PF2 Securities Evaluations

Special Report: First Steps Toward Real Rating Agency Reform

Knowing Where We Need to Go

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Introduction

If we think of economies as pyramids, the ongoing financial crisis would suggest that our pyramid was very poorly constructed. The crisis has caused us to question the structural integrity of every level of our economic framework, including accounting, auditing, risk management and other practices. Each of these practices has shown not only separate weaknesses but also alarming inter-dependencies across asset classes – from counties and municipalities to pension funds, mutual funds, hedge funds, insurance companies and banks, both large and small.

And we have now seen the failure of a key structural support — one upon which nearly every level of our economic structure has come to depend and the failure of which has magnified all the other weaknesses within the structure — the "Big Three" credit rating agencies (CRAs): Moody's, S&P and Fitch.

The failure of the CRAs (and of the ratings they assigned) has exacerbated, even caused, many of the difficulties plaguing our economy today. Moreover, this failure has resulted in a general lack of confidence both in the credibility of the CRAs and in the reliability of the U.S. economy, especially causing foreign investors to shy away from investing in U.S.-based financial products (with the exception, perhaps, of U.S. Treasury bonds).

Unfortunately, the CRA reform measures implemented so far and most of the proposals for additional reform under discussion, though well-intentioned, will not in our view restore investor confidence in the CRAs or revive foreign investment interest in U.S.-based financial products, especially mortgage products; the rating reform measures proposed thus far tackle only issues peripheral to the key problems that caused rating inaccuracies and the widespread dependencies on these ratings.

In order for **economic reform** as a whole to be successful, we must reinforce our financial system against the systemic structural risks created by allowing the structure to be so deeply dependent upon ratings. In addition to this, any remaining ratings dependency will be better served by thorough, meaningful and lasting **rating agency reform**.

Economy-level Rating Agency Reforms

The CRAs continue to be criticized for the quality and reliability of their ratings, particularly those assigned to residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs) supported by RMBS. Separately, the Securities and Exchange Commission (SEC) is increasingly faulted for its oversight of the CRAs. The aim of this section is neither to support nor criticize the performance of the CRAs or of the SEC. The CRAs will again be inaccurate, and the regulatory oversight will again be questioned. The objective of this section is to recognize that future errors will occur and propose reforms that limit the repercussions of forthcoming errors, large or small. *In other words, given the past performance of these institutions and the realization of the challenges they face, we ought to ensure that their future failures do not trigger the catastrophic systemic issues they have in this crisis*.

There are at least two economy-level reform objectives that will substantially limit the likelihood that future ratings failures will trigger catastrophic systemic issues in our economy:

1. decrease the proliferation of ratings across our financial regulatory structure; and
2. decrease the dependence and over-reliance of market participants on ratings accuracy.

Decrease proliferation of ratings across our financial regulatory structure.
Credit ratings have become in many cases *the* integral component of financial risk management, from bank capital reserve requirements to margin requirements at hedge funds and investment suitability criteria at mutual funds.

When an asset is downgraded, therefore, the holder may have to post additional collateral against the asset, mark it down or even sell the asset should it no longer meet the holding requirements in place. Thus, when downgrades occur unexpectedly or on a large scale, there is an associated rush to meet margin requirements — a prominent failing point for leveraged hedge funds — alongside "forced selling" by certain banks and funds that can no longer retain downgraded assets. The forced selling itself acts to bring down the price of the asset, in combination with the tangible risk of further downgrade. Investors can await future forced sales as ideal purchase entry points, and so the forced sale price quickly becomes the market's "fair value." The asset's downward spiral continues as the cost-of-carry typically increases for lower-rated assets as, again, regulatory risk measures and funding costs are directly dictated by credit ratings.[1]

Vicious Circle: De-leveraging in a Stressed Market

Source: UBS Financial Services, Inc.

Thus, to minimize the potency of this "vicious circle" in the future, we need to disentangle ratings from funds' and companies' regulatory restrictions and investment contracts.

