CMBS Subordination, Ratings Inflation, and Regulatory-Capital Arbitrage

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Comments:

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Credit Risk Evaluation Designed for Institutional Targeting in finance

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The Story

- Jan 2002: ***risk-weights*** on CMBS bonds reduced to 20%
- ***Subordination levels*** for senior CMBS bonds demanded by rating agencies fell; and
- Many CMBS ratings ***upgraded***; resulting in
- Reductions in required capital via ***RBCS***

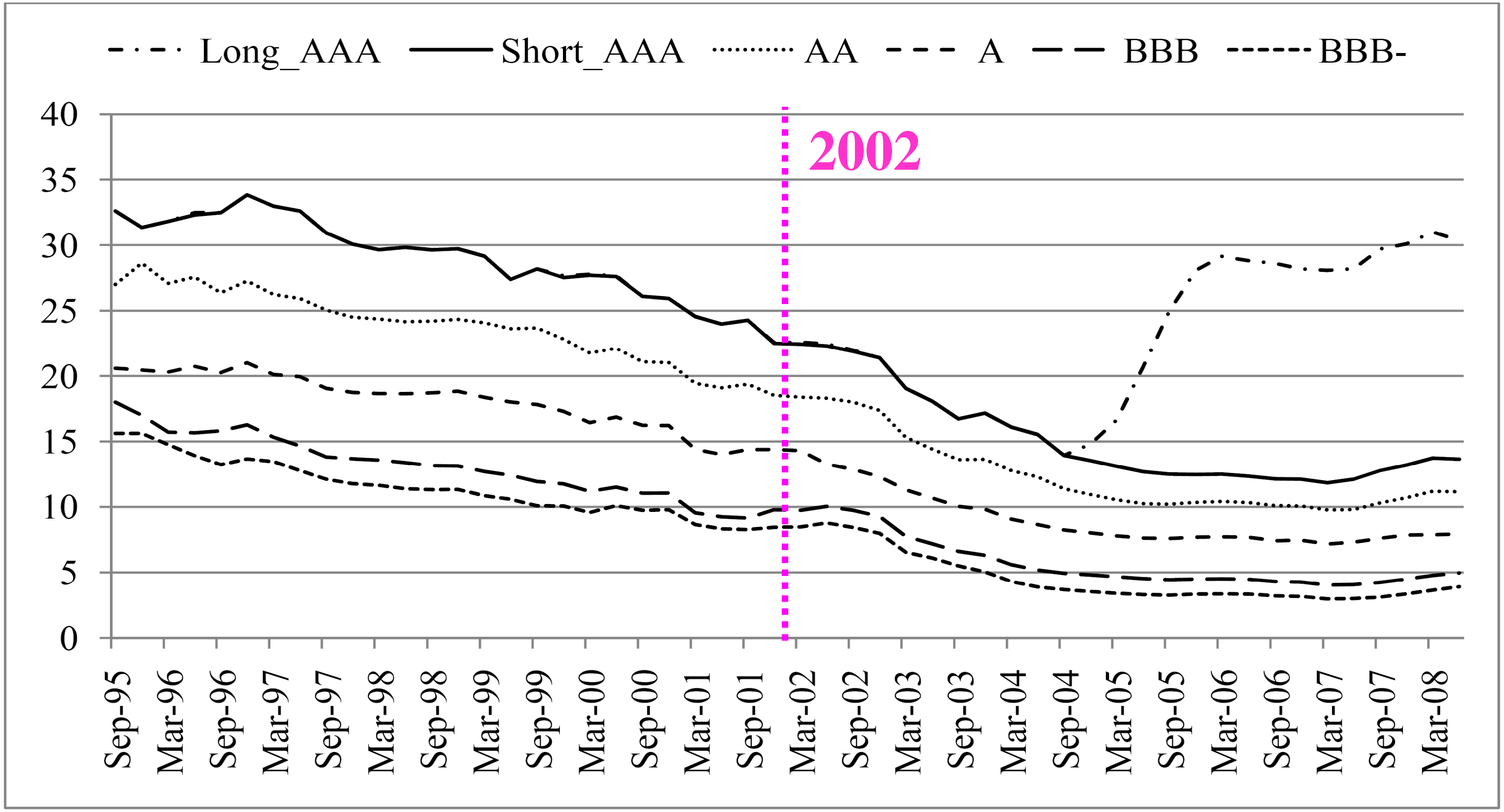
However

- No change in ***characteristics*** of CMBS loans themselves
- Implication
  - ✓ rating agencies facilitated ***regulatory capital arbitrage***
  - ✓ “Net result was to keep risk ***concentrated*** in financial institutions”

