

MEMORANDUM

TO: Public Comment File on Dodd-Frank Implementation
Title IX: Credit Rating Agencies Review and Rulemaking

FROM: Alicia F. Goldin
Office of Commissioner Elisse B. Walter

DATE: November 1, 2010

On October 14, 2010, Commissioner Elisse B. Walter and Alicia F. Goldin, Counsel to the Commissioner, met with the following individuals:

Mahesh K. Kotecha, CFA – President, Structured Credit International Corp
Roy P. Weinberger – Credit Research, Advisory, Consulting
Michael D. DiGiacomo – Vice President, Finance and Administration, the Levin
Institute

The discussion included, among other things, the participants' views regarding credit rating agencies. The participants provided the attached presentation at the meeting, and subsequently submitted a revised version of the presentation, also attached.

**PRESENTATION TO SEC
COMMISSONER ELISSE WALTER ON
RATING AGENCY COMPENSATION
MODEL**

MAHESH KOTECHA, ROY WEINBERGER, MICHAEL DIGIACOMO

**October 14, 2010
Washington. DC**



*SEC Mandated Under Dodd-Frank
To Study Rating Agency Compensation
Models*

Under Section to 439F(b) of Dodd-Frank, SEC to Assess by mid-2012 Rating Agency Compensation Models



1. The credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models
2. The feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns nationally recognized statistical rating organizations to determine the credit ratings of structured finance products, including:
 - an assessment of potential mechanisms for determining fees for the nationally recognized statistical rating organizations
 - appropriate methods for paying fees to the nationally recognized statistical rating organizations
 - the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government; and
 - any constitutional or other issues concerning the establishment of such a system
3. the range of metrics that could be used to determine the accuracy of credit ratings; and
4. alternative means for compensating nationally recognized statistical rating organizations that would create incentives for accurate credit ratings

- *Journal of Structured Finance*, Winter 2010: “The Future of Structured Finance Ratings After the Financial Crisis”, by Mahesh Kotecha, Sharon Ryan and Roy Weinberger
 - Based on market soundings
- SCIC is knowledgeable on structured finance markets
 - SCIC team members have been involved in structured finance from its very beginnings
 - SCIC could help SEC in its study of rating agency compensation models

*SEC Rule 17g-5(a)(3) is a Mixed Blessing
and Does Not Address Conflicts of Interest*

SEC Rule 17g-5(a)(3): A Step in the Right Direction?



- Rule 17g-5(a)(3) is designed to improve the quality of credit ratings through increased competition by making it possible for NRSROs not hired by the issuer or arranger to rate structured finance products on an unsolicited basis
- The Rule requires disclosure of all material information, including non-public information provided to the hired NRSRO, to all other NRSROs qualified to rate the particular type of structured product so the latter can at their option provide unsolicited ratings for a transaction even when not mandated to do so for a fee
 - The Rule obliges an arranger to set up a website to provide the information to NRSROs not retained by the arranger qualified to rate their transactions without request and for no fee.
- But there is confusion regarding implementation of the Rule
 - On information that should be released to the non-hired NRSROs
 - On the use of unsolicited ratings in capital requirements for banks
- Seems out of step with concept that investors should do their own homework and not rely so much on the rating agencies

Importantly, Rule 17g-5(a)(3) Does Not Address Conflicts



- The Rule tips the scales in favor of “investor pay” model whose subscribers gain privileged access relative to other investors
 - Investor pay” NRSROs can use the information to assign unsolicited ratings of structured products and sell them privately only to their subscribers
- The rules on information to be disclosed from (for example) face to face discussions or telephone calls between the hired NRSRO and the issuer to other NRSROs are unclear
 - Some critical information will inevitably be missed
 - Does the rule contemplate recording every meeting and conversation?
- The Big Three “issuer pay” agencies (S&P, Moody’s and Fitch) must weigh the cost of incurring issuer’s wrath if they were to give low unsolicited ratings as doing so would cannibalize potential future fee paying business from the issuer
 - Indeed, in April 2010 Redwood Trust RMBS issue carried a Moody’s triple-A: S&P issued an “unsolicited commentary” (not a “rating”) declaring that in its view some tranches would not have warranted a triple-A had they rated it
- Smaller and/or less established rating agencies will issue unpaid ratings only if they see a realistic opportunity for future fee paying business
 - To attract issuer interest they may be incented to provide more lenient ratings

Issuer Pay Model is Flawed

Birth of the “Issuer Pay” Model



- The debt rating business as we know it today dates from 1969, when a rating cut by Standard & Poor's was widely credited for precipitating the bankruptcy of the Penn Central Railroad Corporation
- The footprint of ratings grew in the capital markets and this jump in demand for ratings allowed Standard & Poor's and its competitors to begin charging debt issuers for ratings during the 1970s.
- The justification was that increasing demands on the agencies required much higher staff and compensation levels than could be afforded through sale of publication subscriptions alone. Income from rating fees quickly eclipsed amounts previously earned from subscriptions.
- A great benefit of the “issuer pay” model is that agencies with this business model typically distribute all their ratings
 - But rating analyses are available only to paying subscribers

“Issuer Pay” Model Conflicts Are Intractable



- Regulatory authorities throughout the world would appear to have blessed the issuer pay model, notwithstanding wide recognition that there are embedded and intractable conflicts of interest
- Rating agencies have long argued that any professional services firm faces conflicts of interest and that the rating agencies have in place policies and processes that effectively manage such conflicts.
- However, the poor performance of ratings on both structured and non-structured products have seriously undermined rating agency assertions that conflicts of interest have been effectively managed.
- *Conflicts must be removed from the rating agency compensation models if confidence in rating agencies is to be restored*

What about the Investor Pay Model ?

