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January 3, 2011

European Commission
Financial Services Policy and Financial Markets
DG Internal Market and Services, Unit G3
Markt-consultations@ec.europa.eu

Submitted by electronic mail

Re: Submission in Response to Public Consultation on Credit Rating Agencies

PF2 Securities Evaluations appreciates the opportunity to comment on the European Commission's Public Consultation on Credit Rating Agencies (CRAs).

PF2 is a New York-based consulting company, which was formed in early 2008 as an independent alternative for evaluating and measuring the risks inherent in corporate and trust-preferred collateralized debt obligations (CDOs). Having spent a considerable part of our prior careers working within a CRA, we are acutely aware of the financial market's deep reliance on ratings and the subsequent importance of furthering ratings objectivity, which leads to accuracy.

Among other things our submission seeks:

1. to urge the Commission to focus, in the near term, on improving the integrity of the rating process in the realm of structured finance;
2. to warn the Commission of the potentially unintended consequences of increasing ratings competition;
3. to propose a schedule for the Commission's promotion of investor due diligence; and
4. to share a working example of a measurement tool that enables investors to compare the relative accuracy and stability of ratings provided by different ratings firms.

Please don't hesitate to contact us should you value further communication.

Sincerely,

Guillaume Fillebeen and Gene Phillips
Directors

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Section 1 — Overreliance on External Credit Ratings

Question 4: Structured Finance and CRA Alternatives

PF2's recent submission to the U.S. Securities and Exchange Commission (SEC) details the substantial informational asymmetries that render the structured finance market particularly sensitive to a premature removal of the credit rating agencies.[1]

Proposed CRA alternatives — such as credit default swap (CDS) spreads and bond prices — remain at this juncture inferior substitutes for credit ratings. CDS spreads remain volatile, often unavailable, and otherwise imperfect mirrors of the referenced securities in the illiquid securitization market. As detailed below, PF2 is also keenly aware of the several limitations inherent with the application of third-party provider measurements.

If no superior alternative is found for these illiquid fixed income instruments, we propose the Commission focuses, rather, on improving ratings quality by limiting CRAs' commercial activities and interests that act as distractions and impediments to ratings accuracy.[2]

Using third party evaluation providers as alternatives to credit ratings

Our chief concern in encouraging reliance on third party providers is that few are truly independent or "disinterested" parties. In fact, numerous third-party providers manage or trade assets similar to those they are evaluating, out of separate business divisions. Given the lack of visibility into practices in the structured finance market, we anticipate the conflicts thus created to be more dangerous than the prevailing conflicts in the existing rating agencies' business models.[3]

Next, the regulation of third-party pricing is light if existent, and their pricing methodology opaque. Absent a requirement for price justification or methodological transparency similar to that imposed on CRAs in the Dodd-Frank Act, third-party pricing services will linger in two key areas in which significant improvements have been made to the ratings process.

Last, we are troubled by the possibility, or probability, that the activity of "price shopping" will pose as great a pressure to price inflation as "ratings shopping" poses to the inflation of ratings.[4]

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[1] http://www.sec.gov/comments/df-title-ix/credit-rating-agencies/creditratingagencies-18.pdf

[2] Visit our submission to the SEC for further detail: http://www.sec.gov/comments/df-title-ix/credit-rating-agencies/creditratingagencies-18.pdf

[3] Michael Lewis' *The Big Short* highlights a similar tension faced by leveraged funds whose variation margin was determined by conflicted parties: "Whatever the banks' net position was would determine the mark," [Scion Capital's Michael Burry] said. "I don't think they were looking to the market for their marks. I think they were looking to their needs."

[4] Our experience evaluating TruPS CDOs exposed us to certain market participants' drive to realize the highest prices on their securities, and the consequences thereof — price inflation. Higher values not only directly enhance companies' and funds' performance returns, but in several cases (potentially artificially) improved performance can increase employee compensation packages. Pricing pressure is thus often exerted by market players who tend to benefit from comparatively higher valuations on their securities. (Failure to respond to this pressure serves to jettison a third-party provider's chances of earning or maintaining the valuation business.) See Appendix for examples of contentious evaluations provided.