Comments

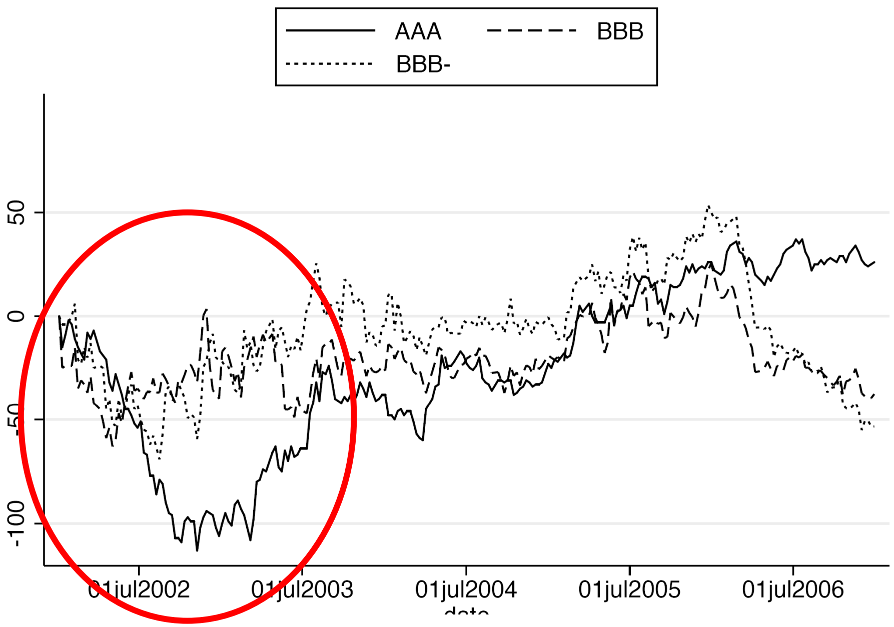
- Issues raised are very important
  - ✓ risk based capital requirements
  - ✓ use of ratings in RBCR
  - ✓ actions of rating agencies, issuer pays regime, competition between agencies vs. value of reputation
- Evidence
  - ✓ significant upgrading
  - ✓ re-pricing of senior loans
  - ✓ reduction of subordination levels

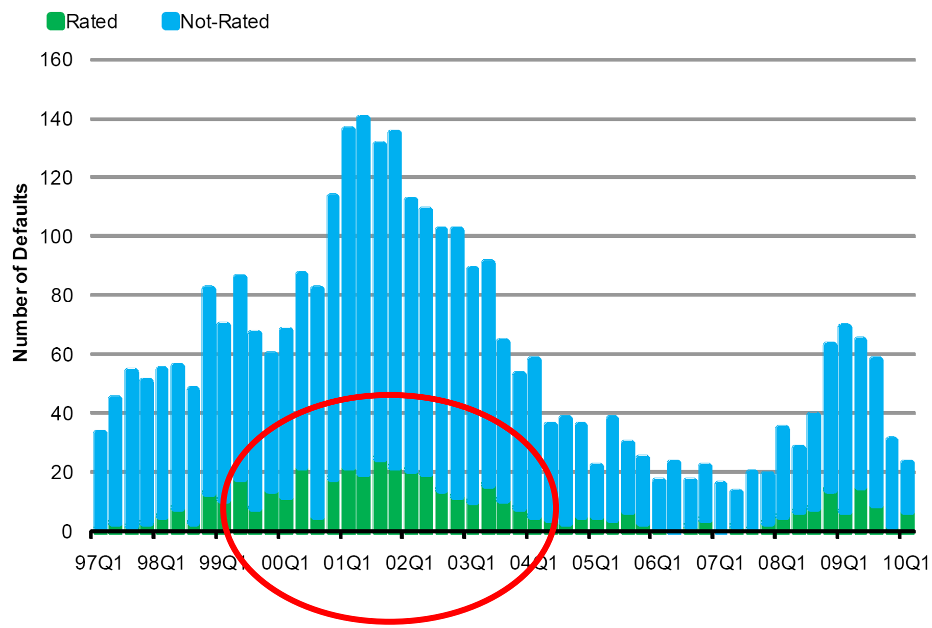
Was the reduction in subordination the result of the change in RBCR?



