PF2 SECURITIES EVALUATIONS, INC.

Opening Wall Street's Black Box

Pathways to Improved Financial Transparency

Americans for Financial Reform | Georgetown University Law Center

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The opinions provided within are my own.

By the end of today's presentation, I hope they will also be your opinions.

High-Level Concept

There are many risks inherent in a structured finance investment.

Some relate to ever-changing market conditions

Some are idiosyncratic

Some are known

Some are unknown

Some should have been known

And some are masked

Can we control some? (or limit them)

High-Level Concept (cont'd)

Market participants advocating for transparency often feel that that the complexity of ABS obscures the transfer of risk(s) – and can trick investors, regulators and (possibly) rating agencies into thinking the ABS structures are safer than they are.

Two high-level items I will address today:

- if buyers will buy anything (no questions asked, high demand scenario), sellers might just sell them *anything*
- if rating agencies have no incentive to turn away business, they might just rate anything and everything at the rating necessary to keep or win business

We'll come back to these in a moment…

Corporate v Structured Finance

Factor	Corporate	Structured
Parties Involved	Company	Many parties need to perform: counterparties (swap/hedge); servicers and trustees
Performance of Product	Management usually active	Many deals are actively managed; but static deals cannot "self-correct" based on rating agency guidance, reviews, or downgrades
Who Gets the Deal Rated	Company-by-company	Usually a sophisticated arranging bank (which often interacts heavily with rating agencies in constructing deal)
Clientele	Company	Arranging banks are (often persuasive) influential, repeat customers, and often large shareholders
Market Position	S&P/Moody's duopoly with ratings required from both	Several new entrants with equal legitimacy and competition for business

Corporate v Structured Finance

Factor	Corporate	Structured
Business Model	Once a company is rated – high reputation / financial costs to drop rating	Transaction based business – little or no cost to drop agency on the next deal
Customization Potential	Low customization potential due to ongoing business constraints	High customization potential as the "business" is created to be sold/rated
Data/Product History	Long history of products and analysis	Short history of product and analysis
Outside Expertise (Potential for Feedback Loop)	Extensive experience with corporate analysis; both fundamental and quantitative allows for outside monitoring	Little expertise outside of those in "the business" and with like incentives to monitor the adequacy of analysis
Ratings Process	"What is your rating?"	"We believe that according to your methodology the rating should be XXX - do you agree to rate it as such?"

Investor *Responsibilities*

If buyers will buy anything (no questions asked, high demand scenario), sellers might just sell them *anything*…

Investors can be encouraged to question everything and to understand the dynamics and conflicts

- Who is ensuring that all calculations and transaction are entered into fairly and in my best interests? Does this party have an incentive to act at all – and to act in my best interests?
  - If not, are we getting paid for *that* risk?

- Who bought that loan on behalf of the trust?
- Why did the seller sell that loan?
- Why did the buyer put it in our vehicle vs. another or vs. his own portfolio?
- How do we know the price was right on the purchase (was this an arm's length transaction)?
- Who accepts the warehouse risk?