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Altogether, any risks or conflicts of interest we seek to avoid in considering alternatives to the CRA model become all the more tangible and potent in the third-party pricing alternative.

The role of CRAs in the structured finance market

CRAs provide a valuable public good to the extent their ratings complement credit quality assessments made by investors. Certain CRAs have, through their involvement in the creation of structured finance instruments, achieved an intricate understanding of mechanisms and restrictions that need to be put in place to limit increased adverse selection.[5] A premature removal of CRAs from their role in the structured finance ratings process might therefore precipitate (or ensure) a decline in underwriting quality.

Questions 7 and 8: Investor Due Diligence Practices and Disclosure Requirements

We share the Commission's interest in fostering an investment culture than encourages, or mandates, active investor due diligence. Many investors remain ill-equipped to internally perform a meaningful analysis of their securities' risks, and so cling to the valuable economies of scale provided by the CRAs' risk measurements. We therefore recommend a gradual introduction of investor due-diligence requirements, as set forth below.

Stage 1 (Short Term) — Risk *Measurement*

First, investors ought to gain comfort with the risks associated with their investments and the techniques available for measuring those risks.

Proposed disclosures to be made by financial institutions to their supervisors include:

> *First*: Demonstration of familiarity with the risks associated with each asset class exposure.
> *Second*: To the extent reliant on ratings agencies to measure the severity of risks identified, demonstration of familiarity with (1) the ratings process; and (2) the meanings of ratings provided.
> *Third*: Identification of large risk exposures across financial institution, and aggregation or decomposition of exposures into risk components.

Stage 2 (Medium Term) — Risk *Measurement* and Risk *Management*

Next, investors ought to be tasked with demonstrating that they possess a more meaningful appreciation for the risks inherent across their portfolios, and that they are actively working to disclose and manage those risks.

[5] For example, in rating collateralized loan obligations (CLOs) the CRAs learnt important "lessons" about loan management styles and managers' aggressive interpretation of the terms of the deals' governing documents. These lessons culminated in the implementation of important deal mechanisms that serve the investors, such as the CCC bucket haircut which aims to discourage managers from building "fantasy" par by buying lowly-rated securities. The CRAs, in other words, have warmed to certain tricks of the management trade and have over time instituted structural mechanisms to protect the investors in rated notes.

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Proposed disclosures to be made by financial institutions to their supervisors include:

> *First*: Demonstration of familiarity with the complexity of different assets and asset classes, and the limitations of risk metrics relied upon.
> *Second*: Demonstration of familiarity with alternative risk measurement companies or tools available; deep analysis as to the comparative *quality* and *levels of expertise* among third-party provider options (including CRAs) in each asset class, including the relative volatility or sturdiness of risk measures across varying asset classes and different sectors.
> *Third*: Presentation of formal documentation describing enterprise-level risk-return objectives and detailing all (potentially grandfathered) lending and investment decisions made that fail to meet, or are otherwise inconsistent with said objectives.
> *Fourth*: Demonstration of consolidated risk and concentration exposures resulting from all transactions with a given entity or counterparty or within a given sector, including aggregation of enterprise-wide exposures (including trading books and banking portfolios, as appropriate) and all clientele (e.g., retail and commercial).
> *Fifth*: Demonstration that adequate credit controls have been constructed around the abovementioned measures, risks and exposures.
> *Sixth*: Demonstration that internal policies and procedures are in place to validate the continued suitability of existing investments.

Stage 3 (Long Term) — Active Risk *Management*

Last, investors should be responsible for maintaining up-to-date enterprise-level risk measures — connected to analytical tools — that enable analysis of the effect of proposed trades on the enterprise's overall risk-return objectives.