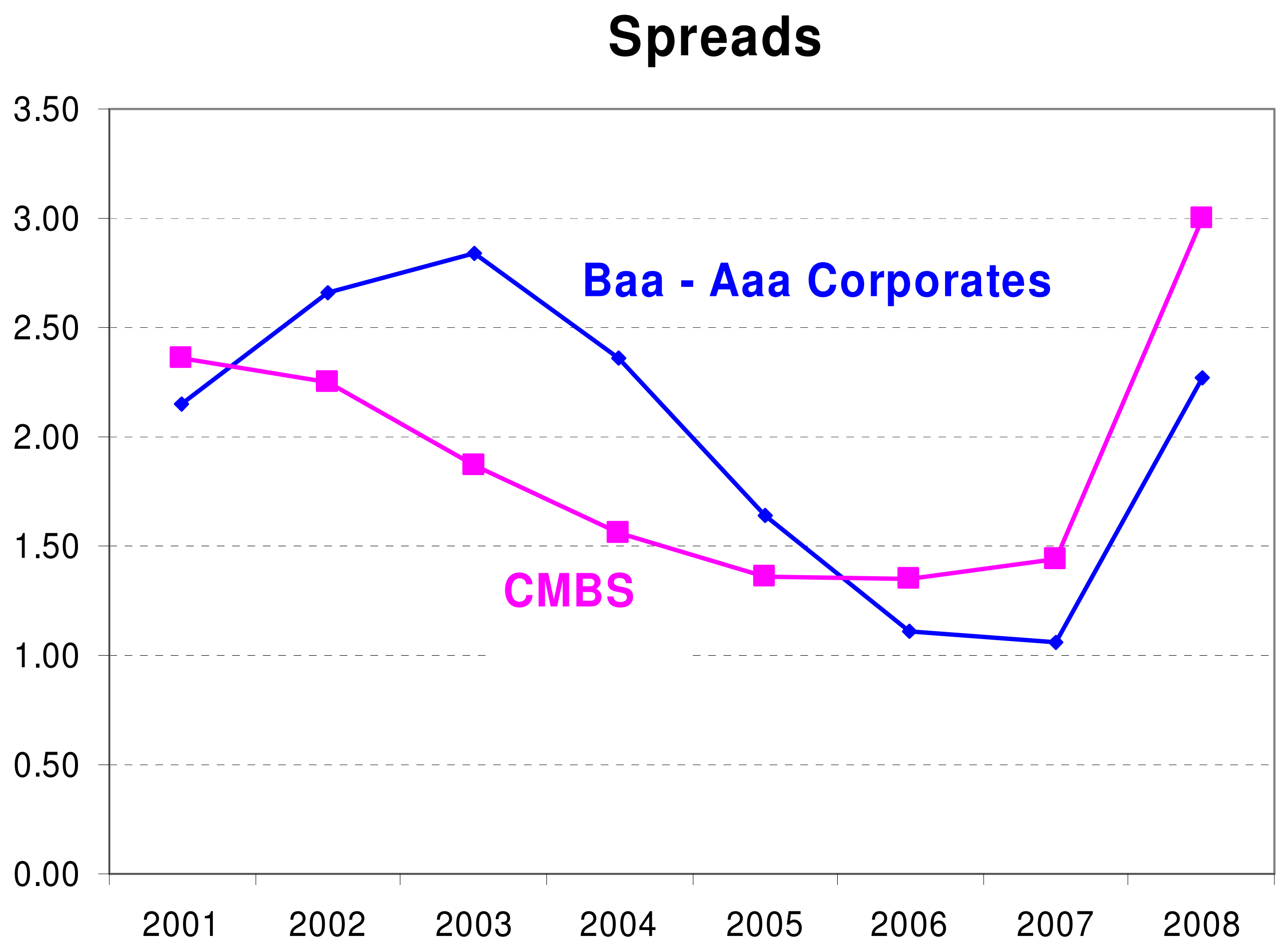
Price Impact of RBCR?

- Did reduction in RBCR push up prices of CMBS bonds? And, if so, why? [Value depends on financing?]
- Yields on CMBS relative to corporate bonds fell after 2001 but default rates on corporates at the time very high.