Moreover, with financial regulatory ratios so heavily centered on credit ratings, the regulators effectively empowered the rating agencies by delegating this mandatory function — a situation the CRAs were understandably reluctant to diffuse.[2] For example, as recently as June 2009, the Department of the Treasury's Office of Thrift Supervision (OTS) created a table of risk-based capital requirements for banks based solely on credit ratings.

In sum, we cannot continue the current regulatory practice of having capital requirements dictated by ratings, especially if these ratings are purely "opinions" without ramifications for being wrong. These ratings, or "opinions," are too deeply embedded throughout our financial structure. Back in 2007 and early 2008, at the

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[1] This self-perpetuating phenomenon is even more noticeable for financial insurance companies who depend on their own ratings to allow them to insure certain financial securities, such as municipal bonds, often to the required AAA level. Appendix 1 to this piece shows the detrimental effect of a ratings downgrade to a monoline, itself.

[2] An excerpt from PF2 Director Mark Froeba's written testimony before the Senate Banking Committee (available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=89e91cf4-71e2-406d-a416-0e391f4f52b0&Witness_ID=dc8a81f0-6a92-462f-aab4-9beb52a05697) describes the regulatory context in which the rating agencies found themselves:

> "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."

The CRAs' ability to resort to journalistic privileges provided by the First Amendment – and their success in obtaining exemptions from securities law requirements including Section 11 and Regulation FD – is explored by University of San Diego law professor Frank Partnoy in "How and Why Credit Ratings Agencies are Not Like Other Gatekeepers," May 2006. It is also a topic being revisited as U.S. District Judge Shira Scheindlin recently rejected claims made by Moody's and S&P that their opinions be protected by free-speech rights in a particular private-placement case, Abu Dhabi Commercial Bank and King County, Washington v. Morgan Stanley, 08-7508, U.S. District Court, Southern District of New York (Manhattan).

height of the crisis, the possibility of Moody's or S&P downgrading either MBIA or Ambac Assurance hung above us, swaying, like the proverbial sword of Damocles.[3]

As German Chancellor Angela Merkel remarked, "no bank should be allowed to become so big that it can blackmail governments." Nor too should any CRA possess this power: the systemic risks posed are too great.

Decrease dependence and over-reliance of market participants on ratings accuracy.
During the period before the crisis, we also witnessed an increased reliance on ratings accuracy as a substitute (or alternative) for investment managers to performing their own due diligence assessment of an investment's quality, particularly for structured finance securities. A 2008 report[4] by the International Organization of Securities Commissions (IOSCO) observes that:

> "many investors and market participants effectively outsourced their own valuations and risk analyses of RMBSs and RMBS-backed CDOs to the CRAs – a tendency the CRAs, some believe, had little incentive to discourage."

This in turn exaggerated the illiquidity crisis: not only were funds and companies discombobulated by the slew of ratings downgrades and their abilities to meet margin, regulatory capital and investment suitability requirements, but they — particularly the less sophisticated investors — became unsure as to the actual value and expected cash flow of their assets.

Ratings dependency, thus, was a major failure of our regulatory system, not of the rating agencies. To buffer against this risk, adequate measures need to be put in place to ensure sufficient analysis is done by investors both before and after investing in securities, especially complex securities. IOSCO's July 2009 report "Good Practices in Relation to Investment Managers' Due Diligence When Investing in Structured Finance Instruments," written in response to this growing tendency, makes noteworthy inroads in this respect and offers a reasonable starting point.

Rating Agency-level Reforms

Similarly, we propose two key initiatives towards improving the CRAs, themselves. These initiatives are designed towards increasing investor confidence in the quality and reliability of the ratings produced by CRAs and the measurement of each CRA's historical performance:

1. incentivize both the accuracy of ratings and the transparency of the methodology that supports the ratings; and
2. create a mechanism external the the CRAs that monitors their performance.