This objective can be broken down into two broad components:

> *First*: Demonstration of ready internal framework that (1) integrates the various sources of risk across the enterprise and (2) offers a consistent decision support tool that enables senior management to manage its risk and return profile.
> *Second*: Demonstration of analytical sophistication that enables senior management to (1) explain the effect of trades, entered and proposed, on enterprise risk and enterprise value and (2) seek out the trades that best align the existing portfolio with risk-return objectives.

Section 3 — Considerations in Respect of "Enhancing Competition in the Credit Rating Industry"

We urge the Commission to revisit its approach to the relationship between ratings competition and ratings accuracy, for the following reasons.

Increasing Number of Rating Agencies Likely Leads to a Decline in Ratings Accuracy

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There is no evidence to support the theory that increasing competition in the ratings environment will yield more accurate ratings. In fact, substantial testimony and evidence supports the opposite hypothesis — that increased competition leads to a decline in ratings standards.[6] The market has shown that it will hurry towards the rating agency with the weakest standards and the highest ratings. Market participants, too, have shown that they will seek to pressure CRAs into weakening their standards by threatening to otherwise seek a more accommodating provider. Thus, enabling more CRAs simply creates increased opportunity for ratings shopping, and with it a heightened tendency for ratings inflation.

Increasing Number of Rating Agencies Likely Leads to a Decline in Regulatory Supervision and Investor Due Diligence

Moreover, adding ratings agencies reduces the effectiveness, and increases the cost, of regulatory oversight: supervisors struggle to familiarize themselves with the numerous different providers, each of which has its unique ratings scale, approach, model and methodology. Most regulatory bodies have shown themselves ill-equipped to police the small number of recognized CRAs that currently exist, and the hurdle would only be increased if they are to regulate a growing CRA constituency.

The same will likely prove true for investors, for whom it becomes prohibitively expensive to acquire the requisite knowledge to follow each new CRA, and to monitor the not-infrequent changes occurring within each CRA. In our experience, many market participants already seek to simplify their analysis across even the two largest CRAs, inaccurately equating **Baa2** ratings with **BBB** ratings despite their material differences.

Active Oversight with Enforcement Capabilities More Likely to Provide Intended Consequences

Rather than ratings competition resulting in higher quality ratings, we believe that prudent, well-implemented CRA supervision would be more conducive to heightening ratings quality. Ratings reform should first seek to remove all barriers to the independence being brought to the ratings process; next it ought to provide a mechanism for the active monitoring of ratings performance, to ensure high standards are being met and maintained; last it should provide enforcement capabilities, with the ability to ban or suspend a CRA to the extent it fails to maintain the environment, and dedicate the resources necessary to providing objective and accurate credit ratings.

Rather than opening the gates to new CRAs and naively hoping market participants will gravitate towards the most accurate solution — which they will not — we urge the Commission to focus on incentivizing rating agencies to be as objective as possible. As mentioned above, the desired extremes of objectivity, which lead to accuracy, can best be achieved by separating the provision of ratings from the CRAs' other commercial interests.

[6] In their September 2010 draft of "How did increased competition affect credit ratings?" Becker (Harvard Business School) and Milbourn (Washington University in St Louis) explain that within the context of corporate debt ratings, their "interpretation of [their research] findings is **not** that the rating agencies were intentionally deceiving markets, but instead compromised ratings quality at the margin as competition increased." (emphasis added) http://www.hbs.edu/research/pdf/09-051.pdf

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Appendix — Examples of Contentious Evaluations

