Scope's Structured Finance Ratings: How We Are Different

Special Comment

Scope defines a new generation of ratings by its innovative edge, analytical excellence, and high quality service. We aim to produce ratings that add significantly more value than the North American agencies. This document answers two questions:

1. **Why offer ratings and analyses in structured finance?**
2. **How are we different from other existing rating narratives?**

In their analyses, North American rating agencies were unable to capture underlying factors explaining why structured finance transactions in Europe exhibited markedly better credit performance than in the US. Rating migrations assigned by North American rating agencies for European structured finance transactions also reflect the mechanistic approach in their methodologies that are barely applicable in Europe – particularly for sovereign and counterparty risk.

Scope's customised analysis and regional perspective challenges global rating criteria and industrialised rating approaches. Scope favours opinion-driven analysis instead of rigid methodologies applied systematically.

Scope's structured finance rating approach allows more rating differentiation by:

i. offering rating stability by adjusting assumptions for a local references, and strong forward-looking fundamental views;

ii. applying a bottom-up analytical approach by examining transactions in their individual context. Scope can therefore analyse a transaction without bias for instance without mechanistic caps, or one-size-fits-all assumptions;

iii. using a post-crisis counterparty risk approach that reflects the more robust credit quality of European banks after implementing the Bank Recovery and Resolution Directive (BRRD).

Since 2014, Scope has assigned ratings to structured finance debt securities including covered bonds, at issuance volumes of over EUR 240bn – and Scope's rating coverage continues to increase rapidly. Rated transactions include SME CLOs, CMBS, RMBS and covered bonds, as well as securitisations of leases, trade receivables and alternative investment funds. Scope not only analysed benchmark European ABS and MBS transactions, but also infrastructure and project finance transactions.

Scope relies on its 'General Structured Finance Rating Methodology', which details key principles for analysing structured finance transactions. Scope has also published sector-specific methodologies for SME CLOs, covered bonds and counterparty risk.

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Related Research

General Structured Finance Rating Methodology

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Why offer ratings and analyses in structured finance?

Wider analytical diversity needed in rating industry: Scope is the first rating agency covering the full spectrum of structured finance assets with rating methodologies designed from Europe. The financial crisis highlighted the risks of markets´ overreliance on external credit ratings from just a narrow core of US-based agencies. Firstly to reduce investors' dependence on external credit ratings. Secondly investors and issuers have called for a wider range of views and analyses in the credit rating industry to encourage a more diverse and stimulating investment ecosystem; and have likewise expressed frustration with mechanistic ratings that use credit views unsuitable for the local market.

Scope as the European choice: Scope aims to fill a market void, and bring more depth and transparency to credit investment decisions by providing understanding of European credit markets. Our independent ownership structure ensures this as our capital is 100% European and private. Scope is the only EU-based rating agency that has embarked on structured finance, banks, corporate, fund and sub-sovereign rating activities on a pan-European scale. This is particularly important at this stage of post-crisis dynamics when traditional rating methodologies for structured finance cannot or are too slow to adapt to evolving European realities, such as stricter rules and European bank supervision.

New EU rating agency regulations: Scope is registered with ESMA and benefits from ECAI status. Under the standardised approach for capital regulatory treatment, the ratings assigned by Scope also lead to the same capital requirements as for large rating agencies. Post-crisis European regulations aim for wider participation in the European rating industry. For example, CRA III Regulation (EU) No. 462/2013 states: (Article 8c) "Where an issuer or a related third party intends to solicit a credit rating of a structured finance instrument, it shall appoint at least two credit rating agencies to provide credit ratings independently of each other"; (Article 8d) "Where an issuer or a related third party intends to appoint at least two credit rating agencies for the credit rating of the same issuance or entity, the issuer or a related third party shall consider appointing at least one credit rating agency with no more than 10% of the total market share, […] provided that […] there is a credit rating agency available for rating the specific issuance or entity."

How are we different?

Offering fresh and forward-looking risk analysis

Rating stability through long-term adjustments of assumptions: Scope uses long-term and local references to assess future performance for an asset type. Scope can therefore apply stable and reasonable stress assumptions while trying to avoid understating stress in good credit cycles and overstating stress in bad ones (for a practical example, please see Spanish SME CLOs: Forward to the Past). Our rating approach also considers the past performance of European structured finance transactions, which strongly outperformed the asset credit performance of North American transactions. This approach is reflected not only in our key input assumptions, but also in how stress scenarios on those assumptions are applied.

