equity pieces included newly established funds to invest specifically in equity pieces as well as certain hedge funds. There have also been some transactions to repackage equity pieces. Credit protection became available on equity pieces and some have also been used as collateral to obtain funding.

For some mezzanine and senior investors, originator or sponsor ownership of the equity piece was seen as a source of comfort in many areas of global structured finance, since it was seen as having some "skin in the game" by remaining the first party at risk of loss through its retention of the equity piece. Where the originator or sponsor is also the servicer or manager of the securitised assets, ownership of the equity piece can be seen by investors as an incentive to perform well in that role, given the originator's position in suffering the first loss should they fail to do so. The development of a market in equity pieces therefore potentially eroded this comfort and led to a perceived increasing misalignment of interests with investors. To date, there has been little transparency as to which originators still retain the risk associated with the equity piece and which do not.

Fitch proposes to invite key transaction parties to disclose on Fitch's transaction surveillance pages whether they: (i) own or have sold the equity piece; or (ii) have obtained credit protection with respect to the economic risk of the equity piece.

Where the key transaction parties opt not to make these disclosures, Fitch proposes that this be stated on the relevant surveillance web pages. A periodic report would also be prepared and made available for non-subscribers to Fitch surveillance. It should be noted that the ultimate success of this transparency initiative depends entirely on the degree of co-operation received from such transaction parties.

Further detail on each of these proposals is available in the report "*Exposure Draft: Retaining Equity Piece Risk - Enhancing Transparency*", which is available at www.fitchratings.com.

Feedback Requested

Fitch is seeking industry comment on the following questions.

- Would the disclosure of key transaction parties' retention of equity tranches within structured finance transactions add value to investors and other market participants?
- What views do industry participants hold regarding the importance of first loss piece retention or otherwise to transaction performance? Despite limited data to assess this, do industry participants believe it has an important influence?
- Would investors see this information as useful in their assessment of the merits of structured finance transactions, both at the time of investment and in assessing ongoing performance?
- Is the nature of the information proposed to be requested from key transaction parties sufficient? How could it be amended or refined? Should there be further disclosures, such as retention or otherwise of interest-only strips or other exposures further up the capital structure?
- How often should such information disclosed by key transaction parties be refreshed ?
- What difficulties do industry participants see with regard to the practical aspects associated with providing the disclosure, particularly from the perspective of the key transaction parties ?
- Do such disclosures belong on rating agency surveillance pages and reports or would they be better disclosed via another forum? If so, what type of forum?