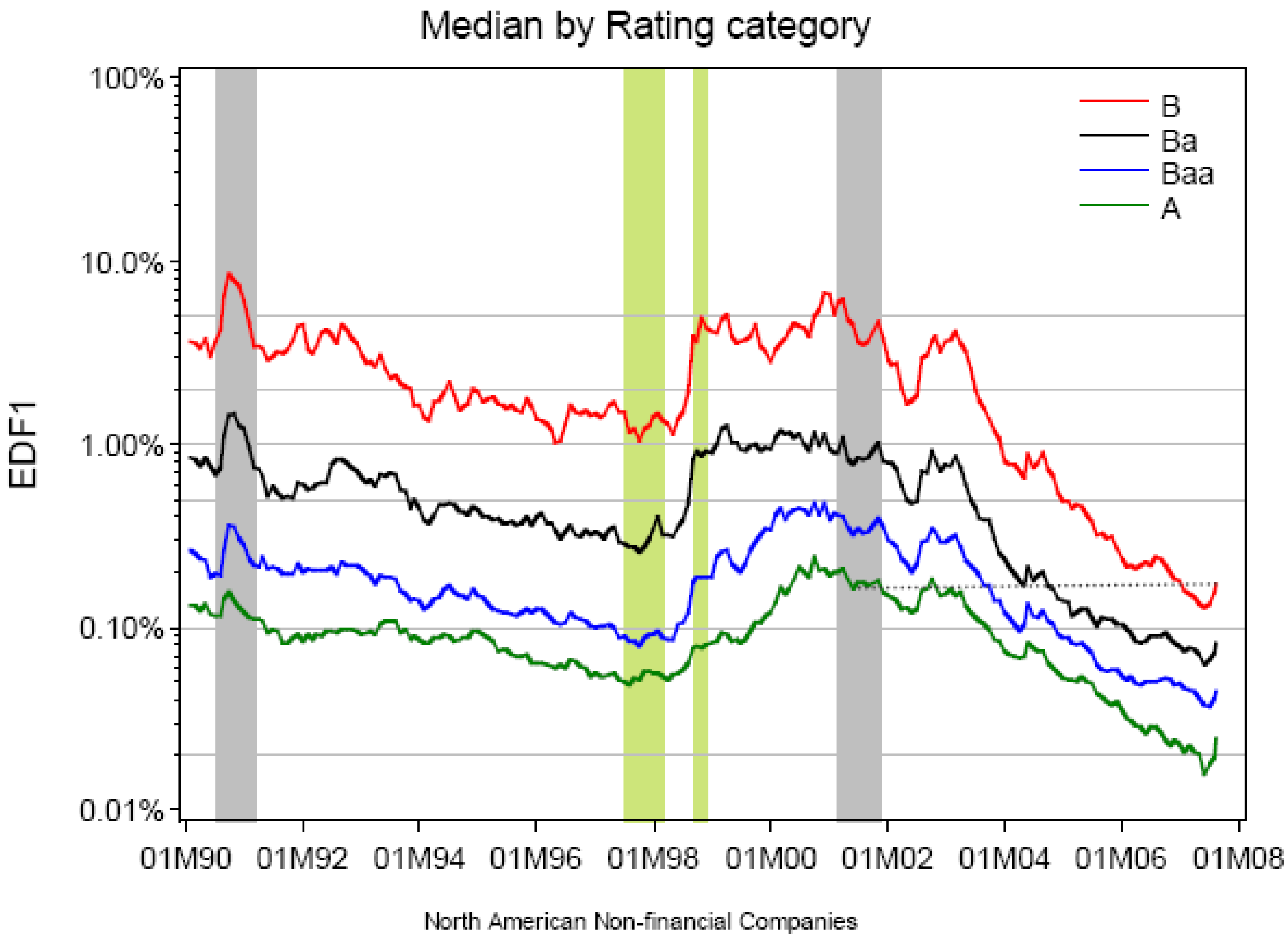




Was credit re-pricing in years leading up to crisis unique to the CMBS Market?