Larger credit differentiation: Scope avoids applying one-size-fits-all assumptions, instead sequentially analysing key sources of risk in structured finance transactions. This includes incentives and profile of the transaction sponsor or originator, the securitised assets, and the structure by examining legal and counterparty risks. Scope therefore applies a bottom-up approach, which allows greater rating and transaction differentiation, even when transactions are from the same originator and the same country. For instance, a bank that originates pools at different times, or pools with different products targeting different borrower groups, can exhibit very different performance and Scope aims to reflect this in its ratings. Scope also recognises that originators know their customers best, which is why we include, originator experience and knowledge when constructing relevant credit risk assessments on loan portfolios.

Emphasis on fundamental analysis: Scope uses a fundamental – as opposed to a purely technical – approach. Scope includes macroeconomic factors in base case assumptions and assesses how structural factors may affect European credit markets. This is achieved by considering fundamental elements, such as changes in consumption patterns, banks' originating strategies, or increased European regulation and supervision. To be consistent in its fundamental analytical view, structured finance rating committees generally also include a bank rating analyst (please see from Scope's bank team: Why Now and How Are We Different).

Analysis in a European context: Scope analyses securitisations in a European context by applying local market knowledge as well as specific criteria. European markets exhibit different laws, features, history and cultures. They are also often more controlled and regulated, and benefit from economic stabilisers or safeguards against certain shocks. Rigid and global industry sector classifications may, for instance, be unsuitable for capturing specific risks in local European markets. For example, it is crucial to differentiate for Spanish real estate between real estate developers and related business service providers, and real estate holding companies investing in the real estate sector.

Our counterparty risk methodology is simple, yet adequately addresses risks regarding bank resolution and bail-in. BBB or higher financial counterparties can support AAA: Scope applies its view of the bank recovery and resolution regimes created after the recent financial crisis. A credible resolution and recovery framework should strengthen stability and predictability of bank ratings over time as insolvency scenarios become more remote. Under these new regimes, lowered risk substitution levels or rating triggers still provide significant comfort that resolvable financial institutions can take on counterparty roles (such as account banks, servicers, or swap counterparties) and, provided adequate structural protections exist, do not limit the highest achievable rating for a securitisation.

No mechanistic link to sovereign credit quality: Scope sees no valid analytical reason to mechanistically cap structured finance ratings by sovereign ratings[1] as sovereign credit quality is not an adequate anchor for a rating cap, particularly in the eurozone where convertibility risk (risk of euro exit) in core countries is immaterial in the medium term. For its sovereign risk analysis, Scope assesses convertibility risk and the risk of institutional meltdown for the tenor of each rated tranche.

Best service: efficient, flexible and transparent rating process.

Experienced analysts know what counts: Scope's analysts understand the need to define strong assumptions and rationales, and capture details beyond global rating criteria. Scope's structured finance analysts offer an extended and eclectic mix of backgrounds and expertise. The team includes analysts that have not only worked at the three largest rating agencies, but also at investment banks or strategic consultancies. Before joining Scope many of our analysts experienced the rigidity of methodology frameworks at other organisations – which Scope considers inadequate for correctly analysing credit risk in European jurisdictions.

Only the necessary time and effort for issuers: There is no unnecessary time and involvement for issuers in the rating relationship, which is in line with our proactive and extensive use of publicly available information from the issuer or sponsor. Scope works with data using any proprietary template because we recognise that originators already produce many valuable metrics for analysing credit risk in various securitised assets. Likewise, analysing asset originators, servicers or asset managers is key to our rating process. We make this efficient while focusing on points relevant for the securitisation in question.

Straightforward rating scale for expected loss posed to structured finance investors: Scope's ratings are on a standard scale from AAA to D, which reflects the expected loss from a rated instrument's contractual payments on a certain payment date or on legal maturity. Ratings include both likelihood of default on such payments as well as loss severity expected upon default.

[1] Sovereign rating of the country of the issuer or of the securitised assets

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