

# **Rating Agency Reform**

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**ABS Vegas 2015**

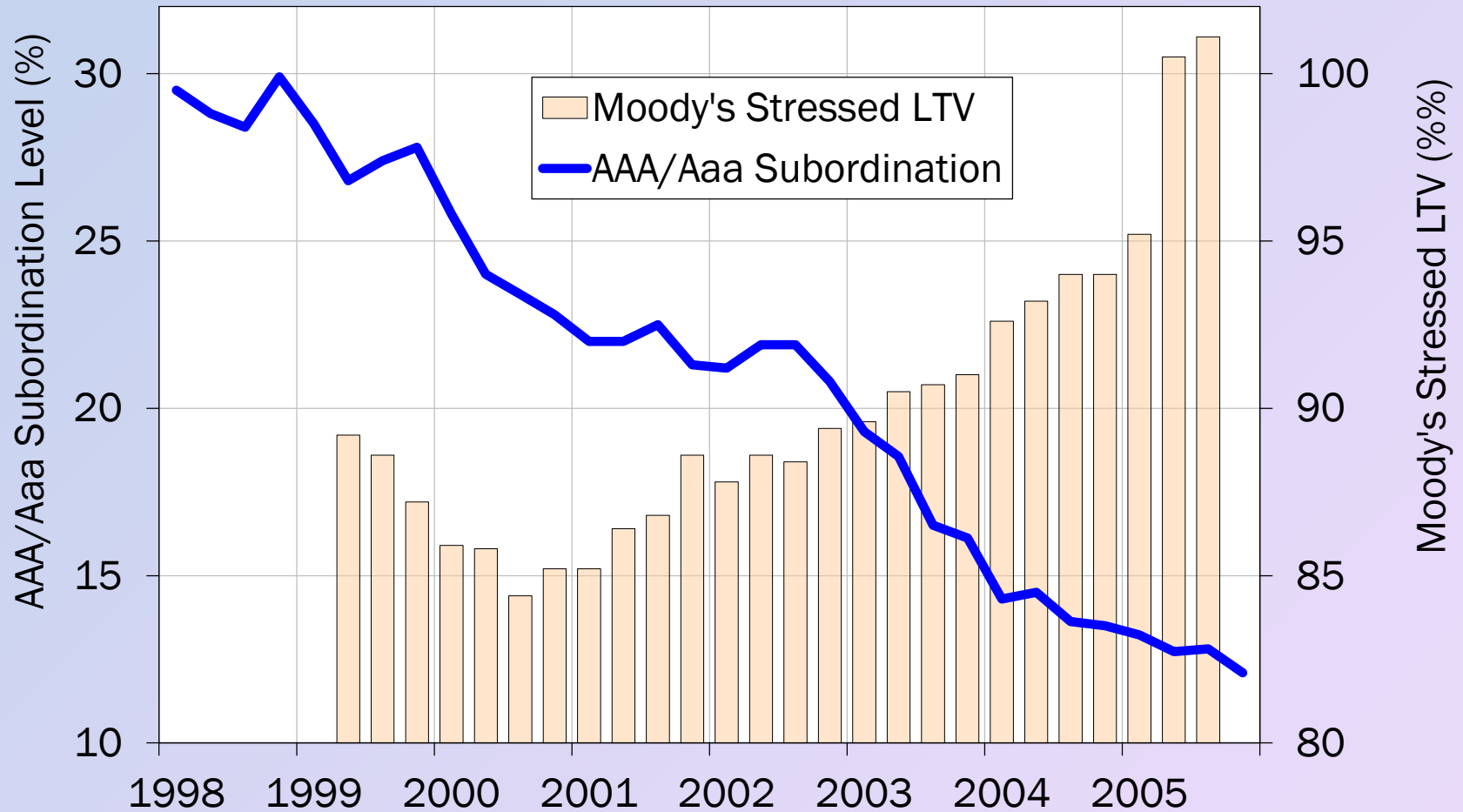
February 8-11, 2015  
The Aria Resort & Casino, Las Vegas, NV

# Issue: Competitive Laxity

- Competitive laxity is when rating agencies compete to win business by loosening their criteria for an entire sector or asset class.
- Rating shopping behavior by issuers and bankers gives rating agencies an economic incentive to practice competitive laxity.

