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## The Role of the Credit Rating Agencies in the Structured Finance Market

Testimony of

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before the

**Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives**

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## Introduction

This written testimony embodies and amplifies on the main points of my brief oral testimony. The key points are as follows:

1. Securitization is an important and beneficial financing tool. America today is better off because securitization got started nearly forty years ago.

2. Credit ratings are important to the healthy operation of the securitization markets. Credit risk is a complex phenomenon and credit ratings help investors to understand credit risk and make comparisons among different kinds of bonds in a simplified way.

3. Despite the outward simplicity of credit ratings, the inherent complexity of credit risk in many securitizations means that reasonable professionals starting with the same facts can reasonably reach different conclusions. This is one reason that the market benefits from the presence of multiple ratings (from different rating agencies) on most securities.

4. Rating methodologies for MBS and CDOs are fully transparent to knowledgeable professionals in the field. The evidence of transparency is abundant and includes the *very* public debate and discourse among securitization professionals about the pros and cons of different rating approaches and about the merits of entirely different approaches for analyzing risk.

5. The rating agencies acted in a timely manner in downgrading various CDOs and MBS in July. The evidence to support such actions was too thin in the spring. Had the rating agencies waited until the start of fall, they would have been late in reacting to firm

indications of credit deterioration. Criticism based on hindsight and Monday-morning-quarterbacking is unwarranted.

6. Most potential conflicts faced by rating agencies are exactly the same as the ones faced by other publishing companies in preserving editorial independence in the face of pressure from advertisers. Rating agencies can handle those conflicts just the same way that other publishers do.

   "Rating shopping" by issuers creates the unique problem of "competitive laxity" for the credit rating industry. In the past, the practice of assigning unsolicited ratings was the industry's method for counter-balancing the harmful effects of rating shopping. However, pressure from issuers and bankers, as well as from policymakers, has caused the rating agencies largely to abandon unsolicited ratings. To restore appropriate balance, policymakers should encourage or require a resumption of unsolicited ratings.

## Securitization Basics

Because securitization is the canvas on which we must paint the issues and conclusions of this discussion, I am starting with a description of securitization:

Securitization is a modern financing tool. It is a close cousin to traditional secured debt. In a typical securitization, a company raises money by issuing securities that are backed by specific assets. In most cases, the underlying assets are loans, such as mortgage loans or auto loans. The cash flow from the underlying assets is usually the source of funds for the borrower/issuer to make payments on the securities. Securitization products are generally viewed as including the following: residential mortgage-backed securities ("MBS"),[1] commercial mortgage-backed securities ("CMBS"), asset-backed securities ("ABS"),[2] collateralized debt obligations ("CDOs"),[3] and asset-backed commercial paper ("ABCP").

[1] For a basic introduction to MBS, see *MBS Basics*, Nomura fixed income research (31 Mar 2006). For an introduction to securitizations of sub-prime mortgage loans, see *Home Equity ABS Basics*, Nomura fixed income research (1 Nov 2004).

[2] The term "ABS" generally refers to securities backed by specific assets, where the payments on the securities are tied to or derived from the cash flows produced by the assets. Examples of typical collateral backing ABS include the following: auto loans, credit card receivables, home equity loans, manufactured housing loans, student loans, and equipment leases. In the U.S., the term ABS does *not* include securities backed by: (1) prime-quality first-lien residential mortgage loans, (2) commercial mortgage loans, or (3) pools of corporate bonds and loans. Outside the U.S., the term ABS may include deals backed by such collateral. ABS also includes securities backed by "esoteric assets" such as; healthcare receivables, tax liens, trade receivables, structured settlements, entertainment royalties, patent and trademark receivables, etc.

[3] A CDO is a securitization structure/technique similar to a hedge fund. In a U.S. CDO, an actively managed pool of rated bonds or loans serves as the collateral backing other debt securities. The underlying bonds and loans may include junk bonds, investment grade corporate bonds, securitization instruments, or syndicated bank loans. A CDO generally issues multiple tranches of debt securities, each at its own level of seniority in the transaction's capital structure. For a basic introduction to CDOs see *CDOs in Plain English*, Nomura fixed income research (13 Sep 2004).