Incentivize ratings accuracy and improved transparency of methodology.
As it currently stands, CRAs are typically paid monitoring fees on structured finance tranches without regard to whether they actually perform these monitoring services or to the quality of any surveillance performed, if performed at all. In a context where payment is guaranteed whether the job is performed and/or performed well — that is, absent any accountability, legal or otherwise — it is not surprising that standards decline. Despite the importance of ratings accuracy, surveillance errors are already often a daily occurrence at the CRAs, rather than being an anomaly.[6]

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[3] A downgrade from their then-current AAA ratings would have precipitated a major market sell-off, with certain funds and companies being unable to hold assets in their portfolios rated below AAA – the level to which the "monolines" had insured them.
[4] See IOSCO's Final Report: "The Role of Credit Ratings Agencies in Structured Finance Markets," May 2008.
[6] See appendix 2 for support of this argument.

Thus, the first step to CRA-level reform is to incentivize CRAs to be accurate or, to say this another way, to penalize CRA inaccuracy. There are several ways to achieve this objective. Columbia Business School's finance professor Charles Calomiris suggests one example: a six month "sit-out" penalty for any CRA which systematically underestimates risk over a significant period of time.[7] Another possibility is to align carefully the payment for ratings with their accuracy, in such a way that CRAs are paid more for accurate ratings, while having their pay reduced, or cut, for poor performance, much like a hedge fund manager.

While certain measures to combat ratings shopping — and the ratings competitiveness and inaccuracies it brings with it — ought to be implemented on the economy level,[8] other measures pertaining to accuracy can be instituted within the CRAs themselves.

Some market participants seem astonished that their CDO tranches continue to suffer rating downgrades.

One reason for the "surprise," they explain, is that the flaws in the CRAs' analytical models have long been recognized and corrected. Why should there not be a positive upgrade-to-downgrade ratio this year for collateralized loan obligations (CLOs), for example, given the strong rally in both CLO performance (as measured by pricing levels and coverage ratios) and their underlying loans. Why, for example, did Moody's only begin to downgrade Aaa-rated tranches after things started to improve?

This is a good question: why?

In our opinion, there is really only one answer: the models were not the only problem. The rating agencies themselves are where the failures occurred — and they have not yet been reformed. In other words, if we do not solve the problems that jeopardize the quality and integrity of ratings, we cannot reasonably expect the ratings quality to improve. Absent any incentive to be accurate, or any punishment for being inaccurate, you can expect continued inaccuracy as the CRAs battle for market share.

Similarly, unless forced to fix a faulty methodology, an expensive operation, you might see a cheaper, band-aid response from a CRA, hoping that the problem will simply go away or that pressure will desist.

Example

Moody's had always been reluctant to produce mathematical support for its correlation assumptions on the RMBS that supported CDOs and for CDOs within other CDOs. The low correlation assumptions they were able to apply allowed them to arguably reach lower subordination levels on CDOs and, again arguably, to win rating business on this asset class as a result. Despite substantial pressure and scrutiny of these assumptions[9] since they were adopted in 2004/2005, it was only well after the crisis had commenced that Moody's finally surrendered to the necessity of rectifying their input. Moody's decided in mid-2007 to implement a quick-fix, patchwork solution, increasing the correlation assumptions for subprime RMBS and CDO assets by up to three times: to 75% for subprime RMBS and 100% for CDOs in CDOs — assumptions even they would likely argue are unnecessarily punitive. But, in the absence of an accurate, transparent and defendable methodology, this ultra-conservative assumption prevailed (and has continued to prevail, as far as we are aware, to this date).

Do we really want our economic stability to be supported by patchwork methodologies?

[7] See Calomiris, Charles: "Financial Reforms We Can All Agree On," *Wall Street Journal*, April 23, 2009.

[8] Ratings shopping is a function of capital markets, as market participants search for their provider of choice by weighing up a number of criteria, including the quality, reliability, transparency and timeliness of the service, and the cost thereof. As such, the ratings shopping issue can only be combated, if at all, on the economy level.

[9] See for example, Cifuentes, Arturo and Chen, Natasha "The Young and the Restless: Correlation Drama and the Big Three Rating Agencies," Wachovia Securities, Feb. 22, 2005.