# Competitive Laxity – Circumstantial Evidence (1)

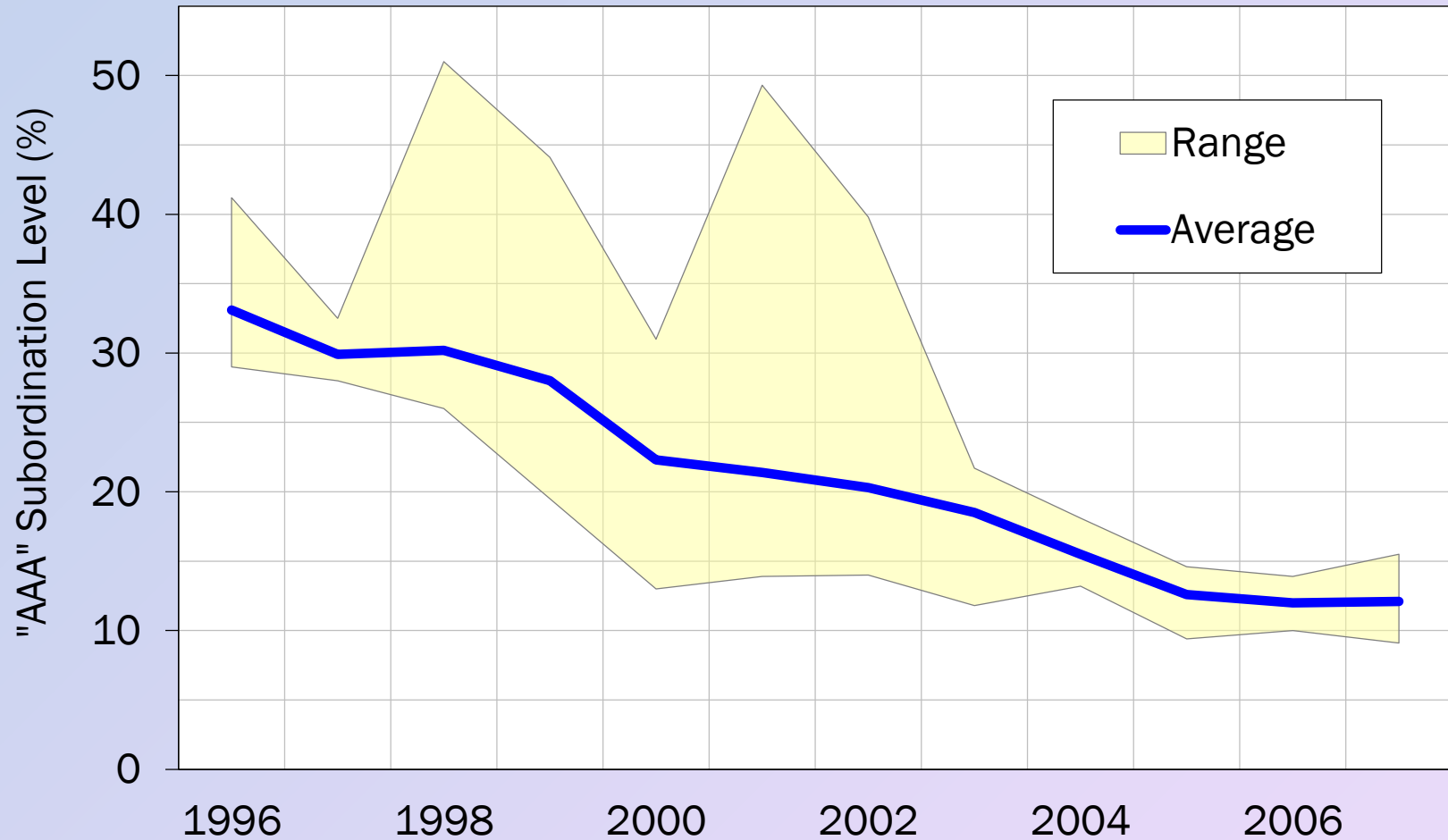
## Trends in CMBS Conduit Subordination (Quarterly)



Sources: Moody's, S&P, Commercial Mortgage Alert, Nomura Securities International

# Competitive Laxity – Circumstantial Evidence (2)

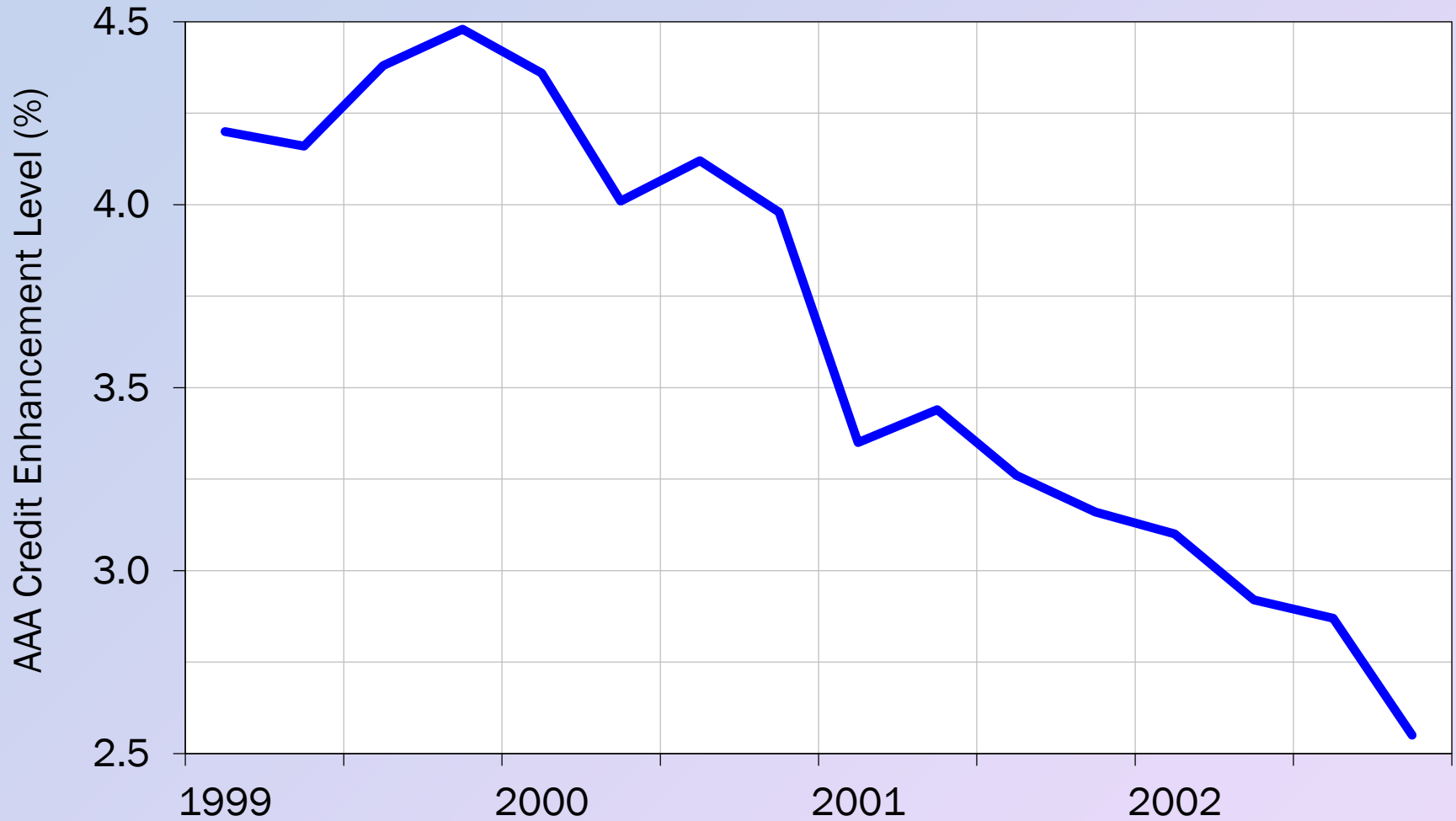
## S&P U.S. CMBS 'AAA' Subordination Levels by Vintage



