Asset Backed Consulting

United States Securities and Exchange Commission

CREDIT RATING AGENCIES
OVERSIGHT ROUNDTABLE

White Paper

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I. Introduction

Did the Credit Rating Agencies (CRAs) cause the current unprecedented financial crisis? Such a conclusion would be overly simplistic. There is plenty of legitimate blame to go around. Condemnation of the CRAs has included categorical indictments of the “investor pay” ratings system, shoddy analysis, overly optimistic model assumptions and even the very value of credit ratings. More focused criticism has targeted the failure of the CRAs to identify the magnitude of the subprime mortgage-fueled residential real estate bubble but has refrained from categorically attacking the CRA system itself. Virtually all critics agree, however, that the precipitous ratings downgrades of subprime and many prime residential mortgage backed securities, their associated CDOs and the financial institutions and funds that held them catalyzed a vicious cycle of asset pricing dislocations and capital shortfalls. The collapse of confidence in CRA ratings was, therefore, central to last fall’s near systemic capital markets breakdown and continues to seriously hamper its recovery.

Underlying these criticisms is the overarching systemic risk posed by the excessive weight assigned by investors and regulators to rating agency opinions. Stable markets depend upon a diversity of behavior among investors. Yet entire categories of investors and classes of financial products rely mostly on the opinions of a narrow CRA oligopoly. No matter how tightly regulated or how conscientiously CRAs perform their function, credit ratings are opinions, produced by fallible analysts and rating committees, with decisions based on generic methodologies, imprecise models and imperfect economic assumptions. Additionally, short-term profit motives and the ensuing pressure to meet revenue targets can too easily tempt CRA department managers to blur the fine line between rational and rationalized analysis – especially in a high volume, rapid turnaround-driven and increasingly complex securitization market. Combined with regulatory-driven issuer and investor market demand for higher ratings, these factors have led to business decisions compromising both accuracy and credibility.
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In our view, market reforms and regulatory actions should address the need to strengthen the quality of credit ratings. Against this background, Asset Backed Consulting examines key concerns with the CRA system and makes recommendations for reform.

II. Key Issues

Asset Backed Consulting has considered certain key issues that require attention. These include:

- The effective abdication of both investor accountability and regulatory oversight for credit risk in favor of a CRA-driven risk management process.
- The compromising of CRA analytical discipline for the sake of commercial expediency and its associated adoption of market share-driven criteria and assumptions.
- The presumption that the investor-pay fee model resolves the conflict of interest of the issuer-pay fee model.
- Practicality of analyzing and monitoring highly complex transactions.
- Rating stability and transparency of rating process.
- The merits and dilemmas of increased competition.
- Nominal code of conducts versus substantive analytical performance quality controls.

III. Recommendations

Regulatory reforms are problematic endeavors necessitating the reconciliation of “perfect world” principals to the practical requirements of the “real world.” This dilemma, along with the need to reconcile the financial and operational constraints of a multiplicity of interested essential parties, usually precludes radical reforms eliminating all potential conflicts and systemic weaknesses. Asset Backed Consulting believes that the most practical approach should involve a reinforcement of conduct supervision and increased accountability and performance-driven models supported by a broader and more
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independent set of analytical checks and balances. In this spirit, Asset Backed Consulting therefore recommends the following:

A. NRSRO Oversight Committee

An NRSRO Oversight Committee should be established to review the standards and procedures followed by the CRAs in the conduct of their business. Failure to pass any component of the examination could result in the suspension of the CRA's NRSRO status or some form of probation depending upon the nature and gravity of the deficiencies in question. A probation would include the provision for a reasonably timed cure period as well as a statement from the regulatory authority regarding the nature and scope of the deficiency and its possible effects on the accuracy and objectivity of ratings.

CRA informational requirements should include:

- The publication of an annual (and quarterly during periods of instability and rapid downgrades) comprehensive CRA status report, the contents of which would include:
  - On-going “apples to apples” rating transition studies across all of the NRSRO rating scales including breakdowns by:
    - geographic region;
    - asset type/industry sector; and
    - vintage years
  The ratings universe should include:
  - all ratings assigned by each CRA (e.g., public ratings, private ratings and credit estimates); and a
  - transaction/issuer coverage ratio per credit analyst;
- Minimal 30-day comment periods for new and modified ratings methodologies prior to publication.
- Minimum education and analytic experience requirement for each credit analyst and analytic manager;
- Mandatory CRA attendance to periodic public CRA round table discussions covering all rated sectors focusing on rating performance and criteria updates;
- Assessment of staff levels and expertise in each sector and annual certification of meeting that minimum requirement.

B. CRA Analyst Certifications

Asset Backed Consulting recommends the development and implementation CRA analyst certifications. Such a system would require all CRA analysts to be registered with a central regulatory authority and
could include a form of licensing requirement with initial testing focusing on ethics and regulation (e.g., a CRA version of the North American Securities Administrators Association's Series 63 Uniform Securities Agent State Law Examination) and periodic continuing education. Educational, analytical training and experience requirements, however, would fall under the SEC’s overall CRA review process.

C. NRSRO Financial Condition Transparency

The ability of a CRA to execute its professional obligations is dependent upon its financial resources. CRAs should, therefore, be required to demonstrate that they have the financial ability to perform all of their required analytical and operational functions on an “on-going basis.” The release of financial statements, audited by major accounting firms, should be required of all NRSRO regardless of their ownership structure.

D. Centralized NRSRO Profile Open Access

In the interest of transparency and accessibility for ratings end-users, the creation and on-going administration of an on-line centralized library for all CRA methodologies, rating transitions studies, financial disclosures, staff levels and SEC audit results should be considered. The site should be organized so as to allow for the easy comparison of research, resources and regulatory assessments by asset class or obligor type as well as for the CRA as a whole. Such a system should only have a minimal impact on the CRAs’ prerogative to generate its traditional subscription revenue, however.

E. Non-NRSRO CRAs

While NRSROs should be the primary focus of the above outlined on-going review process, the methodologies and track records of non-NRSRO CRAs should also be considered for comparative purposes. The “national recognition” of an “established” CRA is not a guarantee of ratings quality. Conversely, a new and smaller CRA staffed by highly experienced analysts with solid track records could easily contribute value-added ratings opinions to the benefit of the markets as a whole.
IV. Conclusion

The implosion of CRA credibility has precipitated criticism and reform proposals from numerous financial industry and public sources. While Asset Backed Consulting believes there is merit to many of these suggestions and supports their incorporation into the ongoing process of CRA regulatory reform as well as prudent business practices, we believe that the primary weakness of the current risk assessment system remains the over reliance of regulatory bodies and investors on CRA ratings for the credit risk assessment function. Clearly, an enhanced and more diverse system of analytical checks and balances could play an important role in providing for greater clarity and stability. While some have called for the complete abolition of CRA-driven risk-based capital (RBC), Asset Backed Consulting believes such an approach would deprive both regulators and investors of an imperfect but still crucial analytical resource. Very few, if any, government institutions or institutional investors can afford to replicate the combined analytical resources of the main CRAs. While often criticized as an anti-competitive barrier to entry, most would also agree that the markets would be worse off without access to the critical mass of their expertise and institutional memory. The solution, therefore, lies in establishing a system that will promote greater ratings stability and transparency for each sector and asset type. For those institutions lacking the resources to review CRA ratings independently, multi-user independent consultants with proven expertise could provide analytically credible, objective and economically efficient support.