***Create mechanism for methodology and quality oversight*.**

The second proposed key CRA-level reform measure is the institution of at least one outside body that supervises the CRAs' methodologies and performance.[10]

As one of our bloggers once commented, the CRAs act as "judge, jury and executioner, and are not required to justify their actions to any regulator or other third party."[11] This observation is appropriate, too, when examining their ability to measure their own performance, *absent any oversight*.

The following example illustrates how the lack of such oversight allows CRAs to manipulate performance data (in the same way that one would expect a public company, absent any auditing requirements, to manipulate its net income).

Example

Suppose that a CRA's historical downgrade rate of AAA assets to below investment grade categories[12] within one year is an observed yardstick for performance. Suppose further that the percentage of, say, single-A assets downgraded to sub-investment-grade levels within a year is a measurement not as heavily scrutinized by those selecting between CRAs.

In reporting on their performance, CRAs have typically used a cohort approach as opposed to analyzing each asset's movement per day for reclassification purposes. Thus, they consider all AAA assets outstanding as of end-of-day December 31 each year, and analyze what percentage of them is downgraded as of December 31 of the following year.

Under this approach, "managing" the timing of downgrades allows for the manipulation of performance data.

Thus, if a company is rated AAA as of December 31, 2007 and a CRA were to determine in December 2008 to downgrade the company to BB, its rating action would affect the CRA's performance insofar as the company is downgraded from AAA to below single-A within one year. To avoid this, the rating agency may determine to downgrade the AAA to single-A in December 2008, thereby recording its rating as a single-A as of 12/31/2008. Then, in 2009, the single-A company could be immediately downgraded to BB. No damage has been done, but the CRA's performance statistics have been artificially enhanced, as the AAA was not downgraded to sub-investment-grade in 2008, and the data point for 2009 shall only show a single A being downgraded to BB.

We need to recognize that rating agencies, much like hedge funds compete on historical performance. With this in mind, an external authority ought to supervise each CRA's approach to analyzing its own performance. The supervision would include the creation of consistencies across the CRAs, such as in their definitions of default for

[10] As an aside, it may be unnecessarily challenging to regulate across different rating measurements; we need to ensure that the ratings used have the same "meaning" across different rating agencies before any effective oversight can occur. Currently, a Moody's rating is an expected loss rating, whereas an S&P rating is a default probability rating – and these have two very different meanings. (Further to this point, though perhaps more subtle, not only do the letter ratings have different meanings, but they are designed off entirely different scales, and so are in no way "piece-wise" comparable.)

Example:

Suppose that Security 1 has the following ratings assigned to it:

- S&P rating (default probability): AA
- Moody's rating (expected loss): Aaa
- Moody's default probability equivalent: A2

Suppose further that the regulatory framework required one to implement the lower of the two CRAs' ratings for regulatory purposes. The implemented rating would be AA, even though if we measured apples to apples, and if we were reserving against "defaults," the ideal rating ought to be A2 from Moody's (or the so-called mapped equivalent of "A" from S&P).

[11] See A Practical Proposal for Rating Agency Reform (http://expectedloss.blogspot.com/2009/08/practical-proposal-for-rating-agency.html).

[12] Investment grade spans AAA to BBB- (S&P) or Aaa to Baa3 (Moody's).

the purposes of the ratings performance. Are federally supported acquisitions (e.g., Bear Stearns) and government takeovers (e.g., American Insurance Group, Fannie Mae, and Freddie Mac) being equally accounted for, either as defaults or not, across all CRAs? Or are some CRAs conveniently excluding these companies from their methodologies of default, so as to gain an advantage when reporting their performance?

Summary

Just as the rating agency “reforms” adopted post Enron did nothing to stave off this financial crisis, so most of the rating agency reforms proposed following the current crisis will fail to prevent future crises.

Investor confidence in ratings must be restored by reforms both inside and outside the ratings agencies. Our financial system as a whole must be reconfigured methodically and systematically to remove ratings and rating agencies from their omnipresent, omnipotent position throughout the system. Rome was neither built in a day nor was it built upon sand. We must rethink our reliance on ratings and avoid overdependence on them. And we need to incentivize the CRAs to be more transparent and accurate.

