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Shaky CMBS market rattled by S&P ratings snafu, Goldman deal swept into drama

The ratings blunder unveiled yesterday by Standard & Poor's — which sidelined the already controversial GSMS 2011-GC4 deal —may have struck a larger, more significant blow to the budding confidence in CMBS 2.0, according to CMBS analysts and two buysiders.

The rating agency is expected to issue a second press release this evening to further explain a mix-up over the way it calculates DSCR, which caused the agency to put its own review process for conduit deals under review, according to a source familiar.

The market was not alone in being caught off guard. Goldman and Citigroup were also out of the loop until last night, according to a buysider claiming knowledge of the situation. The firms have told the accounts that committed to sit tight as they consider reissuing the deal – which was set to settle today—with new ratings.

The timing of the announcement has also raised eyebrows given the controversy the agency and the GC4 deal attracted just last week. The deal priced at eye-popping spreads after investor pushback forced issuers to re-jigger the deal's AAA credit enhancement levels from the original 14.5%, as reported. (see story, 22 July). Despite the new structure, the deal priced much wider than guidance with the deal's BBB tranche pricing at +700bps, as reported.

The rating agency went to unusual lengths to defend its ratings, hosting an impromptu investor call on 18 July to discuss the issues. Analysts attempted to quell concerns over low subordination levels by pointing to the deal's high multifamily concentration, low leverage and lack of pro forma-based appraisals.

The argument did little to win over investors, said a second buysider who listened to the call. "They weren't able to convey how they got comfortable with that [subordination] level…It wasn't clear at all."

Investors are now whispering that the attention last week could have prompted a high-level review of the deal’s underwriting that forced a 360 spin on the deal’s ratings, according to the first buysider.

By adding a super senior class to get the deal done, it harkened back to the heady days of 2007 when investors became the arbiters of risk, leaving egg on the face of rating agencies, the first buysider said.

The DSCR oversight could have popped during that review and formed the perfect excuse, the buysider speculated.

The drama also doesn’t bode well for Goldman and Citi who have been fingered as ratings shopping on the deal, the buysider said. “They were caught with their hands in the cookie jar,” the buysider said.

Curious Timing

The Street also questioned the timing of the announcement.

“It is…interesting that S&P discovered this inconsistency at the same time that it was being severely criticized for the generous subordination levels it awarded to GC4,” wrote Richard Parkus, analyst at Morgan Stanley, in a report issued today. It appears to be the first time a CMBS rating was withdrawn between pricing and closing, he wrote.

It is unclear what the impact will be on deals already rated by S&P if the two DSCR methods are combined. The sparse press release offered little details for investors to gauge potential downgrade impact.

“While it is possible there will be no downgrades or adjustment of subordination levels on future deals, we believe it is doubtful S&P would have put out such a release if there was not a high likelihood of rating changes,” wrote Harris Trifon, analyst at Deutsche Bank, in a report issued today.

Ultimate fallout aside, analysts agree that the whiff of a credibility issue could not come at a worse time given the weakness that has crept into the new issue market in recent weeks. “It's unfortunate," the second buysider said. "The market just got started. There are people on the sidelines who might be inclined to come back in [and] they see the turmoil with this deal. From that perspective, it’s not good."

He added that the announcement further erodes the credibility of S&P and the credit rating agency industry.

"Spreads have gone up, come down and gone up again… this mishap is just going to add more to that volatility," he said.

Investors, who normally need a bond rating from either S&P, Fitch or Moody’s, were likely in a lurch on the GC4 deal given that Morningstar was the only other rating agency on the deal, Triffon wrote.

The move left market observers “dumbfounded,” said one buyside analyst, adding, “And [angry] that [the large rating agencies] still hold the power for bondholders to accept deals. It is absurd.”

The ultimate economic impact for the issuers – who already had to swallow the cost of the additional enhancement levels – will be dependent on their pipeline hedges, said the buyside analyst and the second buysider.

“They are going to have to change the whole deal,” said the first buysider. “[There's] no way Moody’s doesn’t get to an 18% or close to 20% [for the AAA].”

A Goldman Sachs spokesman declined to comment.

“Regardless of their decision, we expect other issuers would not be willing to take the execution risk associated with a S&P rating and will engage three rating agencies going forward instead of the two which have been customary on 2011 conduit deals,” Trifon wrote.

The DSCR issue is linked to a difference in methods being used by the new issue team and the surveillance group, the release said.

Starting in 2011, the S&P team rating new-issue deals began averaging a loan’s DSCR with an S&P-defined constant DSCR, set at 1.20x, when calculating its ratings. Meanwhile, the agency’s surveillance team, in charge of reviewing S&P-rated

transactions and taking ratings actions, continued to use the lower of the two figures, as was standard practice for the agency.

“Besides the apparent lack of internal communication, we are surprised that the actions warranted such a severe reaction,” Triffon wrote. “Could the difference between the two approaches really result in a large disparity of projected defaults, losses and require dramatically different amounts of subordination? It's hard to believe.”

The two teams diverged in their DSCR calculations in early 2011, a likely indication that ratings actions would be limited to S&P-rated deals issued this year. Those deals are limited to MSC 2011-C1, JPMCC 2011-C3 and JPMCC 2011-C4, according to a Debtwire review. The deals also carry a Fitch rating, with the JPMCC deals also rated by Morningstar.

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