Source: Standard & Poor's

# Competitive Laxity – Circumstantial Evidence (3)

## Average S&P "AAA" Credit Enh. Levels for Jumbo RMBS FRM30 Deals

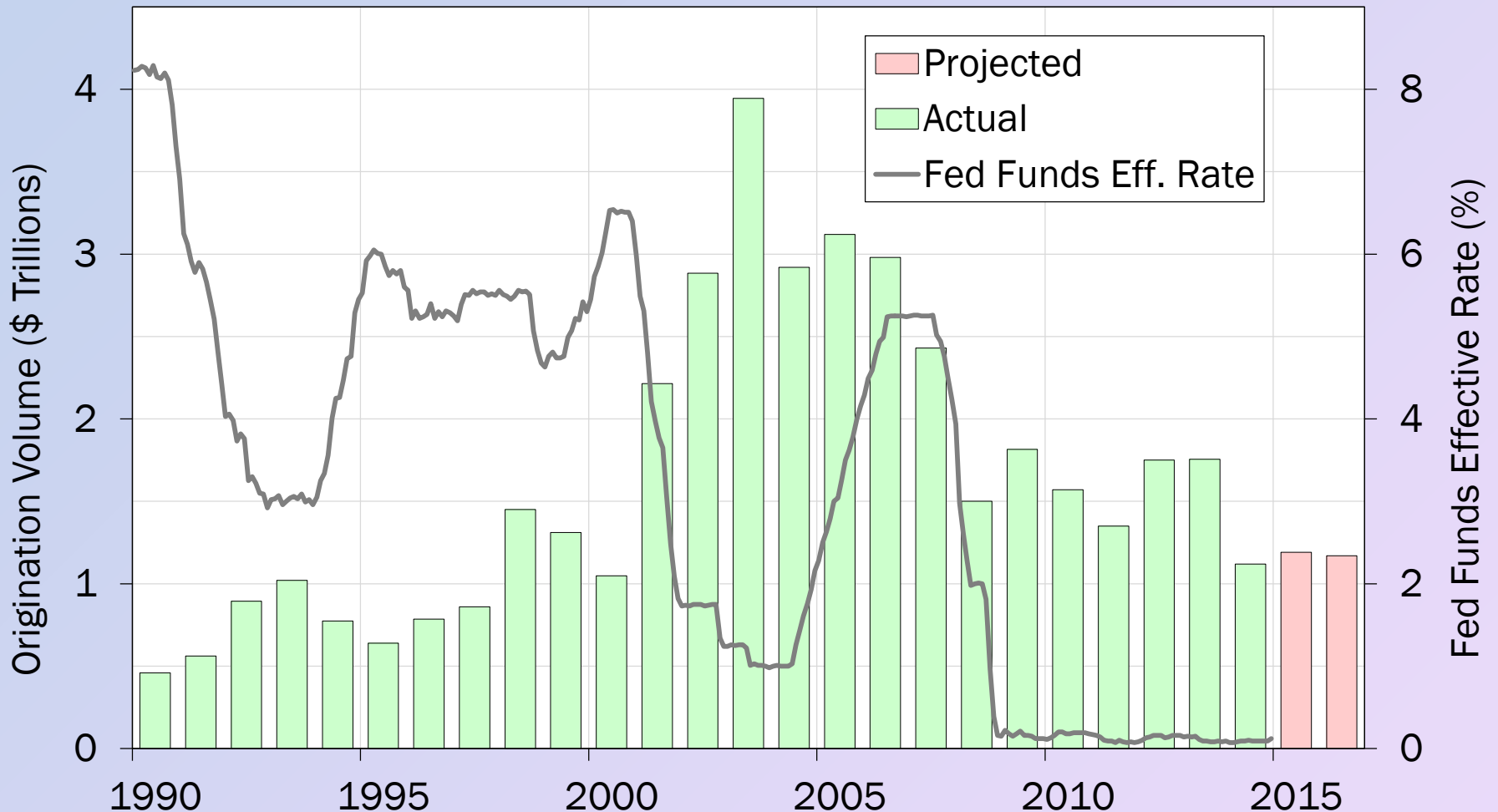


Source: Standard & Poor's

# Competitive Laxity – Direct Evidence?

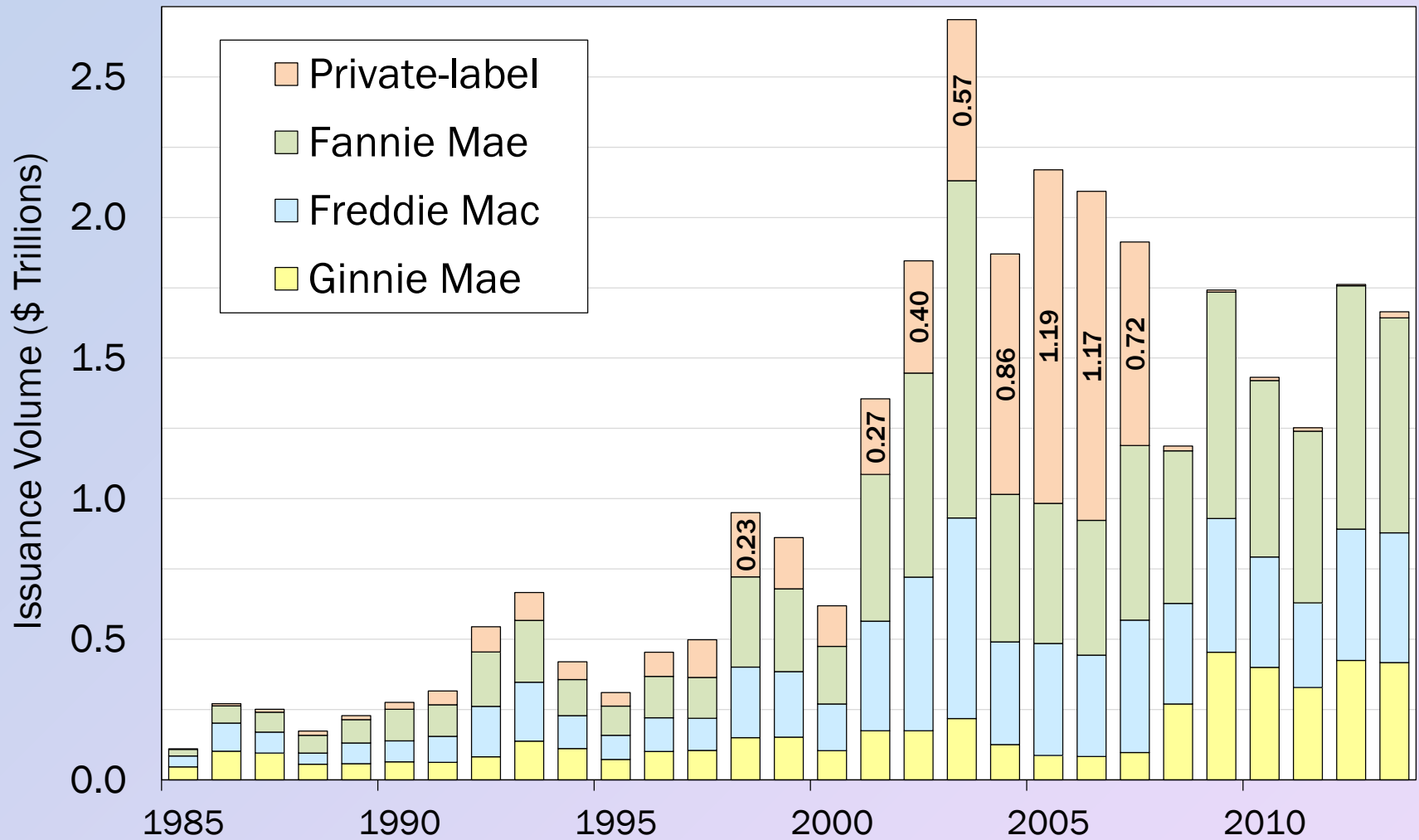
- **Senate Permanent Subcommittee on Investigations**, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, pp. 276-77, 279 (13 Apr 2011).
- ***U.S. v. McGraw-Hill***, No. CV13-00779, CDCA, Complaint ¶¶ 130, 132, 144, 151, 154, 167-68, 172, 176, 179 (4 Feb 2013).
- ***California v. McGraw-Hill***, No. CGC-13-528491, Calif. Super. Ct., Complaint ¶¶ 114, 117, 120, 139, 150, 183 (5 Feb 2013)
- **SEC Release 33-9705** (21 Jan 2015)

# U.S. Residential Mortgage Origination Volume



Sources: Inside Mortgage Finance (1990-2011); Mortgage Bankers Association (2012-2014 and projections); Federal Reserve