Secretary of the Treasury, Timothy Geithner, has expressed the Treasury’s goal of raising capital requirements at banks to strengthen the world financial system, with final standards due by the end of 2010. By means of thoughtful, accurate rating agency reform, we can do more than simply increase burdensome capital requirements: we can create meaningful capital requirements.

The ultimate objective of this reform is to encourage financial market transparency and responsibility, from which liquidity will inevitably follow.

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Please contact PF2 Securities Evaluations if you have questions you would like to discuss about this research piece, or about rating agency reform measures in general.

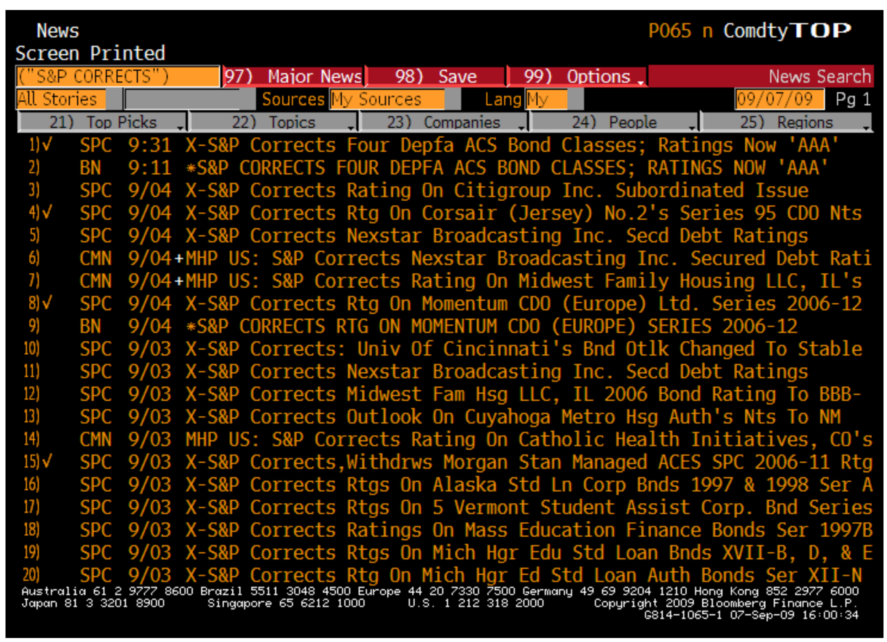
Appendix 1

Financial Guarantors	Moody's Pre-crisis Rating (prior to first downgrade date)	First Downgrade Date	Current Insurance Financial Strength Rating (as of Sept. 7, 2009)
Radian Asset Assurance Inc.	Aa3	6/25/2008	Ba1
MBIA Inc.	Aaa	6/19/2008	Ba3
Ambac Assurance Corporation	Aaa	6/19/2008	Caa2
CIFG Assurance North America, Inc.	Aaa	3/6/2008	Caa2
Financial Guaranty Insurance Company (FGIC)	Aaa	2/14/2008	Caa3 and withdrawn
XL Capital Assurance Inc.*	Aaa	2/7/2008	Ca

* Operating subsidiary of Security Capital Assurance Ltd (SCA), now known as Syncora Guarantee.
Note: Other monolines include ACA; American International Group, Inc. (AIG); Financial Security

Appendix 2

Example:
Right: This screenshot from Bloomberg displays only some of the numerous corrections made by S&P on the days of September 3 and September 4, 2009 (in addition to the two corrections made on September 7, 2009 – Labor Day -- with September 5 and 6 being a weekend). These corrections span various asset classes, including corporate debt, municipal debt, CDOs and other structured finance securities.



The correction of the Citigroup Inc. Subordinated Note (third from the top), for example, reads as follows:

"NEW YORK (Standard & Poor's) Sept. 4, 2009--Standard & Poor's Rating Services said today that it has corrected its rating on Citigroup Inc.'s CHF300 million 2.75% fixed/floating rate callable notes due April 2021 (ISIN Code: CH0024683192) to 'A-'. Due to an administrative error, this issue was inadvertently rated as if it were a senior issue, whereas it is subordinated."

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