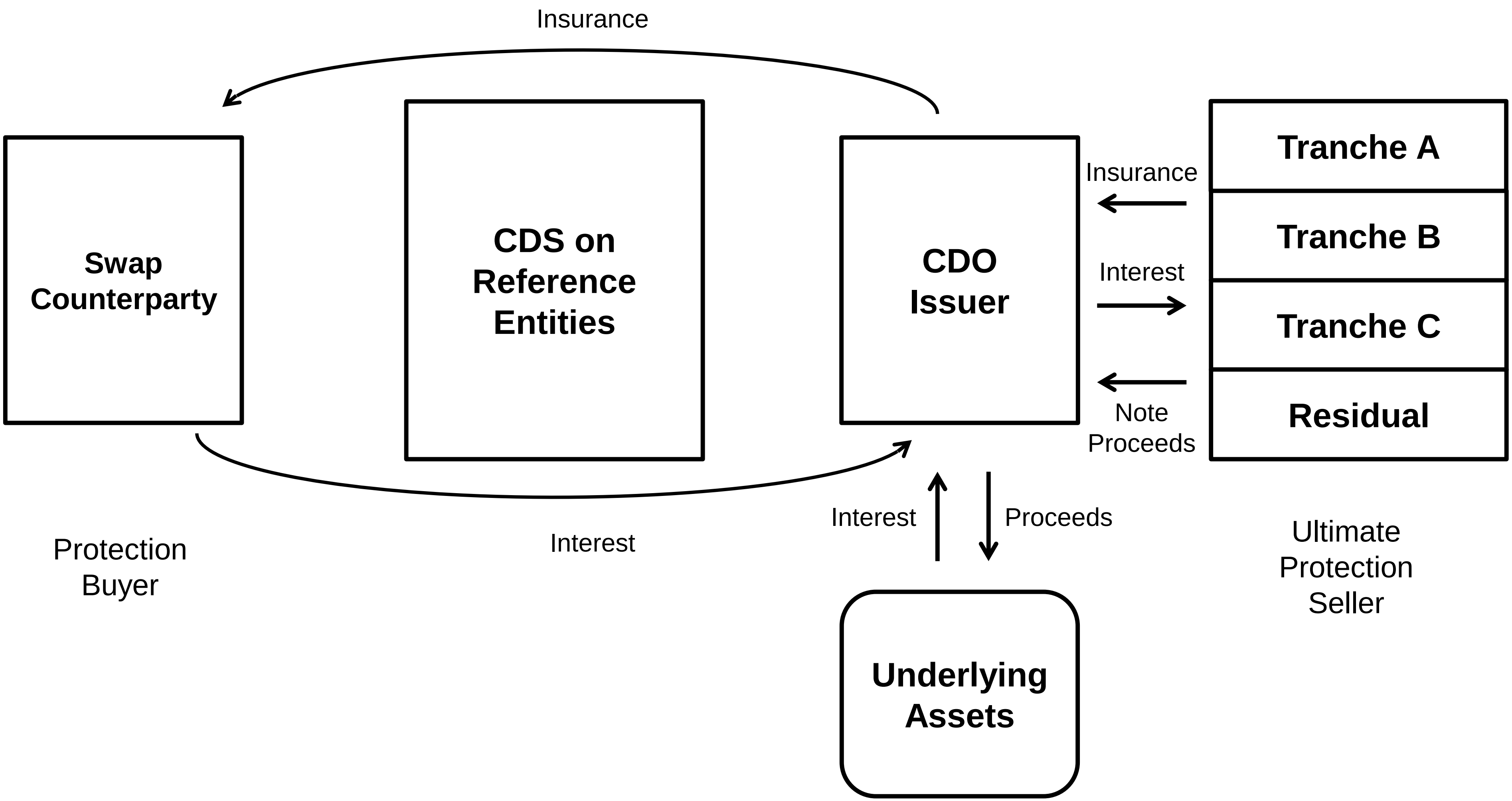
Investor *Responsibilities* (Cont'd)

Investors can be encouraged to question everything and to understand the dynamics and conflicts…