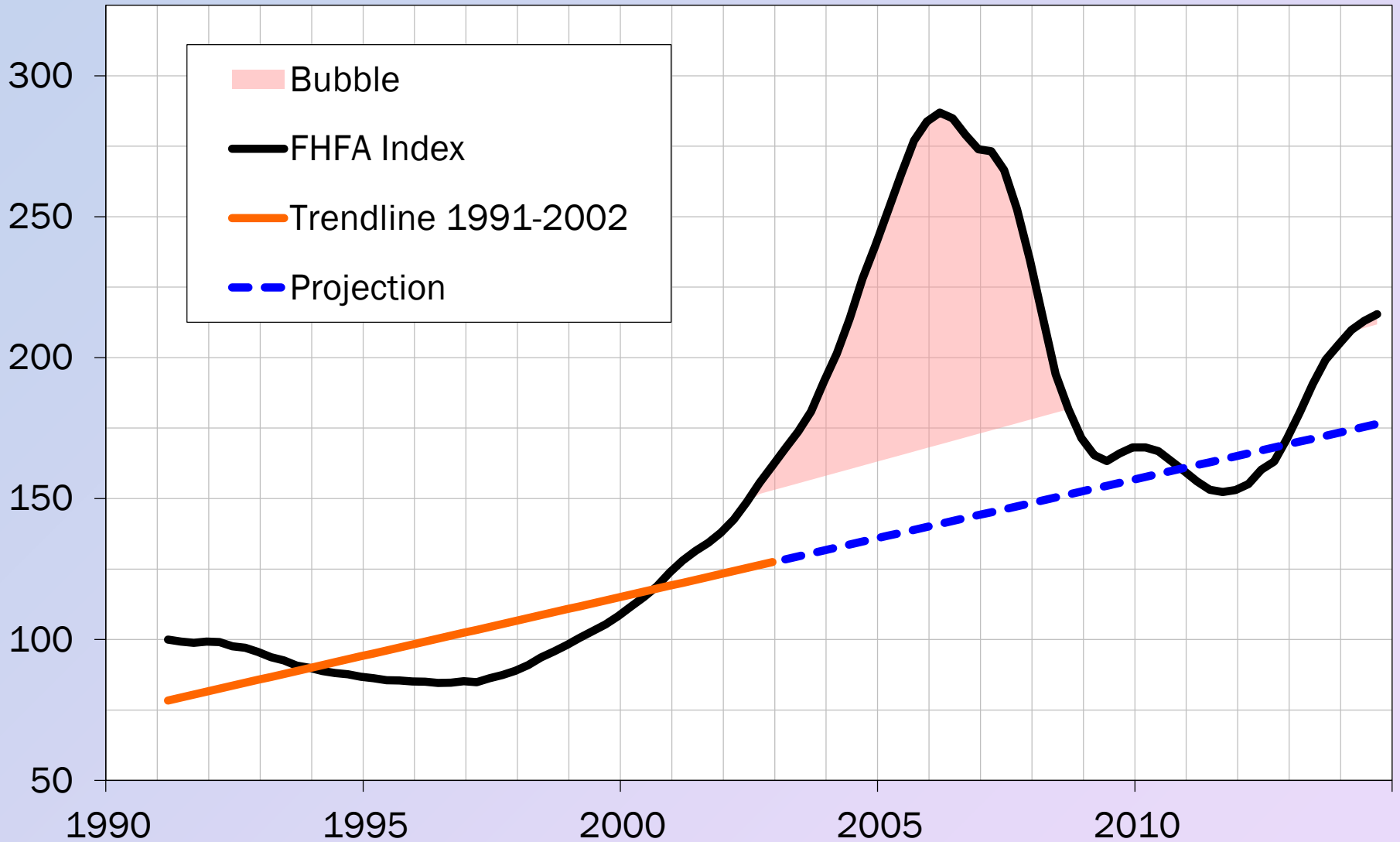
# U.S. Residential MBS Issuance Volume



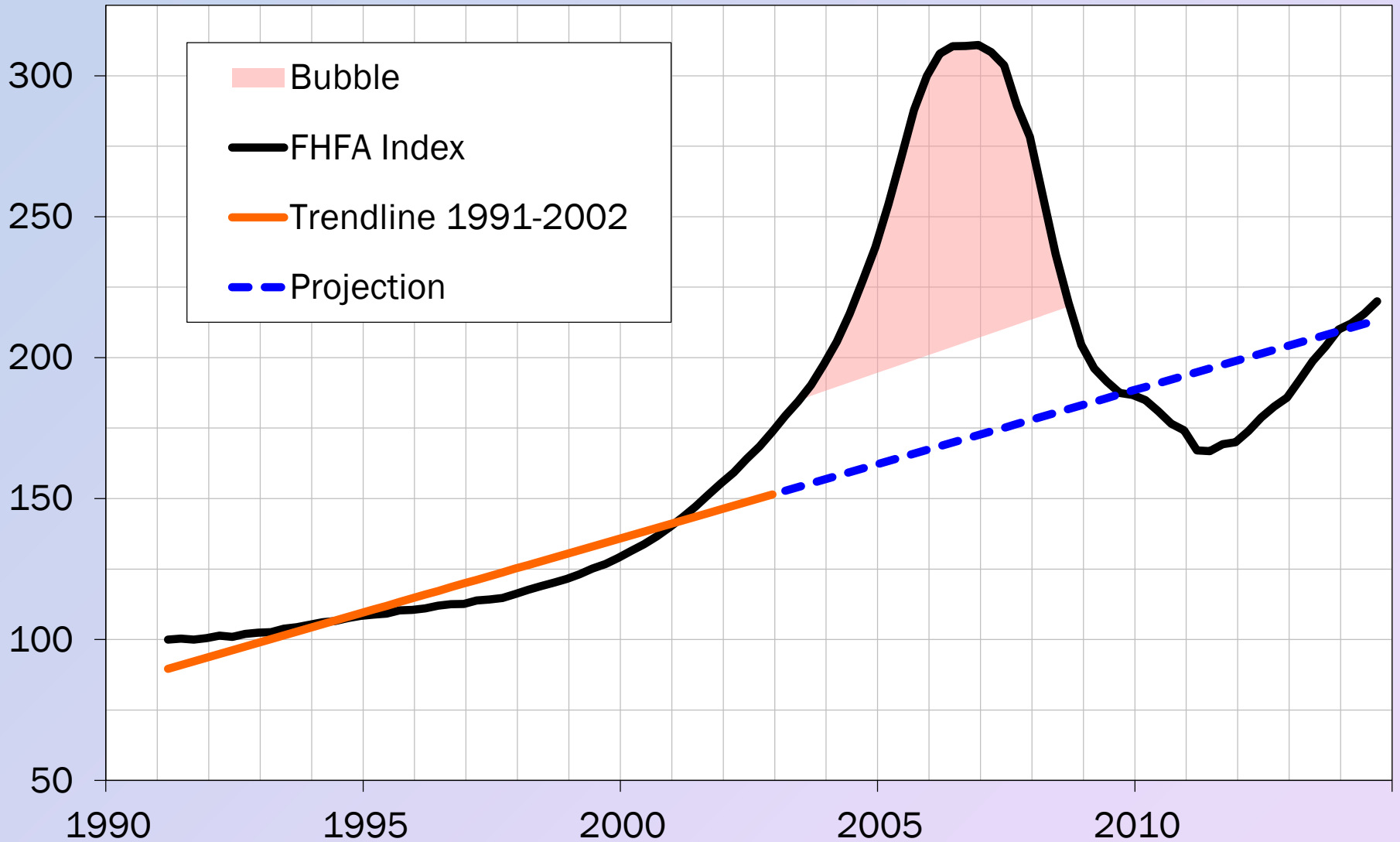
Sources: SIFMA; 2007 Mortgage Market Statistical Annual (for private-label before 1996).



