
Dealing with Ratings Agencies

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Following the Senate and House hearings, it appears that legislators want to do something to alleviate the information problems in credit markets, but they are not sure what is most effective. Hence, I offer a few modest proposals. These are not meant to address all concerns, but in a manner of triage I think these changes will set a foundation for meaningful changes and provide a regulatory touch-point so that the finer details can be assembled outside of Congress.

LETTER RATINGS

Because the ratings agencies have essentially sold letter ratings to the highest bidder, letter ratings now mask enormous differences in risk and are therefore no longer useful. Some suggest that letter ratings can be anchored in an average risk level parameterized by probability of default (PD) for S&P and Fitch or expected loss-given-default (LGD) for Moody's to alleviate the problem. Such a standardization, however, is a stone's throw away from just reporting PD and LGD alone and getting rid of letter ratings altogether. So if we want to go down that road, I suggest just going to PD and LGD and forgetting letter ratings. That still requires getting the letter rating criterion removed from ERISA, but that is the Department of Labor's decision. They deserve some of the blame for being lazy about the meaning of BBB.

Since the meanings of letter ratings have been arbitrated away by the ratings agencies, it makes sense to have them reveal the underlying PDs and LGDs they originally estimated in the initial rating process. Such a move would allow investors to better see what they have bought, and alleviate much of the current market difficulty while avoiding the need for an immediate ratings sweep, or wholesale re-rating.

REGULATORS

Many regulatory suggestions have been very SEC-centric. There is no need to focus on the SEC. The SEC hasn't done its job according to the Credit Improvement Act of 2006, nor in implementing Regulation AB in a timely fashion, nor in enforcing other transparency mechanisms ("true sale" provisions under FAS 133, 140, etc...) that could have substantially mitigated the present

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difficulties. Furthermore, expanding the SEC to include an active supervisory staff with resident examiners in the ratings agencies would require a new philosophy and function at the SEC to be created from scratch.

It could be that the Fed, with existing examination staff and un-intrusive well-balanced model supervisory guidelines already developed in the multinational Basel II process, is better suited to the job. Furthermore, the SEC will now most likely have to deal with primary supervisory issues anyway, as even if they are assigned primary supervisory status the Fed will maintain access as a secondary de facto supervisor with regard to banks using ratings as a backup measure of credit risk under Basel II. Just in case anyone thinks I am a Federal Reserve fanatic, another possibility is to use the Public Company Accounting Oversight Board and treat the ratings agencies as you would an accounting firm.

One thing is clear: ratings agencies are no longer akin to “journalists” with no liability for their reporting under the first amendment. The SEC’s inaction is presumably due to a reluctance of the rating agencies to be classified as investment companies. The question is therefore whether they are investment companies (regulated by the SEC), related to the business of banking (regulated by the Fed), or accounting and audit firms (with PCAOB oversight). Congress needs to make that reclassification to remove the uncertainty about the meaning of ratings that is clouding financial markets and hurting US financial market competitiveness worldwide.

TRUE SALE

Again relating to the SEC, a clear line needs to be drawn between a “true sale” and a “financing.” Firms need to report “representations and warranties” as contingent liabilities and should capitalize operational risks due to remaining ties to the loans, such as those that remain through servicing. Discussions and negotiations regarding those crucial features of financial reporting for securitizing firms have gone on for decades, and – given Enron, WorldCom, and now the subprime crisis – none has yet been implemented that adequately reflects the new financial engineering.

Also, whether or not the entities are not truly sold there needs to be mechanism to trace the loans back to the sponsor or issuer (and those terms still need consistent definition). That identifier is also important to investigate conflicts of interest. Recently, it appears that some investment banks seem to have underwritten and securitized loans and sold the resulting bonds out of their bond desks, a type of vertical integration. It appears that, since those investment banks also serviced the loans after securitization, they could vary the effort of their servicing subsidiaries (who, in some cases, reported directly to the investment bank bond desks) to influence the performance of the loans and therefore the market value of the bonds. The fiction of “true sale” needs to be reconciled with reality.

FREQUENT RE-RATING

Structured finance products over-perform in good markets and under-perform in bad. The issue is one of greater volatility in conjunction with path-dependence for structured products vis-à-vis traditional corporate bonds. That is, primary market structured products (i.e., static-pool securitizations) are very

discrete: they either perform or they don't, and when they don't, they don't recover. Secondary market structured products (i.e., dynamic pool CDOs) share the discrete quality of their performance, but because they cannot raise more capital, augment path-dependence with conflicts of interest (increased propensity to bet it all on risky investments if returns sour). Hence, the first requisite for structured products is frequent re-rating (for the volatility aspect) early in the life of the deal (not later due to the path-dependence). Issuers and ratings agencies will complain about the additional cost and that will constrain industry growth. That higher cost and resulting lower growth, however, will constrain further inappropriate applications of structured finance and create a stable transparent market.

REGULATORY PRINCIPALS MOVING FORWARD

There needs to be an accounting for "structure risk," that is, increased risk to bondholders arising from structures that are too complex to bear the uncertainties of the underlying collateral pool. The idea here is that simple collateral can support complex structures, and complex collateral can support simple structures. In subprime, we had complex collateral supporting complex structures. That doesn't work. Let's not make the same mistake again.