The Rating Reform Papers - In Search of the Missing Pedestal

Assuming Responsibility, or What You Will

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"The brilliant idea of securitization has been nearly destroyed by very poor implementation." - Francesco Papadia

The justification is regularly put forth that greed was a major cause of the financial crisis. While this may or may not be true, it begs the question: is greed new? If people have always been greedy, why didn't this crisis occur earlier? One answer is that several minor crises did occur earlier, due to greed: we simply didn't notice because they weren't big enough, meaningful enough to grab our attention.

Others believe that the issuer-based pay model for rating agencies was an accident waiting to happen and that we finally built a house of cards that, when it faltered, fell from a high enough ceiling to wake us all up.

We find better closure, however, in an alternative explanation: that the escalation of private markets and the rapid increase in analytical sophistication (in advance of regulatory improvements) allowed many market participants the ability to hide what they were doing, avoid disclosure, and escape responsibility.

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We feel the hype concern surrounding the issuer-pay model is legitimate, but that it pales into insignificance alongside many of the other problems that proliferate throughout our financial network; rather, we believe that the key challenges facing rating agencies – and rating agency reform – revolve around transparency, disclosure and the lack of incentive towards being accurate.

When the crisis began in the structured finance market, the media was up in arms about the art form of securitization. On the ratings side the correlated binomial came under intense scrutiny and the issuer-pay model critics returned with renewed enthusiasm. Absent a thorough understanding of, or agreement with, the outcomes of any model, the model itself is immediately brought into question. This is largely a result of the media being better able to describe a model's shortcomings – which are often tangible – than to communicate the deeper intricacies and complexities consistent with its poor implementation.

The issuer-pay model is no greater a concern for rating agencies than for auditing firms. Indeed Arthur Andersen LLP, formerly one of the "Big Five" accounting firms, was brought down after being found guilty of criminal charges relating to the firm's auditing of Enron, its largest client. Does this mean that the issuer-pay model for accounting firms was to blame?

No model will ever be perfect. And, more importantly, *a model is only as good as its user and its inputs*. There's nothing inherently wrong with the art form of securitization, the correlated binomial, or an issuer-pay model: it is their users and underlying assumptions that ought to be at the center of the media's attention.

It supports our theory that the failures began to show themselves in the securitization market: the immature securitization market is noted for its lack of transparency and disclosure. More recently it has been marked by its misrepresentations. Battles continue to be fought over who owns the rights to the mortgages underlying the mortgage-backed securities vehicles; the bankruptcy process for off-shore vehicles remains underdeveloped relative to the United States; off-shore legal counsel seems nowhere to be found; and the complexity of some of the special purpose entities (and the number of different interests being represented) creates havoc for our litigious society. The securitization market was open to abuse. And it was abused.

Where securitization was originally seen as an effective liquidity management tool, it quickly became a risky way of generating short-term profits at the expense of sustainability. Together, the heightened modeling and legal complexity of the structures, and poor levels of disclosure and transparency surrounding them, made securitization a likely candidate to "blow up" and to unravel the weaknesses in the ratings process – especially absent sufficient oversight. *One the one side you have a complex, opaque product. On the other you have a set of relied-upon companies performing little, if any, investigation into the accuracy of the opaque data they're receiving and accepting little, if any, liability or responsibility for their actions.*

Responsibility

The mythical story of Oedipus centered on a son who unwittingly killed his birth-father, King Laius of Thebes, in self defense. Then, on being the first to correctly answer a Sphinx's riddle, the people of Thebes appointed Oedipus as their king and gave him the recently widowed queen's hand in marriage. When Oedipus realized that he had killed his father (whom he hadn't met before) and married his mother, he gouged his eyes out and exiled himself from the city he ruled.

Crucially, Oedipus felt responsible for bringing disaster on the city and his family, despite not having at the time known what he was doing. The securitization market is a far cry from the times of Oedipus: nobody takes responsibility for anything and we all look around to see where we can best direct the blame. Oedipus is dead and Hamlet's queen-mother Gertrude proliferates, moving swiftly from one warm bed to another, absent any feelings of guilt or any measure of responsibility.