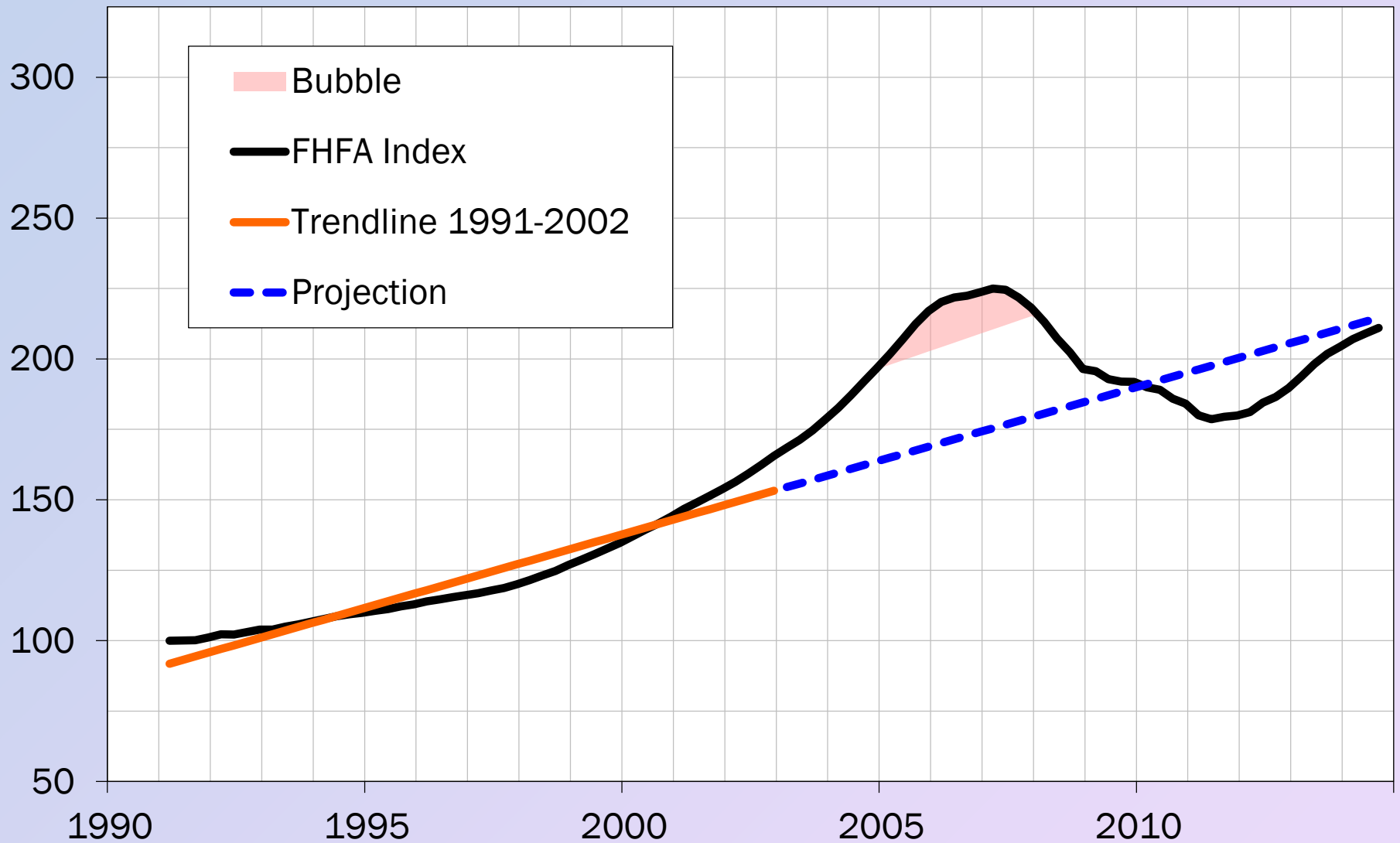
# California Home Price Appreciation



# Florida Home Price Appreciation



# U.S. Home Price Appreciation



# Results (1)

## S&P – Adverse Credit Migrations of 2005-2007 Vintages – **U.S. Subprime RMBS**

Original S&P Rating	Status as of 31 Dec 2010				No. of Ratings
	Default + Near Default	Default	Near Default	Any Downgrade	
<b>AAA</b>	<b>36.5%</b>	<b>1.4%</b>	<b>35.1%</b>	<b>63.0%</b>	<b>1,049</b>
<b>AA</b>	67.0%	28.5%	38.6%	82.7%	3,571
<b>A</b>	86.0%	54.1%	31.9%	94.9%	3,040
<b>BBB</b>	96.8%	76.4%	20.4%	98.4%	3,006
Inv. Grade	77.8%	46.6%	31.2%	88.7%	10,666

**Note:** 'AAA' ratings from the same transaction are treated as a single rating in this table's calculation. Multiple rating actions are aggregated to calculate a security's cumulative rating performance. Near default means rated 'CCC+' or lower.

**Source:** Erturk, E., *Global Structured Finance Securities End 2010 With Rising Credit Stability*, Standard & Poor's research report (7 Feb 2011) (Table 6c).

# Results (2)

## S&P – Adverse Credit Migrations of 2005-2007 Vintages – **All U.S. RMBS**

Original S&P Rating	Status as of 31 Dec 2010				No. of Ratings
	Default + Near Default	Default	Near Default	Any Downgrade	
<b>AAA</b>	<b>56.4%</b>	<b>18.8%</b>	<b>37.6%</b>	<b>76.3%</b>	<b>3,430</b>
<b>AA</b>	78.2%	45.7%	32.5%	88.3%	7,625
<b>A</b>	88.4%	61.9%	26.5%	93.6%	6,881
<b>BBB</b>	93.9%	72.3%	21.6%	95.2%	7,142
Inv. Grade	82.5%	54.0%	28.5%	90.1%	25,078

**Note:** 'AAA' ratings from the same transaction are treated as a single rating in this table's calculation. Multiple rating actions are aggregated to calculate a security's cumulative rating performance. Near default means rated 'CCC+' or lower.

