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CAPITAL PARTNERS

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The Ratings-Reliance Solution

Keep what has worked and change what has not

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The Dodd-Frank mandate requiring Federal agencies to review and remove regulatory references requiring the use of ratings provided by Nationally Recognized Statistical Rating Organizations (NRSROs) is intended to reduce over-reliance on ratings and place more impetus on regulatory agencies and individual investors to develop their own risk framework and conduct their own credit analysis on securities.

Explicitly, Dodd-Frank requires regulatory agencies to make fundamental changes to language in existing regulation that utilizes rating methods to assess a security's credit quality and assign capital charges in the examination of financial institutions.

Clearly there have been deficiencies in a system that places too great of an emphasis on NRSRO ratings; however, eradicating ratings from the regulatory landscape does not in and of itself solve the underlying issue of systemic risk that Dodd-Frank is intended to address. In fact, many market participants have expressed a concern that it may ultimately be counter-productive to policy-makers' larger goal of a more stable, transparent, and better functioning financial system due to the potential unknown and unintended consequences of "starting from scratch."

A more effective and less disruptive approach that fulfills policy-makers' underlying objective is to examine the current regulatory application of ratings, in order to preserve what has been successful and reform what has been unsuccessful.

Preserve what has been successful

The regulatory use of NRSRO ratings for evaluating the risk of "single-obligor" securities has been largely and historically successful and should remain intact. It is the "multi-obligor" securities or structured products where the traditional rating methodology failed the system.

For securities guaranteed by a single obligor, such as Sovereign, Government Agency (including Agency MBS), Municipal, and Corporate debentures, ratings have been effectively used by market participants and regulators as tools for assessing asset quality and assigning capital charges.

Ratings reflect default risk

According to rating agencies such as Standard & Poor's (S&P) and Fitch Ratings (Fitch), a credit rating is, by definition, an assessment of default risk, or in layman's terms, the likelihood that a security will not be paid back in full. Rating agencies conduct "traditional credit analysis" for securities guaranteed by a single obligor, assessing the financial strength of the obligor via financial ratios/metrics, and thereby determining the ability of the issuer to repay the obligation in full.

The use of ratings in this traditional application has provided market participants and supervisory personnel with a standardized and well-understood methodology for assessing credit risk. From a regulatory perspective, the rating agencies' use of a single-letter rating scale (e.g. AAA, AA, A, BBB, BB, B, CCC, CC, C) to assess the credit risk of a single-obligor security has been sufficient through the past century of recessions, booms and busts, and the current credit crisis.

In early August of 2010, former Comptroller of the Currency John Dugan said it best when he commented about ratings that the Dodd Frank Act was "well intentioned…[but] I do worry there is a little bit of throwing the baby out with the bath water...[There are] credit ratings for several issuers that have worked well over the years and have been particularly useful for smaller institutions to rely on, and they have done so in a quite safe and sound way" (*American Banker,* 11 Aug. 2010).

The removal of ratings as a tool for supervisory personnel to assess credit-worthiness in this application appears to be counterproductive to the primary objectives of Dodd-Frank.

Reform where ratings have been insufficient for assessing credit risk

By definition, the single-letter rating scale applied to senior class multi-obligor securities is insufficient for credit stressed environments and requires reform.

Consistent with single-obligor securities, a rating on a security backed by multi-obligors (e.g. asset-backed securities, including private-label mortgages) is also an assessment of default risk. *However, in contrast to a single-obligor security, a default on a senior class multi-obligor security is by nature a materially different and usually less severe economic event.*

Multi-obligor ratings are to the "first dollar of loss"

Typically, this type of security is backed by thousands of individual loans and only defaults when a portion of underlying borrowers default. For illustration purposes, assume a senior class multi-obligor security is created that will pay its obligation in full as long as fewer than 500 borrowers individually default out of a total of 5,000. However, if the 500th obligor defaults, it triggers the entire security, by definition, to default; consequently, the security only pays back 99.99% of the contractual cash flows. Technically, on a $100MM bond, the instance of a $1.00 loss (one dollar, not one dollar per thousand) means the bond has defaulted. *Since ratings are, by definition, assessments of default event risk, ratings on multi-obligor securities are commonly said to be rated to the "first dollar of loss" event*. ***The letter rating is silent on the magnitude of loss an investor may experience.***

In contrast to "traditional credit analysis" techniques utilized for single-obligor securities, the rating agencies' method for assessing the default risk of multi-obligor securities is primarily a statistical stress modeling exercise to determine the likelihood that enough individual loans will default to cause $1.00 of loss to a security—regardless of whether that security has $1MM or $1B in obligations to fulfill.

To reflect the risk of a $1.00 loss on multi-obligor securities, rating agencies employ the same single-letter ratings scale as they do when evaluating the default risk of a single obligor. A multi-obligor security's AAA-rating can be translated to mean the rating agency believes there is a very large cushion between the number of obligors currently expected to default (e.g. 100 out of 5,000) relative to the number of obligors that would have to default to cause a security to incur a $1.00 loss (e.g. 500 out of 5000). Relative to the AAA-rating, a BBB-rating means there is less cushion between obligors expected to default and the number required for the security to default (e.g. 250 expected, 500 required for default). The B-rating roughly translates to mean there is no cushion (500 expected, 500 required). The CCC-rating means the security is expected to default in the future (>500 expected, 500 required).

The single-letter rating provides a limited and, at times, overly simplistic view of credit risk

The use of the single-letter rating scale to assess default risk on a multi-obligor security means, by definition, a letter rating cannot provide the investor or supervisory personnel with certain pieces of critical information in assessing the riskiness of a security: the quantity of obligors with a very high likelihood that are expected to make good on the obligation, and therefore the portion of contractual cash flows (e.g. 80, 85, 90, 95%) an investor can expect to receive with a very high degree of likelihood. In this sense, the usefulness of a rating is limited and suffers from the classic problem of information loss—using a single-letter-based measurement or summary statistic to characterize the credit-worthiness of thousands of obligors.