Is “Investor Pay” Model the Answer?



- A small number of entrepreneurial, US-based firms have within the past 15 years developed a sufficient following among institutional investors to be financially viable with an “investor pay” model
 - This includes three NRSROs: Egan-Jones, LACE Financial, and Real Point LLC (which however uses the “issuer pay” model for new issue ratings)
- *Benefits of the investor pay model*
 - As these companies derive income mainly from subscriptions, they do not have the same conflicts of interest as “issuer pay” firms.
 - Also, as long as their subscriber base is sufficiently diverse, it is unlikely that one or a small number of subscribers could unduly influence their opinions.
- *Shortfalls of the investor pay model*
 - Limited coverage – especially for structured finance, project finance, international and US municipal markets partly because they can only rate an issuer or an issue when publicly available information is adequate
 - Limited ratings disclosure because a value addition for investors is that neither the ratings nor the analyses are generally available to non-subscribers
 - Risk of undue subscriber influence if the agency's customer base is not adequately diversified

*We Think There Is A Better Solution – Both
Investors And Issuers Should Pay For
Ratings*

A New Compensation and Assignment Model



- The new model would lead over time to better ratings which are more accurate in predicting default rates and expected losses through different phases of the business cycle and more timely in terms of rating changes
 - The new model could be rolled out in stages beginning with structured finance markets and extended in time to all ratings.
- Payment for ratings should come from a fee levied on new issues and secondary market trades
- The fee levels would be determined and reset periodically based on a review of the historic and projected volumes of primary market issuance and of secondary market trading so as to equal or exceed the current level of rating agency revenues from ratings
 - The fees would be negotiated by the Fund with the NRSROs on the basis of a ROE target for the NRSROs in a manner not unlike regulated utilities
- For an initial period of , for example five years, if possible two and perhaps more rating agencies qualified to rate such structured issues would be assigned on a rotating basis per a queuing system
 - Over time, the rotating system of rating assignments to be replaced by assignments based on ratings accuracy, which would be reviewed periodically (say 5 years)⁴

The US Ratings Fund

- Fees collected to be deposited in a dedicated Ratings Fund
 - The US Ratings Fund would be modeled after the Municipal Securities Rulemaking Board (MSRB) which was established by an Act of Congress in 1975
 - Like the MSRB, the Fund would likely be established pursuant to an Act of Congress
- The Ratings Fund would pay for ratings of publicly issued securities and others such as those under Rule 144(a)
 - Both term debt and commercial paper would be included
- Governance of the US Rating Fund
 - The Fund should be overseen by a Board of Directors made up of representatives of issuers, investors, intermediaries, NRSROs and independent directors
- The Fund system could expand globally by allowing new jurisdictions to either join or clone the US system

Comparing the Three Rating Agency Business Models

The Three Compensation Models Compared



Attribute V	Investor Pay	Issuer Pay	Pay from Deal Proceeds
Fee paid by =>	Investors	Issuers *	Both issuers and investors
Conflict of Interest	Investors would like ratings as low as possible to increase return	Issuers would like ratings as high as possible to reduce funding costs	Neutral as both investor and issuers pay for ratings
Disclosure of ratings and rationales without paying subscription fee	Disclosure limited to criteria as the paying investors want ratings to be provided only to them	Ratings and criteria disclosed to all; full rating reports, industry and other research only available to fee paying subscribers	Ratings, rationales and criteria would be disclosed for free
Ratings Shopping	Not a concern under this model	Great scope for rating shopping as issuers want to reduce costs of financing by getting as high a rating as possible	Initially, (two or three) agencies would be assigned to rate each issue on a rotating basis if each agency is (i) recognized by the regulator and (ii) qualified to offer ratings for the specific type of issue. Later, assignments would be made subject to accuracy of the agency's ratings
Regulatory issues	Generally not used by regulators	Have been used widely to determine permissible investments and adequacy of capital but their use is likely to decline	Given the lack of conflict, their use likely would and probably should be fostered by regulators.

* Includes investment bankers in the context of arbitrage vehicles

Next Steps ?

We Would Like to Work with the SEC



- Our proposal addresses issues to be studied by the SEC under Dodd-Frank
- The goal is to develop a US solution first and then to work with regulators and market participants world-wide to develop a consensus
 - We have sought and obtained inputs from US and London-based stakeholders
 - Feedback has been positive and we believe building consensus is possible
- We welcome SEC's views



October 14, 2010
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**PRESENTATION
TO SEC COMMISSONER ELISSE WALTER ON RATING
AGENCY COMPENSATION MODEL**

BY MAHESH KOTECHA, ROY WEINBERGER, MICHAEL DIGIACOMO

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SCIC Experience



- SCIC team members have been involved in ratings from its early days
- SCIC is knowledgeable on structured finance markets
- SCIC team members have been involved in structured finance and their ratings from their very beginnings
- SCIC believes that reform of rating agency compensation models is critical to restoring confidence in rating agencies

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Next Steps ?

SCIC is Prepared to Assist SEC



- Our proposal addresses issues to be studied by the SEC under Dodd-Frank
- The goal is to develop a US solution first and then to work with regulators and market participants world-wide to develop a consensus
 - We have sought and obtained inputs from US and London-based stakeholders
 - Feedback has been positive and we believe building consensus is possible
- SCIC welcomes SEC's and others' views