**Source:** Erturk, E., *Global Structured Finance Securities End 2010 With Rising Credit Stability*, Standard & Poor's research report (7 Feb 2011) (Table 6b).

# Results (3)

## S&P – Adverse Credit Migrations of 2005-2007 Vintages – **U.S. CMBS**

Original S&P Rating	Status as of 31 Dec 2010				No. of Ratings
	Default + Near Default	Default	Near Default	Any Downgrade	
<b>AAA</b>	<b>11.9%</b>	<b>5.5%</b>	<b>6.4%</b>	<b>82.1%</b>	<b>312</b>
AA	12.9%	7.2%	5.7%	80.5%	735
A	22.1%	7.0%	15.1%	83.2%	810
BBB	45.4%	14.9%	30.5%	81.9%	1,109
Inv. Grade	27.4%	9.8%	17.6%	81.9%	2,966

**Note:** 'AAA' ratings from the same transaction are treated as a single rating in this table's calculation. Multiple rating actions are aggregated to calculate a security's cumulative rating performance. Near default means rated 'CCC+' or lower.

**Source:** Erturk, E., *Global Structured Finance Securities End 2010 With Rising Credit Stability*, Standard & Poor's research report (7 Feb 2011) (Table 6e).

# Results (4)

## Moody's Multi-Year Cumulative Impairment Rates by Original Rating U.S. Jumbo RMBS (2000 and later vintages)

Original Moody's Rating	Years (as of 31 Dec 2013)					
	5	6	7	8	9	10
<b>Aaa</b>	<b>3.1%</b>	<b>6.6%</b>	<b>9.1%</b>	<b>10.0%</b>	<b>10.1%</b>	<b>10.1%</b>
<b>Aa</b>	22.7%	23.6%	26.1%	27.3%	28.1%	28.1%
<b>A</b>	15.1%	16.5%	27.4%	38.5%	43.2%	46.9%
<b>Baa</b>	18.3%	22.0%	33.5%	49.7%	58.2%	60.6%
<b>Inv. Grade</b>	6.6%	9.7%	13.0%	15.2%	16.2%	16.7%

**Note:** Does not collapse tranches with the same rating from the same deal. "Impairment" includes default, downgrade to "Ca" or "C," and certain other events where an investor receives (or expects to receive with near certainty) less value that would be expected if the obligor or obligation were making payments.