- Under Fire, NIR Group Switches Valuation Firms (http://www.forbes.com/2009/07/24/nir-group-corey-ribotsky-business-wall-street-nir-group.html)
- Deutsche suspends trader over £30 million 'cover-up' (http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article786001.ece)
- Ex-RBC trader says colleagues mismarked bonds (http://www.reuters.com/article/idUSN2621642220071026?dlbk)
- Pricing Tactics Of Hedge Funds Under Spotlight (http://online.wsj.com/article/SB119188830831852841.html)
- “Large Number” of Banks Mis-Marked Assets, U.K. Regulator Says (http://www.bloomberg.com/apps/news?pid=email_en&refer=&sid=auYi0eJARhsI)
- Financial Services Authority’s “Dear CEO: Valuation and Product Control” Letter (http://www.fsa.gov.uk/pubs/ceo/valuation.pdf)
- The Subprime Cleanup Intensifies: Did UBS Improperly Book Mortgage Prices? Several Probes Expand (http://online.wsj.com/article/SB120191503643937097.html)
- FHLB Executive Who Left Cites Securities Valuations (http://online.wsj.com/article/SB123877496763887003.html)
- Evergreen Pays Over $40 Million to Settle SEC Charges that it Overvalued Mortgage-Backed Investments (http://www.investmentfraudlawyerblog.com/2009/06/evergreen_pays_over_40_million.html
- Legal Woes for Regions Financial (http://online.wsj.com/article/SB10001424052702304846504575177750911356446.html)

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Addendum — Measures of the Comparative Adequacy of Credit Risk Measurements

Measure 1: Predictive Content

- Distance-to-default measures separate the amount of time before default per rating level
- Accuracy ratios enable the user to compare how meaningful different ratings providers' ratings are at determining relative default probabilities

Sample Output: Ratings-Before-Default Report

Rating Before Default Report for [redacted], from 01/01/2008 to 12/31/2009:

Datapoints	1 Day	1 Week	1 Month	3 Months	6 Months	1 Year	2 Years
AAA							6
AA+							2
AA					1	1	17
AA-							10
A+							15
A					2	5	39
A-						1	34
BBB+						1	46
BBB	1	1	2	2	2	8	80
BBB-	1	1	1	1	1	2	39
BB+						2	39
BB					2	15	58
BB-					1	3	10
B+						1	4
B					7	35	14
B-				1	2	3	2
CCC	12	12	12	15	21	75	4
CC	52	52	51	56	107	135	5
C	405	405	405	396	325	184	38
Total	471	471	471	471	471	471	462
Average	CC	CC	CC	CC	CC	CCC	BBB
Median	C	C	C	C	C	CC	BBB
Accuracy Ratio	92.61%	92.61%	92.41%	92.10%	88.61%	77.30%	-1.39%

Measure 2: Ratings Stability (or Volatility) and Portfolio Sensitivity

Seek to answer questions about the relative stability of the measures relied upon, and how it may differ by asset class exposure, CRA, or economic cycle.

<u>Ratings Stability</u>:

- Are higher ratings more stable than lower ratings?
- Are one CRA's ratings more stable than another's?
- How large is the average ratings change?
- Is the security or portfolio more likely to be downgraded or upgraded?
- Are corporate debt ratings more stable than municipal bond ratings?

<u>Portfolio sensitivity</u>:

- How quickly might a portfolio's ratings change during a period of heightened economic stress?
- How frequently does a CRA examine the credit quality of bonds in your portfolio?

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Sample Output: Transition Matrix Report

Transition Matrix for [redacted] ([redacted]), from 01/01/2008 to 12/31/2009, including withdrawn ratings:

