The Rating Reform Papers - In Search of the Missing Pedestal

A Centralized Solution

January 22, 2010

By Gene Phillips [A]

"The truth is not for all men, but only for those who seek it." – Ayn Rand

Subscribe to our series on rating agency reform and share your views and opinions at: ratingsreform.wordpress.com

If you would like to contribute an article to the series, email us at: info@pf2se.com

The financial crisis has brought to the fore, and indeed accentuated, the inadequacy of both regulatory bodies and our efforts to measure and mitigate risk throughout the financial system—particularly within the realm of structured finance, or securitization. While it is easy to criticize the performance of various market participants, it would be more productive to contemplate the underlying themes that emerged in the wake of this recent crisis. If we can accurately identify the root causes of the problems, we will be better positioned to resolve them.

One major concern is that a media-driven emphasis to act quickly may decrease the likelihood of implementing successful reform measures. The catchphrases "too-big-to-fail," "systemic risk," "toxic assets," and the like have the potential to undermine the focus of the reform process and divert attention away from the key challenges at hand: *to better align regulatory interests and to create an environment that encourages market transparency, consistency, and responsibility*. Liquidity will inevitably follow.

Securitization

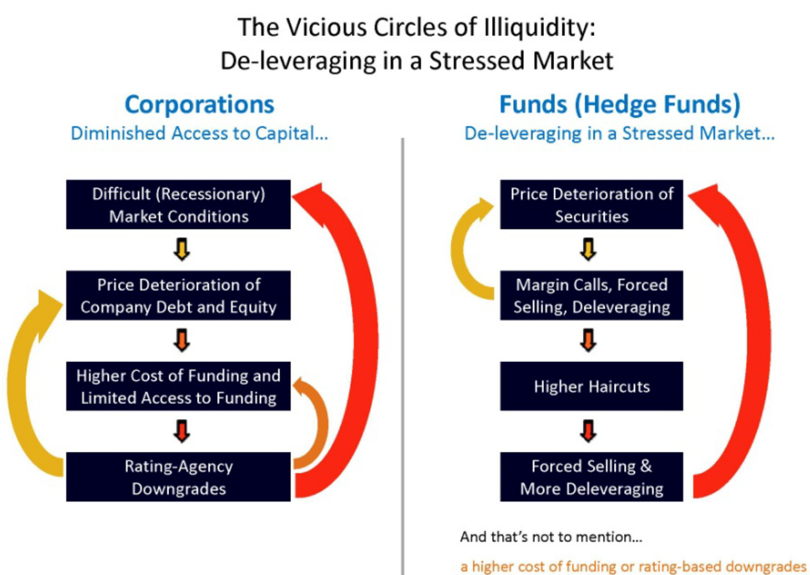
One lesson we have learned over the last three years, is that inter-industry and even inter-product correlations tend to be much higher than expected in the midst of a crisis linked to housing and financial and lending institutions. The CRAs (credit rating agencies) have been severely criticized for their assumption that home prices would never decrease. This assumption, among others, contributed to the underperformance of rated securities that were supported by RMBS (residential mortgage-backed securities) and certain CDOs (collateralized debt obligations) that were in turn supported by RMBS, as well as CDOs supported by CDOs of RMBS—as the securitization and resecuritization cycles were allowed to perpetuate themselves.

But this does not mean that *all* CDOs are "toxic" assets—as the media may have you believe—or that the art form of securitization is to blame. Rather, the poor application of securitization and our unwillingness or inability to mitigate the risks it presents are at fault. The securitization market provides a tremendous source of growth potential as a means of distributing and spreading risk among investors with different risk appetites. In a way, *if carefully managed*, securitization helps avoid the creation of too-big-to-fail institutions by allowing them to off-load exposures, similar to the way an insurer may seek reinsurance on some of its larger risks. More importantly, securitization increases the demand for receivables such as auto loans, equipment leases, and student loans, to name a few. Simply put, if there is heightened demand for student loan risk, student loans and, with them, higher education become more affordable. Securitization helps enable that additional demand.

Rating Agencies

As we consider ways to implement effective reform measures, we need to understand the key downfalls of the existing investment culture and regulatory environment—an environment in which investors and regulators have increasingly relied upon credit ratings as an alternative to performing their own independent due diligence, either before or after investing. We desperately need to move away from a culture in which investors, sophisticated or not, would buy the highest-yielding asset at each rating level, irrespective of its other-than-credit risks and without having performed an adequate analysis (or even possessing the tools or skills to perform such an analysis).

Due to the overreliance on the CRAs, at the peak of the crisis, the market found itself ill equipped to absorb the effects of CRA misjudgments about the housing market. Investors were unable to analyze their own securities or estimate the risk associated with future cash flows. And regulators realized how deeply dependent financial capital reserves were on credit ratings and saw firsthand the effects of the mass deleveraging that occurred in the stressed market—which, in this case, was perpetuated by ratings downgrades that exacerbated further margin calls (see graph below). Only after the economic crisis had begun did market participants come to appreciate the various risks that exist in the over-the-counter securitization market. Aside from the pure credit risks, which the CRAs were measuring, there are liquidity risks, cash flow extension risks, operational risks, complexity or model risks, and accounting risks, among others.



Sources: PF2 Securities Evaluations, UBS Financial Services, Inc.

