When AAA Does Not Mean Roadside Peace Of Mind

November 12, 2004

A Credit Perspective on Rating Limitations of AAA-Rated ARS Bonds

by Lance Pan, CFA, Director of Credit Research
lpan@capitaladvisors.com

INTRODUCTION:

Corporate treasurers frequently make investment decisions based on debt ratings from nationally recognized statistical rating agencies, namely Moody's, Standard & Poor's, and Fitch. This article addresses the credit risks of Auction Rate Securities (ARS) that are not adequately addressed by long-term credit ratings alone in short-term investment selections.

LONG-TERM RATINGS DO NOT ADDRESS SHORT-TERM RISKS

Long-term ratings on auction rate securities do not specifically address the near-term risk to most auction rate investors; that is, the timely payment of principal and interest at the end of a rate reset cycle. We learned from the rating agencies that such ratings are based on a security's final legal maturities, not on the reset dates. This is an important distinction since the majority of auction rate buyers do not intend to hold the bonds beyond money market terms of 13 months.

The claim that AAA rated ARS are credible alternatives to money market funds creates a false sense of security for short-term investors.

The rating misconception came to our attention after we observed sales literature from the broker-dealer community promoting ARS with AAA long-term ratings as high-grade alternatives to money market funds. We suspect that claims of this nature create a false sense of security for an investor who is either unfamiliar with the distinctions between long and short-term ratings or is inexperienced in structured finance transactions.

AUCTION RATE SECURITIES DO NOT HAVE SHORT-TERM RATINGS

To gain a better understanding of rating limitations in ARS, one needs to be cognizant of a separate set of rating designations by major rating agencies for short-term risk. Generally speaking, debt rated A-1/A-1+ by S&P, P-1 by Moody's, and F-1/F-1+ by Fitch is considered of highest credit quality.

While long-term ratings reflect both the likelihood of default and any financial loss suffered in the event of default, short-term ratings place more emphasis on the probability of default due to lack of liquidity. The short-term rating process relies on available liquidity support, either internally or externally, to meet the issuer's obligations in a timely manner[1].

Unlike most corporate and municipal securities, auction rate products do not have short-term ratings, since rating agencies never view these as short-term debt. This deficiency makes it difficult, and irrelevant, to compare their short-term risk to that of other asset classes. Without external liquidity and support, we believe the credit quality of ARS is significantly less than A-1/P-1 thanks to below investment grade servicer risk and its reliance on investor confidence.

ARS ARE LOAN-BACKED FLOATING RATE SECURITIES

Auction rate securities are not an asset class, but a unique way of issuing debt with Dutch auctions to set payment rates and re-offer the same securities. In other words, any asset class can be offered using auction rates. This market experienced explosive growth recently, thanks to a low interest rate environment and a growing number of new issuers. Different types of structures, issuers, assets, and tax treatments make it impossible to define the overall market.

The liquidity risk of ARS may be significantly less than A-1/P-1 thanks to below investment grade servicer risk and reliance on investor confidence.

In this article, we focus on the largest and most common segment of the ARS market: the auction rate tranches of asset backed securities (ABS) collateralized by student loans, a type of investment that falls under the umbrella of structured finance.

An issuer of student-loan backed notes sometimes divides the debt into multiple classes of securities that are backed by the same pool of assets. These classes include one or more series of fixed rate, floating rate, and auction rate transactions that could either be taxable or tax-exempt. The rating process for ARS is, for the most part, identical to other types of ABS, since rating agencies are primarily concerned with "the likelihood that note holders are paid by the legal final maturity, not by the reset date."[2] Accounts that do not allow asset backed securities or floating rate securities in their investment portfolios would exclude ARS as eligible securities.

ARS ARE NOT VARIABLE RATE DEMAND OBLIGATIONS

Similar rate reset features for ARS and variable rate demand obligations (VRDOs) in the municipal market sometimes lead to the misconception that the two are similar in risk characteristics. The fundamental difference is: long-term VRDOs can legitimately be considered short-term securities because of associated demand guarantees that are not present in auction rate products.

In the case of VRDOs, an issuer uses a liquidity provider, usually a commercial bank, through a Letter of Credit, who promises to purchase the bond from the investor at par on a rate reset date should the issuer fail to find a matching buyer. In essence, the investor receives a "hard" put option to redeem the security at par as long as the bank that provides liquidity is solvent.

In a sense, the ARS market has its roots in the municipal VRDO market. Since the late 1990's, the cost of "buying liquidity" increased for the issuers and most U.S. banks exited the business of providing letters of credit to municipal issuers. The "demand guarantee" was thus replaced with an "optional put" facilitated through the Dutch auction.