Compared to traditional secured debt, securitizations are intended to provide a lender/investor with greater protection against the corporate credit risk of the originator of the assets. In principle, a securitization lender/investor is a kind of "super-secured creditor," with rights that surpass those of a traditional secured lender. Securitization employs the notion that the subject assets have been "sold" by the originator and, therefore, will not become entangled in bankruptcy proceedings if the originator files for protection under the bankruptcy code.

Accomplishing a "sale" of the securitized assets often requires the use of a special purpose entity or "SPE." A typical securitization is structured as a two-step transaction. In the first step, the originator transfers the subject assets to an SPE in a transfer designed to constitute a "true sale." In the second step, the SPE issues securities backed by the assets. The SPE uses the proceeds from selling the securities to pay the originator for the assets. In addition, part of the "consideration" that the originator receives for transferring the assets to the SPE is ownership of the SPE.

In some securitizations, the originator does not receive the equity in the SPE. Instead, the originator may retain the subordinate or equity position in the securitized assets through other means, such as variable fee structure.

## Importance of Securitization

**The Positives:** As a financing technique, securitization offers certain important advantages, which translate into benefits to America and to the American economy. The most vivid example of such benefits is in the residential mortgage sector. The securitization activities of the GSEs – Ginnie Mae, Fannie Mae, and Freddie Mac – have produced a highly liquid secondary mortgage market. Roughly $4 trillion of residential mortgage loans are packaged into MBS issued or guaranteed by the GSEs. Another $2¼ trillion is packaged into MBS issued by private companies. In all, about half of all the nation's residential mortgage loans are packaged into MBS.

As a result, funds for residential mortgage loans are available all across the nation, and regional differences in interest rates for residential home loans are virtually non-existent. The MBS market has directly molded lending practices. It has standardized the application process for most mortgage loans, thereby providing faster decisions to applicants. Most important, MBS have helped to boost the rate of homeownership in America. Increasing home ownership arguably strengthens America's democracy by giving more Americans an economic stake in their communities. A homeowner with an economic stake is more likely to care about his community and, therefore, to participate in the political process by casting his vote each November on Election Day. For this alone securitization can rightly be viewed as the greatest financial innovation of the 20th Century.

Beyond the mortgage area, securitization has expanded the availability of consumer credit in general. Securitization of auto loans and credit card receivables has made auto loans and credit cards available to more Americans than would otherwise be the case. Superior access to credit by responsible households is undeniably beneficial, even though easier availability causes some consumers to borrow more than they should.

The benefits of securitization extend to the commercial sector as well. Equipment leasing companies use securitization to finance their leases on many different types of equipment. This makes the equipment available more cheaply to businesses of all types. Lessees of aircraft, computers, medical equipment, trains, and office equipment have all benefited from cheaper lease rates because of securitization.

Securitization produces its benefits by improving the efficiency of the financial system. It allows lenders to finance their lending activities more efficiently than they could with traditional corporate bonds or with bank loans. The sources of improved efficiency include: (i) asset liability matching, (ii) lower funding costs, and (iii) improved liquidity.

Countries around the globe have embraced the model of securitization developed in America. Those countries seek to realize for themselves the improved financial efficiency that securitization brings. Companies in those countries want to harness the asset-liability matching, lower funding costs, and improved liquidity that securitization can offer. The global acceptance of securitization reaffirms the conclusion that securitization is an important and beneficial innovation.

**The Negatives:** On the other hand, as with many important inventions and innovations, securitization has been used in ways that may have caused harm as well as good. For some companies, the primary motivation for using securitization has not been asset-liability matching, lower funding costs or improved liquidity. Some companies have used securitization as a way to exploit accounting loopholes or gimmicks. In one variation, companies (including some banks) use securitization as a way to finance assets "off" their balance sheets while retaining virtually all of the economic risk. Those transactions can lower a bank's required level of capital without a commensurate reduction in the institution's risk. Other companies have used securitizations as a way to obfuscate their financial condition in order to conceal wrong-doing.

Also on the negative side, easy access to funding through securitization makes the credit pendulum swing farther as the economy moves through the credit cycle. This certainly appears to have happened over the past few years, particularly in the sub-prime mortgage area. Sub-prime lenders let their credit standards virtually evaporate. They made loans with ridiculous terms (*e.g.*, 100% financing to a borrower who would not document his income). The lenders did not care about the credit quality of the loans that they made because they did not retain significant risk from poor future performance. However, this phenomenon is a by-product of the larger trend toward financial disintermediation, of which securitization is merely one dimension.

