How to Improve the Credit Rating Agency Sector

It’s the Models - Not the Box of Godiva

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Joshua Rosner
Managing Director
Graham Fisher & Co., Inc.
Jrosner@graham-fisher.com
(646) 652-6207

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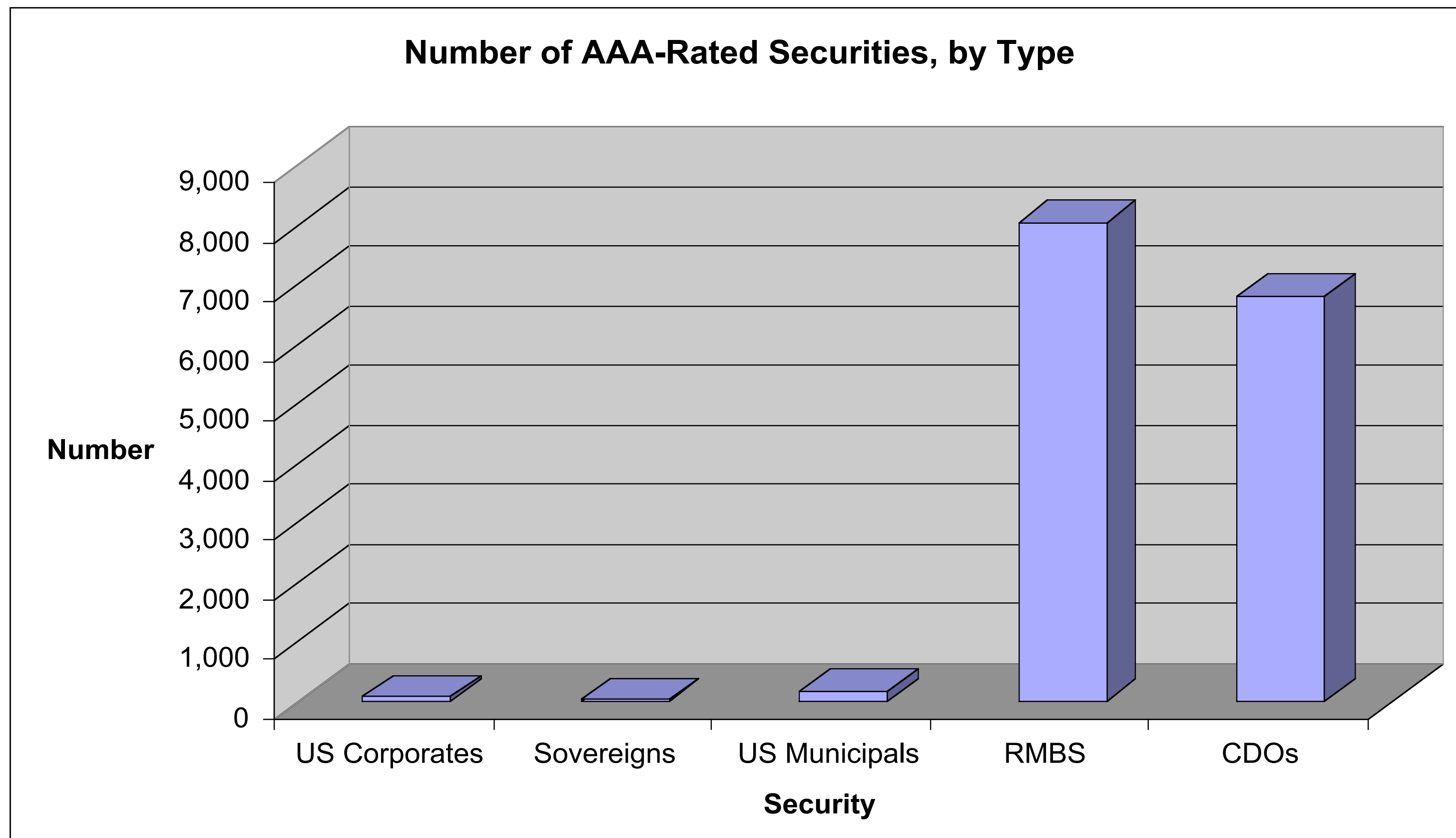
We got lost along the road to structured finance

- Historically: “Approach, in both policy and practice, is intended to provide a consistent framework for risk assessment that builds reasonable ratings consistency within and across sectors and geographies”- S&P
- Newer structured products required agencies to develop new models to rate newer securitized assets: “learning by doing”
- There is some good news today - assuming I read the draft of the Frank Muni Bill: If you read Title I - which concerns the rating agencies: ‘‘(iii) to apply such rating symbol in a consistent manner for all types of securities and money market instruments to which that symbol is assigned”. This appears to mean that an AAA, as example, will have to mean the same thing in terms of the probability of default, across asset classes. I would applaud this approach. That would make more sense than…

Hmmm- Does this make sense?