Froeba (2009) describes the opportune position the ratings agencies found themselves in as a result of the deeply embedded nature of ratings throughout our financial system: "First, they enjoyed an effective monopoly on the sale of credit opinions. Second, and more importantly, they enjoyed the benefit of very substantial government-sanctioned demand for their monopoly product. (A buggy whip monopoly is a lot more valuable if government safety regulations require one in every new car). Third, the agencies enjoyed nearly complete immunity from liability for injuries caused by their monopoly product."

Given the rating agencies' implicit government sanctioning, their limited liability for inaccuracy, and their goal of increased market share—Moody's is a publicly listed company, for example, and Standard & Poor's is owned by McGraw-Hill, which is also a public company—the resulting decline in ratings standards is perhaps not surprising. Some ways to buffer against this problem would be to incentivize the CRAs to be accurate (or penalize consistent inaccuracies) and to decrease investor reliance and regulatory dependence on ratings. There are various steps that can be taken toward achieving these ends:

- Calomiris (2009) suggests a six month "sit-out" penalty for any CRA that systematically underestimates risk over a significant period of time. An alternative is to carefully align the payment for ratings with their accuracy, so that CRAs are paid more for accurate ratings, while their pay is reduced, or cut, for poor performance—much as it is with a hedge fund manager.
- To help regain investor confidence in ratings integrity, CRAs could be embedded within existing regulatory frameworks (such as the Securities and Exchange Commission), could be disallowed from being public companies, or could have their owners restricted from involvement in the ratings process.
- Measures could be implemented to limit investment in complex securities to those investors who are positioned to perform a certain minimal level of due diligence, as is described by the International Organization of Securities Commissions (2009).

Centralizing Data and Regulatory Functions

The creation of central depots to regulate financial companies and to share financial data (including transaction prices) will promote numerous important initiatives, including the movement toward market transparency and away from informational asymmetries.

Additionally, it will discourage regulatory arbitrage maneuvers—processes including those by which financial institutions choose to hold securities in those units that are regulated by the most lenient regulators. Furthermore, the movement toward a centralized solution, regulator, or data source enhances the ability for market participants to compare apples to apples from both a product and accounting perspective; the resulting clarity and consistency will heighten investor demand and promote an environment in which regulators are empowered to take more responsibility in tandem with the broadening of their authority and jurisdiction..

Fully grasping the difficulty in regulating across CRAs that have different ratings methodologies and scales, Kolchinsky (2009) proposes an independent body to set public ratings standards, using the Financial Accounting Standards Board as an example: "The key limitation has been the existence of a single set of standards or methodologies which all accountants need to abide by (e.g., GAAP). While CPAs are free to compete on price and service, they cannot change much the definition of revenue or loss."

Kolchinsky's proposed regulator would solve another major concern highlighted by, among others, Jarrow and van Deventer (2009): CRAs measure their own ratings performance, which is somewhat akin to hedge funds internally marking their portfolios or measuring their returns. This conflict, in the worst case, may incentivize CRAs to overstate their performance, as it is a key attribute in the competition for market share.

The reform proposals that were instituted after the rating agencies failed to foresee the demise of Enron proved ineffective in buffering against this most recent financial crisis. The first goal, thus, must be to reduce the market's overreliance on ratings. Rating agencies are not infallible. Why balance our entire financial structure on their accuracy? Concurrently, we ought to correct the core problems with CRAs so as to restore investor confidence in the integrity of ratings. We can achieve these objectives by appropriately aligning CRA incentives with investor interests—that is, ratings accuracy—and by ensuring we have a responsible external body supervising CRA performance.

By way of a centralized, transparent body, potential investors will be better able to gauge and compare the holdings of funds and institutions. More informed investors generate demand that, together with consistency and transparency, generates liquidity.

References

Calomiris, Charles. April 23, 2009. "Financial Reforms We Can All Agree On." *Wall Street Journal*. http://online.wsj.com/article/SB124044213684645481.html.

Froeba, Mark. August 5, 2009. "Examining Proposals to Enhance the Regulation of Credit Rating Agencies." Prepared testimony for the Senate Committee on Banking, Housing, and Urban Affairs. http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=89e91cf4-71e2-406d-a416-0e391f4f52b0&Witness_ID=dc8a81f0-6a92-462f-aab4-9beb52a05697.

International Organization of Securities Commissions. July 2009. *Good Practices in Relation to Investment Managers´ Due Diligence When Investing in Structured Finance Instruments*. http://www.iosco.org/library/pubdocs/pdf/IOSCOPD300.pdf.

Jarrow, Bob, and Donald R. van Deventer. March 15, 2009. "The Ratings Chernobyl." Kamakura Blog. http://kamakuraco.com/Company/ExecutiveProfiles/DonaldRvanDeventerPhD/KamakuraBlog/tabid/231/EntryId/11/The-Ratings-Chernobyl.aspx.

Kolchinsky, Eric. September 30, 2009. "Credit Rating Agencies and the Next Financial Crisis." Prepared testimony for the House Oversight and Government Reform Committee. http://oversight.house.gov/images/stories/documents/20090930083904.pdf

[A] Gene Phillips is a Director at PF2 Securities Evaluations, based in New York. In his spare time he plays table-tennis, reads classical literature, and considers new and varying ways to make the world a better place.

This opinion piece constitutes one article in a series of articles on rating agency reform, entitled "In Search of the Missing Pedestal." Articles written under this series can be found at http:/ratingsreform.wordpress.com. Prior pieces include *"Gaming" the Ratings System, or the Observer Effect* and *Assuming Responsibility, or What You Will*.