Prior to the credit crisis, for senior class multi-obligor securities such as private label mortgage-backed securities, the limitation of ratings that only reflected default risk had not been problematic. Historically, senior class AAA-rated multi-obligor securities performed within a reasonable expected range of performance and extreme levels of downgrades (e.g. BB, B, CCC, CC) were a rare occurrence. The use of the same letter-based ratings for evaluating single-obligor and multi-obligor securities was sufficient for the regulatory purposes of assessing asset quality and assigning capital charges.

However, the housing crisis exposed the weakness of a single-letter rating scale to assess the credit risk of senior class multi-obligor securities. As homeowners defaulted beyond rating agencies' expectations (this itself is a separate issue for Dodd-Frank, along with conflict of interest issues), massive downgrades on senior class multi-obligor securities ensued. Hundreds of billions of formerly AAA-rated securities now faced the prospect of extreme downgrades to levels never experienced—BB, B, CCC, etc. The single-letter rating scale equates the risk of these downgraded multi-obligor securities with that of a single-obligor security. While they may share the same rating and probability of default, a CCC-rated single-obligor corporate bond is a dramatically different *economic* risk than a CCC-rated multi-obligor security. On a $100MM multi-obligor security, this could be losing $1.00, while on a corporate single-obligor security, this could be losing $90MM (think Lehman Brothers and 10% recovery rates).

The use of a single-letter rating scale in stressed environment leads to overly harsh cliff-like events

Essentially, AAA-rated, senior class multi-obligor securities experienced a ratings "cliff event," with the same statutory and regulatory implications of BB, B, or CCC-rated single-obligor securities that could face heavy losses such as corporate bonds. The single-letter rating scale is an "all or none" credit risk assessment—the result is that either all of the asset is deemed "toxic" or none of the asset is deemed "toxic."

For investors who purchased multi-obligor securities at discounts such as 60, 70, or 80 cents on the dollar (prior to deep downgrades), the use of single-letter ratings grossly misrepresents the credit risk, even from a directional perspective. For instance, in the case of Investor A, who owns a security at 70 cents on the dollar, and Investor B, who owns the same security at 100 cents on the dollar, the single-letter rating is not reflective of the risk of Investor A. In fact, the security could be expected to pay back 90 cents on the dollar (meaning the associated rating would be CCC or less) and Investor A would be made more than whole on their investment. Is paying 70 cents on the dollar and receiving 90 cents considered a bad investment (with the associated regulatory penalties)? In a single-letter rating system, yes.

The "cliff event" also manifests itself in another fashion. Since the large majority of investors in AAA-rated senior class multi-obligor securities are, by definition, conservative or regulated entities, wholesale downgrades in the PLMBS sector slap a "toxic" and impermissible investment label on these securities, eliminating the natural buyer base of these securities at any price, thereby depressing market valuations. For example, due to punitive rating implications, a security that was BB-rated and expected to return 100 cents on the dollar, would no longer be purchased by the natural buyer base, even at 50 cents on the dollar. If the issue were contained to a few "toxic" BB-rated securities, the impact would be minimal; however, when hundreds of billions of dollars of securities face this prospect, the resulting implications have huge ramifications on mark-to-market valuations and considerable impairment charges.

The following reforms to the single-letter ratings scale need to be made:

- Rating agencies need to create two supplemental, numerically-based ratings, the "AAA recovery rating" and the "BBB recovery rating," in conjunction with any necessary supervision by the SEC, the NRSROs' regulatory authority.

- In the event of a rating's downgrade for any originally AAA-rated senior class multi-obligor security, these supplemental numerically-based ratings will be released by the rating agencies, providing market participants, supervisory personnel, and accounting professionals with more transparency as to the recovery prospects of the security at a AAA and BBB-level of likelihood.

  For example:

  Original rating: "AAA"

  Current, downgraded rating: "B"

  AAA Recovery Rating: 90
  "90% recovery is expected with a AAA-level of likelihood"

  BBB Recovery Rating: 97
  "97% recovery is expected with a BBB-level of likelihood"

- The numeric "recovery rating" will be elevated to the equivalent regulatory status as traditional single-letter ratings and will be recognized and utilized by supervisory personnel as the means to assess asset quality and assign capital charges in the instance of a downgrade on any originally AAA-rated senior class multi-obligor security.

In 2009, the National Association of Insurance Commissioners (NAIC), recognizing the deficiency in the letter grade system, successfully took a similar course of action for evaluating the risk of investment portfolios. The NAIC voted to ignore the letter ratings for regulatory purposes and independently evaluate all MBS held in its members' portfolios, with the focus on assessing a security's recovery prospects.

Rating agencies currently conduct recovery analysis as part of the ratings process for multi-obligor securities but do not officially disclose the results. This analysis can be made available to investors, but from a legal perspective, it is only considered a "credit opinion" and does not carry the weight of a "credit rating." The disclosure of a security's recovery prospects via officially sanctioned recovery ratings would serve to increase the transparency around ratings, eliminate the unintended consequences of the ratings "cliff event," and result in a more effective use of ratings by investors, accountants, and supervisory personnel.

About The Performance Trust Companies

The Performance Trust Companies are an SEC-registered investment advisor and FINRA regulated broker/dealer, with proprietary investment methodologies and products designed to accomplish investment objectives. Based in Chicago, Performance Trust focuses on educating fixed income investment professionals and assisting client institutions to invest through total return. For more information, go to www.performancetrust.com.

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