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Information Overload

- We commend the SEC for their rulemaking efforts. We believe that the proposed public release of information provided by arrangers and other parties to NRSRO's is a step in the right direction. We do believe that without disclosure of items substantially similar to static pool data and broader disclosure of information about stressed performance assumptions this data may not be fully utilizable. Moreover, given the limited amount of time that an investor has to analyze a deal before it closes, the ability to have data formatted into a workable tool is of paramount importance.

What does this all mean?

- “Can specific structured finance products with a AAA credit rating produce a return of up to 200 bp for investors, while a AAA corporate or a AAA MBS tranche produces only a 10/20 bp return? What does that mean? – AMF
- “Uncertainty about the meaning of original ratings is significant” – Nomura

Why Structured is Different

The Single Issuer Rating

- Broad base of Issuers, Law Firms, Corporate Management, Allowed, Investors
- Less complex legal structures
- Lengthy legal precedent on structures
- Empirical based models
- Issuers are “dynamic”
- Rating is a passive opinion
- Structures transparent
- Structures liquid
- Issuers generally issued for economic business management purpose

The Structured Product Rating

- Concentration of Issuers, Law Firms, Buyers, Structure Management (Servicer, CAM)
- Complex Legal Structures
- Relatively little legal precedent on structures
- Statistically based models
- Issuers are usually “static”
- Rating is more active iterative process
- Structures opaque
- Structures often illiquid
- Issuers often issue for speculative returns purpose

Why Structured is Different

The Single Issuer Rating

- Corporation exists prior to rating
- Assets are generally dynamic and managed
- Models are based on long history of empirical data
- Corporate structures and management create heterogeneity - low correlation
- Collateral is heterogeneous from issuer to issuer
- Large body of required public filing disclosures
- Corporations define their own corporate structures
- Credit risk is the primary (first) risk to the instruments
- Little principal risk

The Structured Product Rating

- Corporation exists upon rating
- Assets are expected to be static (other than during revolving period)
- Models are based on statistically derived assumptions
- Corporate structures creates homogeneity - high correlation
- Collateral is homogeneous from issuer to issuer
- Almost no required public filing disclosures
- Rating agencies define the corporate structures
- Market and liquidity risk is the primary (first) risk to the instruments
- Large amount of principal risk

Now that we have established this

- Will credit rating agencies always lag markets in non-credit risk instruments?
- Is there really increasing competition and what are they competing for?
- Is the problem the issuer pays model?
- Why is the SEC afraid to establish methodological, not model, standards?
- Are liability exemptions for structured ratings defensible?

Will credit rating agencies always lag markets in non-credit risk instruments?

- Markets began to widen spreads due to RMBS EPD in fall of 2006
- Rating agencies began large scale re-ratings and downgrades in Summer 2007
- Rating agencies continued to claim active management of CDO's resulted in low correlation to RMBS downgrades - liquidity problems disavowed active management
- Markets drove spreads wider on ABCP, SIV and CLO, rating agencies lagged
- Markets are suggesting CMBS and CMBS based CDO are a coming problem - rating agencies are slow to respond
- Markets are beginning to anticipate TRUP CDO deferral problems - rating agencies lag
- Markets downgraded monolines due to underlying structured exposures - rating agencies lagged
- Perhaps credit risk rating must be separated from the right to rate structured securities
  - Basel II banks
  - Pension Assets
  - Insurance Assets

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Is there really increasing competition and what are they competing for?

The SEC: “To date, a total of nine credit rating agencies have been granted registration with the Commission as NRSROs pursuant to the Rating Agency Act and the rules thereunder.”

- How many of the new entrants have any proven capability in structured securities
  - Should structured require a separate form NRSRO application?
  - What should the qualifying standards be?
  - Have anyone’s models successfully past the test over a cycle?
  - Would the incumbents qualify based on their history?
    - IOSCO Code @ 1.7 “The CRA should ensure that it has and devotes sufficient resources to carry out high quality credit assessments of all obligations and issuers it rates. When deciding whether to rate or continue rating an obligation or issuer, it should assess whether it is able to devote sufficient personnel with sufficient skills sets to make a proper rating assessment, and whether its personnel likely will have access to sufficient information needed in order to make such an assessment.”
    - IOSCO Code @ 1.1 “should adopt, implement and enforce written procedures to ensure that the opinions it disseminates are based on a thorough analysis of all information known to the CRA that is relevant to its analysis according to the CRA’s published rating methodology”
    - “no obligation to verify or audit any information provided to it from any source or to conduct any investigation or review, or to take any other action, to obtain any information that the issuer has not otherwise provided ”

Why is the SEC afraid to establish methodological (not model) standards?