In referring to a complex structured finance security, a rating agency analyst once commented: "it could be structured by cows and we would rate it."[1] You may frown, but do you blame the rating agencies for rating *anything*, everything? If your company was publicly traded and thus pressured to increase returns, absent any risk (reputational or liability-oriented) to your government-mandated oligopoly, pure capitalistic influences would have you rate everything too, even if it were "structured by a cow." But you frown, nevertheless. That's because the rating agencies aren't *supposed* to be pure capitalists. They have however become the de facto regulator of the structured finance market. But we made them that – powerful and trustworthy. We ultimately helped create a situation in which unsophisticated investors would often (unfortunately) rely wholly

[1] http://www.washingtonpost.com/wp-dyn/content/article/2008/10/22/AR2008102202311.html

on the rating agencies as a means of "outsourcing" their investment due diligence; meanwhile the rating agencies would claim to merely be providing an opinion, which may or may not be accurate. Having until recently doggedly defended their ratings performance even on mortgage-backed securities, one could now cogently argue that if they were to publish a dogma of rating agency infallibility, it would be among the most modest pretensions of its kind.

A high-ranking rating agency executive highlights the problem: "We had blinders on and never questioned the information we were given … these errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue, or a little bit of both."[2] Not being regulators, rating agency analysts were arguably less concerned than auditors or other supervisors as to the accuracy of the data they relied upon.

If we are to admit, as we must, that the current positioning of rating agencies as de facto regulator absent liability was a blunder, we must broaden their roles sufficiently as to include responsibility in their charter. The alternative is the worrying progression towards the fastest or cheapest mode of analysis, which inevitably decreases precision.

Our first challenge, then, is to orchestrate a return in mindset at the rating agencies from "we will find a way - or we will make one" to something closer to Arthur Andersen's original stance. Arthur refused to sign off on flawed accounts despite the inevitable loss of a major client, saying there was "not enough money in the city of Chicago" to make him sig off.[3] Let us hope we have not crossed the Rubicon.

Ideally, we would want the ratings agencies to have none of the overwhelming motives of political convenience, popularity or market share to bias them. We would want there to not be enough money in New York to encourage them to rate an inferior asset AAA.

Former rating agency analyst Mark Froeba told the *Wall Street Journal* that "there was never an explicit directive to subordinate rating quality to market share. There was, rather, a palpable erosion of institutional support for rating analysis that threatened market share." Froeba associates the changes he saw at Moody's with, among other things, their spinoff into being a public company, in late 2000. Froeba described his solution to the subsequent capitalistic tendencies in his August 2009 testimony before the U.S. Senate:[4]

> ***First, put a "fire wall" around ratings analysis***. The agencies have already separated their rating and non-rating businesses. This is fine but not enough. The agencies must also separate the rating *business* from rating *analysis***.** Investors need to believe that rating analysis generates a pure opinion about credit quality, not one even potentially influenced by business goals (like building market share). Even if business goals have never corrupted a single rating, the potential for corruption demands a complete separation of rating analysis from bottom-line analysis. Investors should see that rating analysis is virtually barricaded into an "ivory tower," and kept safe from interference by any agenda other than getting the answer right. The best reform proposal must exclude business managers from involvement in any aspect of rating analysis and, critically also, from any role in decisions about analyst pay, performance and promotions.
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> ***Second, prohibit employee stock ownership and change the way rating analysts are compensated***. There's a reason why we don't want judges to have a stake in the matters before them and it's not just to make sure judges are fair. We do this so that litigants have confidence in the system and trust its results. We do this even if some or all judges could decide cases fairly without the rule. The same should be true for ratings. Even if employee stock ownership has never actually affected a single rating, it provokes doubt that ratings are disinterested and undermines investor confidence. Investors should have no cause to question whether the interests of rating agency employees align more closely with agency shareholders than investors. Reform should

[2] *Id.*
[3] Arthur Andersen LLP was based out of Chicago.
[4] http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=89e91cf4-71e2-406d-a416-0e391f4f52b0&Witness_ID=dc8a81f0-6a92-462f-aab4-9beb52a05697

ban all forms of employee stock ownership (direct and indirect) by anyone involved in rating analysis. These same concerns arise with respect to annual bonus compensation and 401(K) contributions. As long as these forms of compensation are allowed to be based upon how well the *company* performs (and are not limited to how well the *analyst* performs), there will always be doubts about how the rating analysts' interests align.

These important initial measures seem easy enough to effectuate.

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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*.