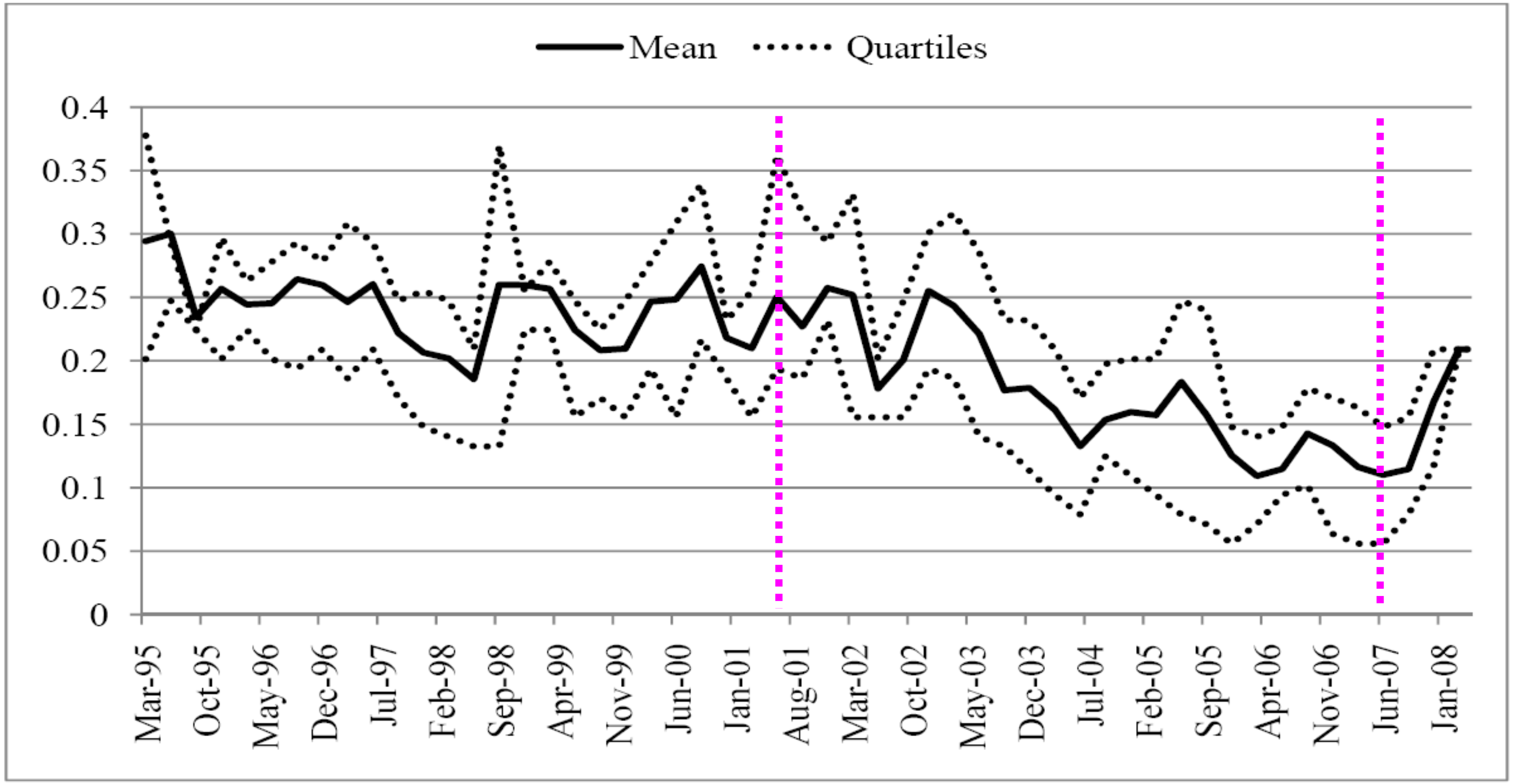


For corporate debt re-pricing in period leading up to crisis reflected substantial reductions in objective measure of credit risk



Source: Moody's KMV – "Credit Risk matters", Fall 2007.

Does Appear to be some significant reduction in CMBS implied vol. in years leading up to crisis



(a) Industrial

Regulatory Capital Arbitrage

- From July 2002 banking regulators in US reduced capital requirements on AAA and AA CMBS bonds by a factor or FIVE
  - ✓ RBCR for BB bonds 10 TIMES that for AAA/AA
- What was intention of regulators?
  - ✓ presumably to encourage banks to hold senior debt rather than junior debt (?); and
  - ✓ implicitly to encourage securitization in order to facilitate creation of senior and junior quality CMBS bonds (?)
- If this is what actually happened, is it right to call it arbitrage?