The consequence of doing away with the demand feature is the ineligibility of ARS in money market mutual funds, because they no longer satisfy the legal final maturity maximum of 397 days. Despite repeated lobbying efforts from the broker-dealer community, the U.S. Securities and Exchange Commission continues to exclude auction rate products as eligible investments for 2a-7 mutual funds.[3]

AN "OPTIONAL PUT" IS NOT A PUT OPTION

The term "optional put" in ARS does not fit the financial definition of a put option, which refers to an agreement that allows the holder to sell a certain security at a predetermined price on a specific date.

There are always two parties to an option transaction, with the seller of the option agreeing to purchase the underlying security back from the buyer at a later date. In an auction rate transaction, there is not such a seller to act as the counter-party to the buyer. Stating it differently, the "optional put" allows the investor to attempt to sell the securities at an auction with no guarantee that such an attempt will be satisfied. This arrangement is no different from any other type of negotiation in the marketplace, and therefore does not contain economic value.

Investors who do not allow asset backed securities or floating rate securities should exclude ARS as eligible investments.

AN AUCTION MAY FAIL DESPITE HIGH RATINGS

We received clarification from Moody's recently that, to arrive at a long-term rating, the agency tests cash flow obligations under different stress scenarios for failed auctions. As long as the agency is reasonably assured that the underlying loans generate enough income in excess of the maximum interest payment when a bond is in "failed auction" status, it is not considered in default and may in fact maintain the current ratings. This could result in investors holding an AAA-rated security that has no active market for an extended period of time.

RECENT RATING CONCERNS

Lack of regulatory oversight and issuer transparency has always been one of the main concerns with the ABS market, especially in less homogenous industries such as the student loan-servicing sector. In fact, the need for better disclosure and greater oversight was the main theme in this year's ABS West conference.

An "optional put", unlike a put option, does not have an economic value. AAA Credit ratings do not, and are not meant to, protect investors from failed auctions.

In its annual review of the student-loan backed market, Moody's sounded the alarm that the rapid growth of for-profit consolidation loan originators, in addition to the introduction of "innovative structures", further accentuated the need for better oversight and control.[2] If left unchecked, the agency hinted that the sector could repeat the serious credit problems of health care, credit card, and equipment leasing sectors in previous years.

In this report, Moody's cautioned that, "reporting and oversight risk is of special relevance to the growing ranks of loan consolidators who generally are less established, more aggressive, typically have no strong parent affiliation, have thin tangible capitalization, little if any agency or government oversight, and have less detailed histories of their student loan programs."[3]

It is our opinion that, aside from liquidity deficiency, the student loan backed ARS market is experiencing growing pains that may present credit risks beyond the tolerance of most short-term investors. Concerns presented by Moody's will likely place downward pressure on the long-term ratings of some of the less financially sound transactions.

ARS INVESTORS MUST LOOK BEYOND LONG-TERM RATINGS

In conclusion, long-term ratings are ineffective in assessing the credit risks of auction rate securities for short-term investors. With the absence of short-term ratings, corporate treasurers need to assess each transaction on its individual merit prior to investing.

When evaluating the fundamental credit risks of structured finance transactions, one needs to consider factors that include, but are not limited to, the credit quality of the asset collateral, the strength of structural support, experience and solvency of the servicer, diversification of participating broker-dealers, diligence of supervising authorities, effective internal control policies, and proper disclosure of issuer operations. The absence of relevant information for public investors, limited regulatory oversight, and lack of industry-wide effort by broker-dealers to improve marketability add to the opaque nature of this new market segment.

CONCLUSION

When a market needs to turn over $200 billion of ARS debt each month, the risk of failed auctions is not merely a statistical possibility. The question is: *why haven't we heard of them?* Stay tuned for SEC findings.

Notes:

1. "Moody's Rating Symbols & Definitions", Moody's Investors Service, August 2003; "Rating Short-Term Debt", Fitch Ratings, February 3, 2004.
2. "2003 Review and 2004 Outlook: Student Loan-Backed Securities Growth to Continue", Moody's Investors Service, January 20, 2004.
3. "No-Action Letter Under Investment Company Act – Rule 2a-7: Merrill Lynch Investment Managers", U.S. Securities and Exchange Commission, May 10, 2002.
4. "Securitization Pros Call for Transparency", Securitization News, Institutional Investor, February 10, 2004.

The information contained in this report has been prepared by Capital Advisors Group, Inc. ("CAG") from outside sources, which we believe to be reliable; however, we make no representations, express or implied, as to its accuracy or completeness. Opinions expressed herein are subject to change without notice and do not necessarily take into account the particular investment objectives, financial situations, or particular needs of all investors. This report is intended for informational purposes only and should not be construed as a solicitation or offer with respect to the purchase or sale of any security. CAG is under no obligation to make changes or updates to this report and therefore disclaims any liability should the information or opinions contained herein change or subsequently become inaccurate. Past performance is no guarantee of future results.

© 2004 Capital Advisors Group, Inc. All rights reserved. This report may not be reproduced or distributed without CAG's prior written consent.