**Source:** Roy, D.D., Kanthan, K., Metz, A., and Weill, N., *Default & Loss Rates of Structured Finance Securities: 1993-2013*, Moody's special comment, pp. 33, 40 (30 Sep. 2014).

# Results (5)

## Moody's Multi-Year Cumulative Impairment Rates by Original Rating U.S. Subprime RMBS (2000 and later vintages)

Original Moody's Rating	Years (as of 31 Dec 2013)					
	5	6	7	8	9	10
<b>Aaa</b>	<b>14.7%</b>	<b>16.0%</b>	<b>17.5%</b>	<b>18.0%</b>	<b>18.3%</b>	<b>18.5%</b>
<b>Aa</b>	49.2%	49.9%	50.9%	51.8%	52.5%	53.5%
<b>A</b>	59.7%	63.1%	73.5%	78.9%	82.2%	84.0%
<b>Baa</b>	70.1%	75.3%	87.3%	94.0%	95.4%	95.9%
<b>Inv. Grade</b>	42.3%	45.0%	51.7%	55.8%	57.9%	59.0%

**Note:** Does not collapse tranches with the same rating from the same deal. "Impairment" includes default, downgrade to "Ca" or "C," and certain other events where an investor receives (or expects to receive with near certainty) less value that would be expected if the obligor or obligation were making payments.

**Source:** Roy, D.D., Kanthan, K., Metz, A., and Weill, N., *Default & Loss Rates of Structured Finance Securities: 1993-2013*, Moody's special comment, pp. 33, 40 (30 Sep. 2014).



# Results (6)

## Moody's Multi-Year Cumulative Impairment Rates by Original Rating U.S. Alt-A/Option ARM RMBS (2000 and later vintages)

Original Moody's Rating	Years (as of 31 Dec 2013)					
	5	6	7	8	9	10
<b>Aaa</b>	<b>29.4%</b>	<b>36.5%</b>	<b>41.2%</b>	<b>44.2%</b>	<b>44.6%</b>	<b>44.7%</b>
<b>Aa</b>	73.6%	78.0%	82.4%	83.9%	84.5%	85.2%
<b>A</b>	76.1%	79.4%	87.4%	89.4%	90.8%	91.6%
<b>Baa</b>	82.4%	84.7%	90.4%	92.4%	93.4%	94.0%
<b>Inv. Grade</b>	45.2%	51.1%	56.5%	59.2%	59.9%	60.3%

**Note:** Does not collapse tranches with the same rating from the same deal. "Impairment" includes default, downgrade to "Ca" or "C," and certain other events where an investor receives (or expects to receive with near certainty) less value that would be expected if the obligor or obligation were making payments.

**Source:** Roy, D.D., Kanthan, K., Metz, A., and Weill, N., *Default & Loss Rates of Structured Finance Securities: 1993-2013*, Moody's special comment, pp. 33, 40 (30 Sep. 2014).

# Three Key Features of the New Rules

- Prohibit sales and marketing influence on individual ratings and criteria development
- Avoid forcing ratings to embody absolute probabilities of default
- Require consistent meaning of each agency's symbols across sectors

# Prohibition of Sales & Marketing Influence (1)

- Rule 17g-5(c)(8)
- Explicit inclusion of criteria development
  - Not present in Exchange Act § 15E(h)(3)(A)
  - Present in 2011 rule proposal
  - Specific discussion in 2014 adopting release
- "Influence" broadly construed
  - Principles-based requirement
  - Can include compensation arrangements, performance appraisals, compliance systems, and direct pressure from managers

# Prohibition of Sales & Marketing Influence (2)

- "Sales and marketing" considerations
  - Can include fees, market share, inflated ratings, “business concerns,” and “other business interests”
- Strictness of the prohibition
  - Absolute prohibition
  - Unsuccessful attempt to influence can be a violation

# Prohibition of Sales & Marketing Influence (3)

- Enforcement mechanism
  - Attestation requirement for ratings but not for criteria
  - Suspend or revoke NRSRO registration under Exchange Act § 15E(h)(3)(B)(ii)
  - Standard penalties under Exchange Act § 32(a)
- Bottom line
  - Long reach from broad interpretive guidance
  - Strong enforcement mechanism behind it

# Absolute Default Probabilities Not Required

- Plain language of the new rules seems to require every rating to embody an “expected probability of default” and an “expected loss in the event of default” [Rule 17g-7(a)(ii)(L)]
- Rule language mirrors statutory language
- Interpretive guidance allows agencies to retain relative risk paradigm
- Comply by publishing historical defaults and losses.

# Consistent Meaning of Rating Symbols

- Each agency must have consistent meanings for its symbols across all sectors  
[Rule 17g-8(b)(3)]
- Partly a response to competitive laxity
- Redefining the whole rating scale for all sectors is not prohibited but has real costs
- Standardization of symbols across agencies not required

# Conclusion

- New rules handle three difficult issues extremely well
- Should help to reduce competitive laxity
- Should help ratings remain useful and valuable tools for investors

**See, Adelson, M. and Jacob, D., *Strengthening Credit Rating Integrity*, forthcoming in the JOURNAL OF FINANCIAL REGULATION AND COMPLIANCE.**