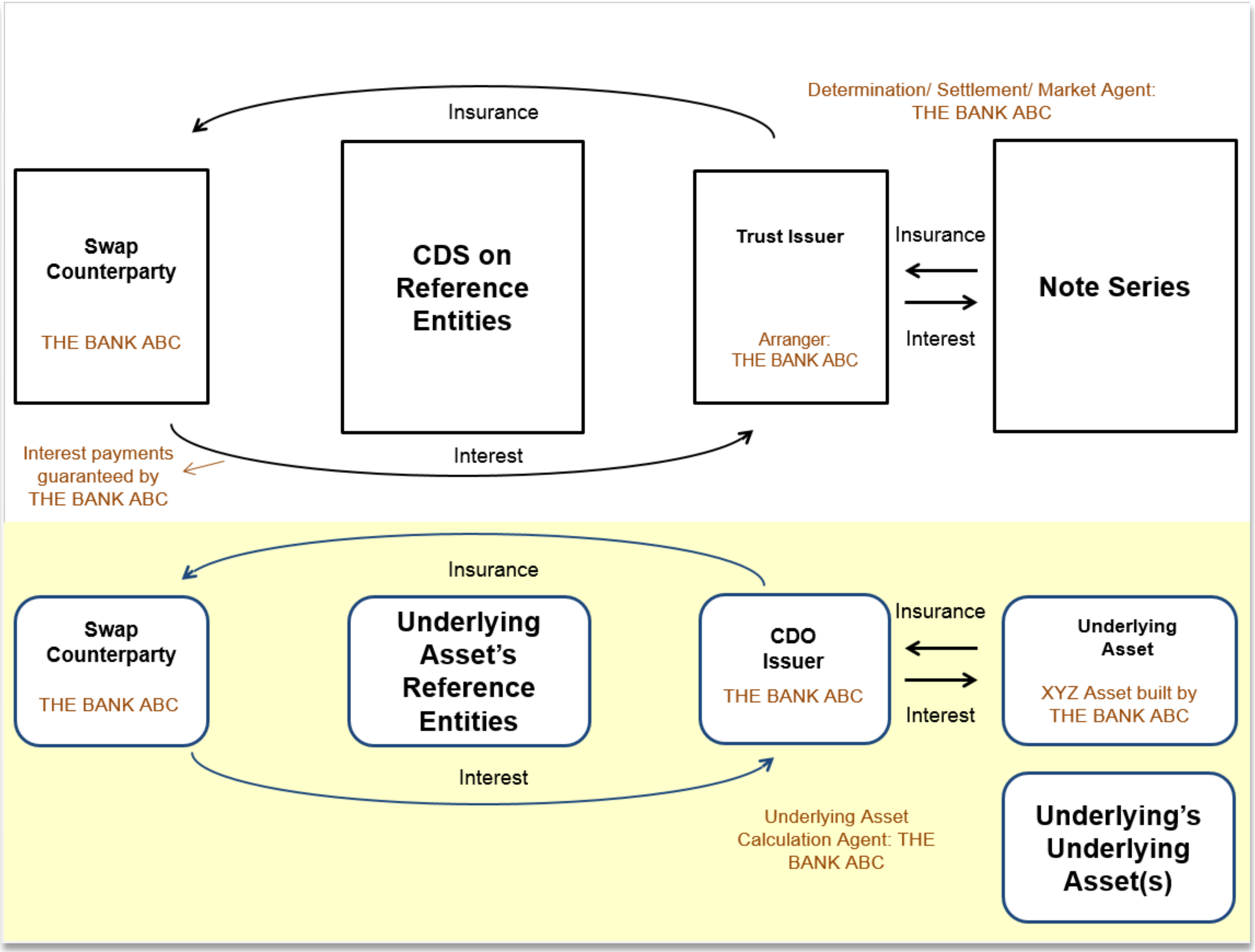
- Who is on the other side of the trade?
- Is the counterparty a client of yours (seller's)?
- Is seller acting as a fiduciary?
- What is seller's research division saying about these assets?
- Does seller have an axe?
- What recourse is available if this goes wrong?
- Are we taking credit risk outside of the credit risk to the immediate assets that secure the SPV?

- Can noteholders, voteholders or external investors pierce the securitization?
- In worst case scenario, can or will the trustee or controlling class stop an investor from purchasing the trust's assets at a discount?
- In best case scenario, is there a way (if needed) to sell underlying collateral if opportune to the noteholders?
- Can the noteholders establish a quorum?

Funded Synthetic CDO Structure



Product Complexity and Counterparty Risk



Ratings Shortcomings & Challenges

There are many. Here are some:

- At a basic level, no clear conception of **what a rating means** or what we want it to mean – what it entails; what its limitations are
  - Long-term v. short-term
  - Ordinal v. cardinal
  - Expected loss v. default probability
  - Point-in-time v. through-the-cycle
  - What is AAA? Should they be the same?
  - Different *scales* for different products – nowhere comparable

When looking at the same pieces of fruit, one rating agency says:

"These peaches are sweet."

The other says:

"These nectarines are sour."

They could both be "right." (What does it mean to be right?)

Ratings Shortcomings & Challenges

- **Lack of self-correcting mechanism**
  - Investors don’t have a loud voice (RMBS is not the first structured finance sector to go awry from ratings perspective)
  - Model errors

- Many parties (including influential, paying parties) **benefit** from (or seek out) faulty or **inflated ratings**

- Issuer-paid model and other conflicts

- Misinformation or disinformation about ratings competition
  - Rating shopping is real: having more “shops” $\not\Rightarrow$ improved product.

- Lack of incentive to turn business away or monitor existing deals (allowing rated securities to be pooled elsewhere at stale ratings).