- **The SEC and others assert that Congress prohibited the SEC from directing the substance of rating models and even methods. As a result it may be that limited legislation is the only way to solve the current problems in the rating of structured securities.**
- **Can you fix the problem of systematic model failures without fixing the modeling process?**
- Housing codes do not limit the number of builders or types of buildings that can be built
- Rating agencies design and build few types of houses but rate them any way that achieves the desired ratings “You start with a rating and build a deal around a rating” - Brian Clarkson

Our Recommendations

- Charter constrained investors may only buy exchange traded structured instruments
- Require the application of updated models in a timely manner
- Require the automation and utilization of full original assumptions and life loss curve coupled with monthly remittance data for *regular* secondary market re-rating
- Reduce liability exemptions for certain structured finance rating practices
- Create minimum industry standards for analyst professional training in structured finance
- Prohibit revolving door practices
- Require an independent office of Chief Statistician, or keeper of the models, at each NRSRO

Charter constrained investors may only buy exchange traded structured instruments

- This would create minimum standards of public disclosures in support of independent analysis
- This would reduce burden on safety and soundness examination staff
- This would create reputation based issuer incentives to build better pools
- This would create a market where both price and value could be discoverable
- Where issuers chose not to list securities chartered investors could still purchase securities but would be required to demonstrate to examiners that their own internal analysis independently supported holdings - reducing reliance on credit ratings

Require the application of updated models in a timely manner

Given the "learning by doing" process that results in frequent changes in structured ratings models, rating agencies should apply new models to all securities (not just new issues) at the introduction of the newer model.

- This would reduce ratings migration between vintages
- This would prevent, as example, stale ratings of RMBS from being used to structure newer vintage CDOs
- This would reduce the confusion in the market that has resulted from large numbers of ratings models per asset class
- Rating agencies typically do not go back and apply new models to securities rated with the prior models on a regular and timely basis
  - IOSCO Code @ 1.9 "Except for ratings that clearly indicate they do not entail ongoing surveillance, once a rating is published the CRA should monitor on an ongoing basis and update the rating by: (a) **regularly** reviewing the issuer's creditworthiness; (b) initiating a review of the status of the rating **upon becoming aware of any information that might reasonably be expected to result in a rating action** (including termination of a rating), consistent with the applicable rating methodology; **and** *[NOT 'or']* (c) updating on a timely basis the rating, as appropriate, based on the results of such a review"

Require the automation and utilization of full original assumptions and life loss curve coupled with monthly remittance data for regular secondary market re-rating

- Currently, secondary market 'monitoring' relies primarily on pipeline losses but do not redraw the entire loss curve using the underlying monthly pool cash flow data
- Static assets move in one direction and given the limited collateral and limited maximum possible cash flows in structured products this would create consistency between "at issuance" and "secondary market" ratings
- This would force the rating agencies to recognize and consider the 'false positives' that servicer advances may represent
- This would create a positive information feedback loop to increase the value of models
- This would prevent rating migration that results from disparate review timeframes of re-rating actions
- Remember - just because the surveillance team has remittance data doesn't mean they use it on a timely basis - information owned is different from information used

Reduce liability exemptions for certain structured finance rating practices

- We must consider the difference between an objective journalist and a statutory underwriter
- We must create a standard of verification of information
- We must require rating analysts to refuse to rate structures that they have reason to believe contain fraud and a fair safe harbor only once they have met that threshold

They do provide advice

The SEC states, but does not confirm; “In addition, the interaction between the NRSRO and the arranger during the RMBS and CDO rating process has raised concerns that the NRSROs are rating products they designed (i.e., evaluating their own work).”

