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Recent Bank Loan Research: Implications for Moody's Bank Loan Rating Practices

Summary

- Moody's ratings rank order credit risks with respect to expected loss rates, which reflect the product of the probability of default and expected severity of loss in the event of default.
- Speculative-grade issuers' bank loans are, therefore, generally rated higher than their bonds, because loans typically benefit from higher seniority and greater collateralization which should result in lower expected loss rates.
- This case for higher ratings on loans relative to bonds is strongly supported by Moody's research, which shows that both default rates and loss severity rates are significantly lower for loans than for bonds issued by the same obligor.
- Recent research, however, suggests that for a non-financial speculative grade obligor's loan and bond ratings, even the usual one or two rating notch differentiation fails on average to sufficiently capture the difference in experienced loss.
- Moody's rating committees will consider these historical research results as they calibrate obligors' bond and loan ratings, when differences in seniority and collateral are material. Since individual rating conclusions require careful analysis of the issuer's capital structure, as well as loan collateral and covenants, it is not possible to say in advance which currently rated loans are likely to be upgraded over time.
- While the bulk of Moody's bank loan ratings — and, consequently, the bulk of this research — pertains to North American corporate issuers, Moody's employs the same broad analytical approach in other geographical regions. Within the context of each region's particular credit environment, Moody's assigns ratings to loans and bonds that reflect the expected credit loss implications of their structural features and collateral. Moody's intends to continue monitoring loss data on corporate issuers, both inside and outside of North America, and adjust ratings where necessary to equate expected loss rates across similarly rated loans and bonds.

Moody's Investors Service
Global Credit Research

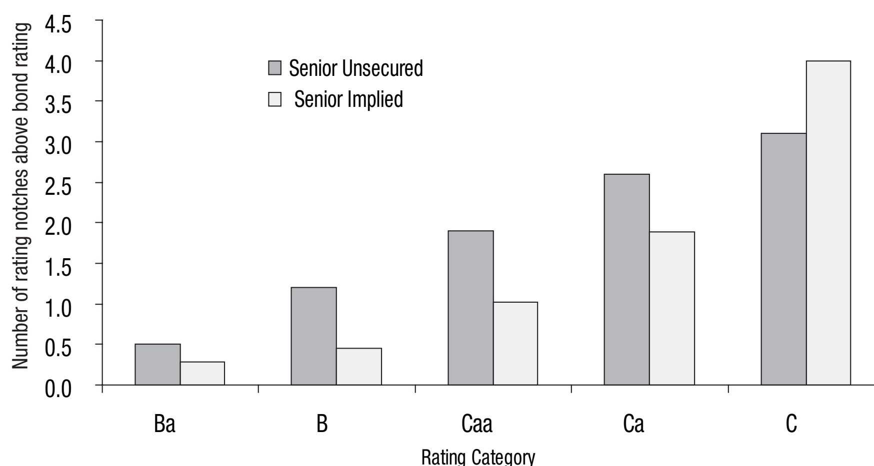
Moody's Bank Loan Rating Practices

Moody's bank loan ratings are measures of expected credit loss rates and use the same ratings scale as Moody's bond ratings. Moody's bank loan rating practices, which have been discussed in detail in a number of Moody's publications, acknowledge that bank loans are typically senior instruments that are often secured and enjoy a variety of structural advantages over other debt within a company's capital structure.[1] Because bank lenders generally benefit from structural protections and pledged collateral that are not extended to a firm's bondholders, loan ratings are often higher than the ratings on the same firm's senior unsecured debt obligations.

Moody's rates bank loans individually, not according to any simple rule of thumb, but based on a careful analysis of structure and collateral. Typically, loans are rated anywhere from on par with an issuer's senior-implied rating to up to three alpha-numeric rating categories higher. The data in Exhibit 1 show the current distribution of North American bank loan ratings relative the same issuers' senior unsecured and senior-implied ratings across rating categories.[2]

Exhibit 1

Bank Loan Ratings Relative to Senior Unsecured and Senior-Implied Ratings
(average number of alpha - numeric notches above bond rating)



Recent Moody's Bank Loan Research

Over the past ten years during which Moody's has been rating bank loans, a considerable amount of data has become available with which to evaluate their credit loss experience. Moody's has recently published a number of studies examining the credit characteristics of bank loans. The key results from these studies entail findings about the two components of credit losses — default rates and loss severity rates — along with specific findings about credit losses on bank loans relative to credit losses on bonds.

