‘Buy-side’ Rating

Bringing Transparency to Fixed Income and Pensions

A Framework Developed

by

M•CAM® Inc

The Addressable Market - Bonds

- Global estimate $89 trillion (PIMCO estimate)
- U.S. market represents about 34%
- U.S. Corporate Debt; Commercial Paper; Foreign Corporate Debt; and, Foreign Commercial Paper accounts for $15-20 trillion

Outstanding Debt (in trillions)	Global Bond Market Segments
$ 8.9	**U.S. Mortgages** Ginnie Mae (GNMA) & Fannie Mae (FNMA) Freddie Mac (FHLMC) MBS & CMOs Commercial & Residential MBS Private-label MBS & CMOs
$ 7.5	**U.S. Corporate Debt** Investment Grade High Yield
$11.6	**U.S. Government-Related** Nominal Treasuries Treasury Inflation-Protected Securities Federal Agencies (ex MBS)
$ 2.9	**U.S. Money Markets** Commercial Paper Bankers Acceptances Large Time Deposits
$ 2.9	**U.S. Municipal** General Obligation Revenue
$ 2.2	**U.S. Asset-Backed** Auto, Credit Card, Home Equity, Manufacturing, Student Loans and Other
$ 53.3	**Foreign** Non-U.S. Developed Emerging Markets - Denominated in U.S. Dollar Emerging Markets - Denominated in Local Currency

SOURCE: PIMCO, SIFMA, Bank for International Settlements | Outstanding debt of the global bond market is shown as of December 31, 2010.

The Addressable Market - Pensions

- **Labor Department estimates assets in pension plans, 401(k)s, IRAs and related accounts at $18 trillion**
- **U.S. accounts for about 60% of global pension market**
- **PBGC insures plans for 44 million people in over 27,500 pension plans**
  - Assets of $78 billion; current obligations of $99 billion
  - Possible future obligations an additional $20 billion
  - 61% exposure in fixed income (rated instruments)
- **Pension exposure derived both from <u>insured exposure</u> and <u>fixed income performance</u> – *data we can include and model for actuarial and rating purposes***

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The Addressable Market – Bank & Insurance Reserve Accounts

- **Determined under Basel II / III**
  - *Require cash, cash equivalents and investment grade rated instruments*
- **Determined under Solvency II**
  - *Require cash, cash equivalents and investment grade rated instruments*
- **Section 939A of Dodd-Frank penalized rating agencies for egregious rating inflations contributing to the financial crisis (P.L. 111-203)**

TOP 1000 AGGREGATES

	2010	2009	Change (previous year)
Tier 1 capital	$5434bn	$4915	10.6% (15.0%)
Total assets	$101,641bn	$95,532bn	6.4% (-0.9%)
Pre-tax profits	$709bn	$401bn	77% (249%)
Profits/Tier 1	13.10%	8.16%	
Return on assets	0.69%	0.42%	

Source: www.thebankerdatabase.com

REGIONS BY TOTAL TIER 1/TOTAL ASSETS/TOTAL PRE-TAX PROFITS 2010

Country	Tier 1 ($bn)	Assets ($bn)	Pre-tax profits ($bn)
US	1034.1	13,144.6	114.4
Eurozone	1297.2	31,847.5	85.5
UK	449.3	9705.4	36.1
China	619.5	10,999.8	149.8
Japan	561.2	11,928.1	43.2
Brazil	116.5	1638.0	35.3

Source: www.thebankerdatabase.com

1975 to Present – declining confidence

- **National Recognized Statistical Rating Organization (NRSRO) authorized by the SEC for bank and broker-dealer capital requirements**
- **Rating Agency Reform Act of 2006 expanding oversight due to considerable methodology and business model compromises**
  - ‘Issuer Pays’ model filled with actual and perceived conflicts
  - Reg FD issues raised
- **Dodd-Frank ‘No Confidence’ in rating agencies**

Policy Imperatives

- **'Issuer Pays' model rife with conflicts including knowledge of pricing, NRSRO market share considerations, etc. in violation of 15 U.S.C. 78o-7(h)(1) § 15E(h)(1)**
  - Recommendation to disqualify any rating if the underlying assets of the product are not disclosed
- **Disclosure of models and assumptions mandatory**
  (and not conformed – according to Dodd-Frank)
- **Asset allocation (statutory and investment charter) requirements for rated products expanding**

New Players

- **Big Three (S&P, Moody's, Fitch) have company – now 10 NRSROs**
  - Kroll Bond Rating; Meredith Whitney Advisory Group; A.M. Best; Dominion Bond Rating Service, Ltd; Japan Credit Rating Agency, Ltd; R&I Inc; Egan-Jones; Morningstar
- **Primary focus on <u>rated product</u>**
- **Opportunity to focus on products and issuers with broader inputs and enhanced, forward informed models**

M•CAM Proposition

- **Use incumbent NRSRO framework/models**
- **Include performance indicators**
  - Proprietary / Sovereign controls of forward cashflows
  - Structural Duration / Velocity of performance confidence
  - FOREX – assets and contract exposure
  - Innovation susceptibility
  - Interest rate sensitivity
  - Counter-party risk (dependencies and interdependencies)
- **Provide <u>time horizon confidence assessment</u> in addition to investment rating**

Conclusion

- Include expanded metrics and performance indicators in risk rating model.
- Align incentives and compensation with performance.
- Compensate agencies based on investment performance at end of the rated investment term, not at rating issuance.