Ratings Problems

"…if rating agencies have no incentive to turn away business, they might just rate anything and everything at the rating necessary to keep or win business"

- Rating agencies have been accused (not just S&P) of calibrating or engineering their models to achieve the result desired by the analysts. (In which case, you may ask, what is the purpose of the model?)

- Worst case scenario: nobody differentiates between or among rating agencies (based on quality)
  - Rating agencies compete solely based on the "solution" they provide, and the efficiency thereof:
    - Cheapest
    - Best customer service (say "yes," and ask fewer questions)
    - Most optimistic view (i.e., highest rating)

Ratings Problems

"[Moody's Investors Service] has no obligation to perform, and **does not perform, due diligence with respect to the accuracy of information it receives or obtains in connection with the rating process**. MIS does not independently verify any such information. Nor does MIS audit or otherwise undertake to determine that such information is complete. Thus, in assigning a Credit Rating, MIS is in no way providing a guarantee or any kind of assurance with regard to the accuracy, timeliness, or completeness of factual information reflected, or contained, in the Credit Rating or any related MIS publication."* (emphasis added)

and…

"… **in the absence of key information, assumptions are utilized**."** (emphasis added)

Can we encourage/require rating agencies:

- to check (on behalf of investors)?
- to *at least* disclose when the data they're relying on is being provided by an interested party?
- to turn away a deal to the extent the data are incomplete or of skeptical credibility (rather than simply accepting promises as true)?
- to refuse to rate deals that are "unratable" – or too complicated?

[This is not just Moody's…]

Sources: * Moody's Code of Professional Conduct (Nov. 2008); ** Moody's Revised US Mortgage Loan-by-Loan Data Fields (Apr. 2007)

Ratings Solutions

Absent legal liability or reputational risk (for being wrong) how do we encourage rating agencies to say “no”?

Measure them, publicly, and advertise the results of such measurements.

- Rater ABC is not implementing its models consistently
- Rater DEF has only one analyst covering 125 securities, most of which are complex, resulting in stale/outdated ratings
- Rater KLM’s ratings are unreflective of new information or methodological changes
- Rater PQR’s ratings in sector A show no or little predictive content over any period longer than 3 months
- Rater XYZ has not maintained appropriate records of situations in which its model-implied ratings differ substantially from the ultimate ratings being provided by the ratings committee

Ratings Solutions

Rating agencies must have a **reason** and **incentive** to want to outperform the others.

- If rating agencies were forced to **compete on performance**, and/or if one or more lost (or had suspended) its license to rate one or more product types, we would see a swift return to careful ratings standards

- If fund/company investors or board members know the fund/company is relying on less accurate (inflated) ratings, they might push for ratings from a more accurate provider

Many Rating Agency Criticisms – Easily Avoidable

Some pointed criticism put forward by Paul Kedrosky (BusinessWeek 2/2011) when addressing Moody's downgrade of Egypt's sovereign rating.

- It is late. Telling investors on Monday that Egypt is a riskier sovereign debt is slamming the barn door after the cows had left. The debt had already sold off, and some were even contemplating buying it as a contrarian trade. Only then Moody's shows up?

  In Q2 2013, Moody's downgraded 1,276 RMBS securities; upgraded 251

  In Q1 2013, Moody's downgraded 558 RMBS securities; upgraded 72

  ... despite *Moody's Sector Comment*: "Improving home prices will help to **lower losses on existing RMBS** mortgage pools." (June 2013, emphasis added)

- It is pro-cyclical. Rather than being helpful, it makes a bad situation worse, by lowering the investment rating on credits, thus forcing some holders to have to sell, which potentially creates further issues for an already troubled country, thus reinforcing its spiral into desperate problems.

- It adds no information. It doesn't make the situation any more certain for observers or the country. It merely adds to the risk that Moody's (or others) will show up later in the cycle and downgrade again.

Many Rating Agency Criticisms – Easily Avoidable

- The key is that when the data change, the opinion ought to change.

- Kedrosky is critical of opinion changes that lag the reality (and downgrades can be so delayed, in fact, that they come during upswings!)

- Many instruments are being maintained at <u>outdated</u> rating levels. This exacerbated the financial downturn by allowing further instruments to be created based on faulty security.

- Models can express an opinion in "real time" – we can require (or at least encourage) rating agencies to produce timely rating changes. [DISCUSSION]

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