Loan Default Rates

Recent Moody's research finds that loan default rates are approximately 80% of bond default rates for speculative-grade rated non-financial issuers with both loans and bonds outstanding.[3] This result contrasts with the previously widely-held view among market participants that loan and bond default rates are roughly equal.

1. *See Moody's Special Comments: "Moody's Bank Loan Ratings: Pricing Implications and Approach" (April 1996), "A Sense of Security: Moody's Approach to Evaluating Bank Loan Structure and Collateral" (October 1997), "Moody's Analytical Framework for Speculative Grade Ratings" (May 1999), "Notching for Differences in Priority of Claims and Integration of the Preferred Stock Rating Scale" (November 2000), "The Case for Bank Loan Ratings" (January 1996), "Bank Loan Collateral: Credit Risks of Accounts Receivable" (June 1995).*
2. *The "notching relationship" widens at the lower end of the rating scale because, though the percentage difference in expected loss rates between an issuer's loans and its bonds remains constant as ratings decline, the percentage difference in expected loss rates associated with moving from one category to the next gets smaller at lower rating levels. As a result, more notches are required to reflect the same percentage difference in expected loss rates at lower rating levels. For a fuller discussion, see "Summary Guidance for Notching Secured Bonds, Subordinated Bonds, and Preferred Stocks of Corporate Issuers," Moody's Special Comment (September 2001).*
3. *See Moody's Special Comment "Relative Default Rates on Corporate Loans and Bonds" (October 2003) and Moody's Special Comment "Characteristics and Performance of Moody's-Rated U.S. Syndicated Bank Loans" (March 2004).*

Loan Loss Given Default Rates

Recent Moody's research finds that loss-given-default rates (LGDs) for loans are approximately 45% of LGDs for bonds of the same issuers.[4] In other words, loan recovery rates are more than two times greater than bond recovery rates, on average, for loans and bonds of the same issuers.

Credit Losses for Rated Loans

Consistent with the results on default rates and LGD, recent Moody's research finds that historical credit losses for rated bonds are roughly three times greater than for rated loans of speculative grade issuers with both Moody's-rated loans and bonds outstanding.[5]

Credit Losses for Similarly Rated Loans and Bonds

Recent Moody's research finds that historical credit losses for speculative grade bonds are approximately 1.5 times greater than for similarly rated loans.[6] These results indicate loan ratings have historically been too low to achieve Moody's policy of equality of expected losses across similarly rated loans and bonds.

Research Implications for Bank Loan Rating Practices

The Moody's research on North American bank loans outlined above strongly supports Moody's bank loan rating practices of oftentimes rating speculative grade issuers' loans higher than their bonds. The results indicate that not only are loan recovery rates significantly higher than bond recovery rates, but also that loan default rates are materially lower than bond default rates.