- I will confirm it:
  - “We conclude that the sealed material makes it clear that ASB's claim that Fitch plays an active role in structuring the transaction is extremely credible.” UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT Docket Nos. 03-7062, 03-7076
  - Senator Menendez "...I listened to your answers to these questions and Ms. Tillman you say 'we don't tell them what to do, we have a dialog' and Mr. Kanef you said 'we have a feedback'. Well, clearly someone comes to you and in this 'dialog', in this 'feedback', I assume there are conversations going on that say 'well, if you did this’ or if the person or entity comes to you and says 'well what if we did this?' then you would say 'then we would to x in terms of the rating’. Is that a fair assumption?" Mr. Kanef: "Yes Sir, I believe it is". Senator Menendez: "So then the 'dialog', the 'feedback' goes into a process in which the entity is molding how they are going to present to you in order to achieve a certain rating, a higher rating, hopefully, for their purposes. Is that a fair statement?" Mr. Kanef (2:14:43): "I believe Senator that is a fair statement” - Senate Testimony Sept 26, 2007

The fine line

- The SEC seeks to prohibit NRSROs from advising on structuring
  - The fail to create a workable bright-line definition
  - Where, as a result of crossing the line "from an objective credit analyst to subjective consultant" (SEC proposed rules at p.60) it seems they should be unambiguously exposed to statutory underwriter liabilities.
  - Investment bankers have a fiduciary obligation to their investing clients and, where they fail to live up to those obligations are exposed to civil liabilities. When a rating agency acts as 'advisor' or 'underwriter' why should they be provided safe-harbor?
    - "The (Securities and Exchange) Commission has emphasized that, NRSROs, as registered investment advisers under the Investment Advisers Act of 1940, have a special duty to base their opinions upon current and adequate information." - SEC
    - "Underwriter" - " broad enough to encompass all persons who engage in steps necessary to the distribution of securities." - Harden v Raffensperger, Hughes
    - "Congress knew of the collateral participation concept and employed it in the Securities Act . . .The Court's footnoted discussion makes clear that, in its view, one who "participates," or "takes part in," an underwriting is subject to section 11 liability." - Harden v Raffensperger, Hughes

Other liabilities

IOSCO Code @ 1.1: “The CRA should adopt, implement and enforce written procedures to ensure that the opinions it disseminates are based on a thorough analysis of all information known to the CRA that is relevant to its analysis according to the CRA's published rating methodology.”

IOSCO Code @ 1.9: “The CRA and its analysts should take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of any issuer or obligation.”

- Should the intentional avoidance of information gathering, allowing one to say ‘I didn’t know’, be a basis for liability exemption?
- Where a ratings analyst knows or has reason to believe that fraud exists in a deal should they have an obligation not to rate the security or, where they continue with the rating assignment, should they be subject to clear liability? This is not theoretical, we can point to more than a few instances where an NRSRO rated a deal knowing there was fraud.
- When a rating agency is aware of clear model failures should they have some product liability? Haven’t we seen this as a real problem in the CPDO and monoline CDS rating failures?

Create minimum industry standards for analyst professional training in structured finance

- "The Commission requests comment on the appropriate subjective criteria that a credit rating agency should use in assessing the experience and training of an analyst to meet the proposed NRSRO definition?"
  - "While(S&P) Ratings Services is confident that its standards and procedures for analyst background and training would meet any minimum requirements imposed by the Commission, Ratings Services does not support the promulgation of NRSRO designation criteria that are conditioned on specific attributes of a rating agency's staff." - S&P's President Kathleen Corbet in answer to the SEC's Proposed Rules June 2005
  - In the highly complex and continuously evolving structured finance market are we to believe that analyst training is adequate within a particular organization and is standardized in any manner throughout the NRSRO community? Shouldn't you, for the protection of others, need a license before being allowed to drive a dangerous vehicle?

Prohibit revolving door practices

- The commission has proposed rules to prevent analysts from receiving gifts of $25 or more. We have never heard of a rating analyst selling a rating for a box of Godiva.
- The more real threat is an analyst seeking to curry favor, and future employment, from an investment bank for whom he/she is rating a deal. This is an increasingly frequent occurrence.
- The SEC should promulgate rules that prohibit the revolving door practice of a rating analyst leaving the employment of an NRSRO to work on the structuring side of a client firm for a period of one year. There is successful precedent for this in Section 206 of Sarbanes-Oxley regarding auditors.

Office of Chief Statistician

- While the SEC proposed rules seek to ensure that analysts are not influenced by business line considerations they fail to get to a more pressing issue.
  - If the models are compromised even the most honest and competent analysts work is compromised
  - The creator of rating models must be fire walled from revenue line management and their independence must be guaranteed.
  - Each NRSRO should have an independent Office that creates, tests and reviews the models and the Office should be removed from regular reporting lines and should report to a committee of independent Board members.

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