%	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	CCC	CC	C	RD/D	WR	Total Percent	Ratings Drift	Up:Down Ratio	Rating Actions	Securities Analyzed
AAA	**48.02**	3.37	19.49	6.39	4.24	3.19	0.96	0.14	1.75	0.05	0.02	0.85	0.01		0.88		3.27	4.78	2.50	0.05	0.01	100.00	3.18	0.00	5,083	9,742
AA+	0.46	**58.32**	2.87	25.69	2.96	0.83	0.18	0.09	0.92	0.28		0.46			0.46	0.09	1.20	1.94	3.05	0.18		100.00	1.92	0.01	451	1,082
AA	0.51	2.78	**54.59**	4.30	12.72	2.53	0.59	0.08	3.79	0.17		1.94		0.34	2.44		2.53	2.86	6.82	1.01		100.00	3.15	0.08	563	1,187
AA-	0.10		1.37	**67.32**	6.75	12.23	2.94	1.17	1.37			1.57	0.39		0.78	0.10	0.88	0.59	1.96	0.49		100.00	1.33	0.05	372	1,022
A+			0.78	6.46	**62.13**	10.96	4.70	1.37	1.66	0.98	0.29	2.54			1.08		1.08	1.66	3.13	1.17		100.00	1.54	0.24	415	1,022
A	1.14	0.13	3.05	0.38	2.66	**47.08**	7.49	2.79	4.70	0.76		4.19	0.38		3.30	0.51	4.06	5.58	8.63	3.17		100.00	3.42	0.16	422	788
A-	1.42			3.31	0.71	4.49	**42.79**	11.11	7.57	1.42	0.24	2.13	0.24	0.24	3.31	1.18	2.60	4.49	6.38	6.38		100.00	2.93	0.21	243	423
BBB+				0.24	1.18	0.94	2.59	**48.11**	14.62	3.30	1.18	2.12	0.47		2.12	0.71	3.54	4.72	7.08	7.08		100.00	2.89	0.11	221	424
BBB					0.16	0.47	0.16	5.53	**33.02**	17.06	3.32	4.11	2.21	0.95	2.53	0.63	3.16	5.85	11.69	9.16		100.00	3.57	0.10	428	633
BBB-				0.37	0.37	0.37			9.70	**42.16**	2.99	5.22	2.24	1.49	1.12	3.73	3.73	4.48	8.96	13.06		100.00	3.12	0.23	159	268
BB+									0.64	7.37	**15.71**	1.60	36.86	0.96	1.28	1.60	1.28	19.23	8.97	4.49		100.00	3.37	0.11	263	312
BB										0.38	0.77	**22.69**	2.31	2.31	4.23	3.08	5.77	6.92	26.15	25.38		100.00	4.87	0.02	202	260
BB-							0.78				6.98	6.20	**24.81**	6.20	21.71	6.20	3.10	4.65	6.98	12.40		100.00	2.08	0.23	97	129
B+												1.19	10.71	**21.43**	11.90	10.71	5.95	5.95	10.71	21.43		100.00	2.44	0.18	66	84
B						0.72							0.72	2.17	**7.25**	7.97	12.32	10.87	33.33	24.64		100.00	3.12	0.04	128	138
B-															2.13	**42.55**	21.28	14.89	14.89	4.26		100.00	1.11	0.04	28	47
CCC						1.28									1.28	3.85	**26.92**	15.38	23.08	28.21		100.00	1.26	0.10	61	78
CC														3.23			9.68	**19.35**	32.26	35.48		100.00	0.81	0.19	25	31
C																			**36.52**	63.48		100.00	0.63	0.00	73	115
RD/D																						0.00	0.00	und.		0

Summary Statistics

- Weighted Average Ratings Drift: 2.89
- Total Upgrades:Downgrades: 4.49%
- Rising Stars: 0.13%
- Fallen Angels: 11.34%
- Total Rating Actions: 9,300
- Total Securities Analyzed: 17,785
- Average Rating Actions: 52.29%
- Securities Not Acted Upon: 47.71%

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Resources

PF2's Credit Rating Agency Research

http://www.pf2se.com/Content.aspx?Type=Research

Relevant Regulatory Submissions

November 12, 2010: *Comments on SEC Initiatives under Dodd-Frank Act Title IX Subtitle C — "Improvements to the Regulation of Credit Rating Agencies"*

August 31, 2010: *Response to FDIC, FRB, OCC, OTS's "Advanced Notice of Proposed Rules (ANPR) on Alternatives to Use of External Credit Ratings"*

Related Credit Rating Postings

RatingsReform: www.ratingsreform.wordpress.com
Expect[ed] Loss: http://expectedloss.blogspot.com/search/label/Rating%20Agency%20Reform