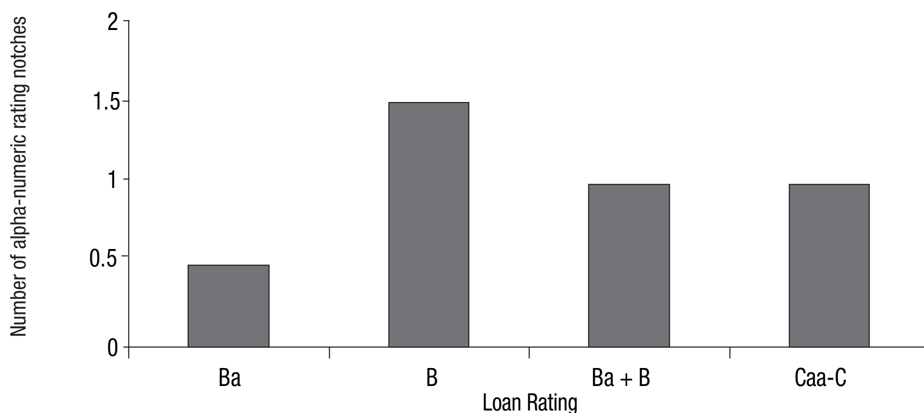
Importantly, however, the results on similarly rated bank loans and bonds indicate that credit losses on loans are materially lower than for similarly rated bonds. While these results support Moody's bank loan rating practices, they also suggest these practices need to be moderately recalibrated so that Moody's policy of equating expected credit losses across similarly rated loans and bonds can be achieved. As stated above, a key objective of Moody's is to ensure consistency of its ratings regardless of the type of capital market instrument to which the rating applies. A Ba2 rated bank loan, for example, should have the same loss expectation as a Ba2 rated bond. Therefore, with the passage of time, the cumulative loss experience of bank loans should be similar to that of similarly rated bonds.

Due to these research results, Moody's intends to more closely scrutinize loan collateral and structures to identify those situations in which the expected loss approach implies higher loan ratings relative to bond ratings. Consequently, there will be upward pressure on some loan ratings over time. The data in Exhibit 2 signal the likely magnitude of future upward pressure on loan ratings by showing the average upward revisions to historical loan ratings that would have been required to ensure equality of historical credit losses between similarly rated loans and bonds.[7] The data suggest that credit losses on Ba- and B-rated loans and bonds would have been approximately equal if loan ratings had been one notch higher than they actually were. Parsing the data more finely, the results suggest a greater lift (about 1.5 notches) for B-rated loans than for Ba-rated loans (about 0.5 notches).

4. *See Moody's Special Comment "Recovery Rates on North American Syndicated Bank Loans, 1989-2003" (March 2004) and Moody's Special Comment "Recovery Rates on Defaulted Corporate Bonds and Preferred Stocks, 1982-2003" (January 2004).*
5. *See Moody's Special Comment "Characteristics and Performance of Moody's-Rated U.S. Syndicated Bank Loans" (March 2004)*
6. *See Moody's Special Comment "Credit Loss Rates on Similarly Rated Loans and Bonds" (November 2004)*
7. *Ibid.*

Exhibit 2

Average Upward Adjustments in Loan Ratings Required to Equate Loss Rates on Similarly Rated Loans and Bonds



Since individual rating conclusions require careful analysis of the issuer's capital structure, as well as the loan's collateral and covenants, it is not possible to say in advance which individual loans are likely to be upgraded over time. As a practical matter, all loan ratings will be reviewed as a consequence of these research findings during the normal course of business conducted in rating committees.

Related Research

Special Comments:

Bank Loan Collateral: Credit Risks of Accounts Receivable, June 1995 #02375

The Case for Bank Loan Ratings, January 1996 #04869

Moody's Bank Loan Ratings: Pricing Implications and Approach, April 1996 #05965

A Sense of Security: Moody's Approach to Evaluating Bank Loan Structure and Collateral, October 1997 #27061

Summary Guidance for Notching Secured Bonds, Subordinated Bonds, and Preferred Stocks of Corporate Issuers, September 2001 #70456

Relative Default Rates on Corporate Loans and Bonds, September 2003 #79477

Recovery Rates on Defaulted Corporate Bonds and Preferred Stocks, 1982-2003, December 2003 #80272

Recovery Rates on North American Syndicated Bank Loans, 1989-2003, March 2004 #81684

Characteristics and Performance of Moody's Rated U.S. Syndicated Bank Loans, March 2004 #81723

Credit Loss Rates on Similarly Rated Loans and Bonds, December 2004 #89981

Rating Methodology:

Moody's Analytical Framework for Speculative Grade Ratings, May 1999 #40026

Notching for Differences in Priority of Claims and Integration of the Preferred Stock Rating Scale, November 2000 #61860

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