## Value of Credit Ratings

Credit ratings are valuable because they provide simplified, one-dimensional, summary opinions about complex, multi-dimensional phenomena. The challenge for a rating agency is to have a methodology that balances the diverse factors that contribute to a security's "credit quality" in a way that is useful to investors.

At first blush, the idea of "credit quality" seems very simple. However, deeper examination reveals layers of subtlety. For example, one possible way to define credit quality is in terms of the likelihood that a security will default. S&P emphasizes this approach. A second

way is to focus on the security's expected loss (*i.e.*, the probability of default times the anticipated severity of loss following default). Moody's takes that route. Other possible approaches might emphasize the range of potential future outcomes (*i.e.*, widely or narrowly dispersed) or the variability of different factors over time.

Although rating agencies differ in how they define credit quality and in their criteria and methodologies for analyzing it, they all express their ratings with symbols along one-dimensional rating scales (*e.g.*, AAA, AA+, AA, AA-, A+…). Rating symbols cannot necessarily communicate nuances such as "low risk in the short run but higher risk over the long term" or "low risk right now but subject to the possibility of changing quickly." Consider an analogy to the weather. We can attempt to describe the weather with a one-dimensional scale with categories or symbols as follows: great, good, OK, bad, and horrible. Obviously, such descriptions omit all nuances. Each category would include different combinations of temperature, humidity, wind speed, cloud cover, barometric pressure, and precipitation. The weather can be bad or horrible for any of several reasons: too hot, too cold, too windy, too rainy, etc. Likewise, great weather for the beach would be horrible at a ski resort in the winter. This example illustrates the inherent limitation of one-dimensional rating scales.

On the other hand, one dimensional rating scales offer the ability to make coarse comparisons between or among very different kinds of securities. Within the context of how each rating agency defines credit quality and credit risk, its ratings allow an investor to make rough comparisons among securities and obligations as different as corporate bonds, mortgage backed securities, bank loans, insurance policies, bank deposits, and derivative contracts. Although it may be rough, such a comparison can still be very useful.

Accordingly, many institutional investors frame their investment policies for fixed income investments in terms of ratings. For example, some have investment policies that require bonds to have ratings of at least double-A from both S&P and Moody's. The institution's investment policy does not delve into the detailed nuances of different kinds of bonds, but rather uses rating agency ratings as a rough benchmark.

## Complexity Leads to Multiple Points of View

The level of complexity in a typical securitization is high enough that creating a methodology[4] for analyzing the deal is not a mechanistic, cut-and-dried process. Rather, the process embodies a range of qualitative judgments and, accordingly, is one through which reasonable people can come to different results.

Let us get the right perspective. Creating a methodology for analyzing a securitization is neither rocket science nor brain surgery. In fact, the complexity of a typical securitization is arguably somewhat less than that of a modern automatic transmission in a car. However, the

[4] Moody's favors the term "methodology," while S&P uses "criteria." For convenience of exposition, I am using the term "methodology" generically to encompass the approach, criteria, or methodology of any rating agency, regardless of what it is called.

complexity of a typical securitization is *far* above that of traditional bonds. It is above the level at which the creation of the methodology can rely solely on mathematical manipulations.

For example, in the private-label MBS area, both investors and rating agencies use combinations of tools for performing analysis. They use prepayment and default models to estimate the future cash flows from the loans backing a security. Then they use other models to apply those cash flows through the MBS structure, which allocates prepayments and losses among the various classes of a deal according to the deal's terms. Then they may repeat the process dozens, hundreds, or thousands of times to test the impact of alternative scenarios with different patterns of prepayments and losses. Although the models are entirely quantitative, creating them involves key analytic decisions that are qualitative. The choice among competing models and the selection of key assumptions (including which scenarios to emphasize the most) are inherently qualitative in nature.

Likewise, in the CDO area, market participants rely very heavily on quantitative models for their analyses. Most of the models work by treating bonds as if they behave according to a set of mathematical rules. Here, too, although the models themselves are strictly quantitative, both the specification of the modeling framework and the choice of modeling inputs are matters of qualitative judgment.

Understanding the role of qualitative judgment is essential to understanding why different market participants can reasonably reach different results from analyzing the same securities. Two investors might start their analyses with two different sets of equally reasonable assumptions and yet reach different conclusions. Two rating agencies might develop equally reasonable mortgage models that place differing degrees of weight on different factors that affect credit risk. They also might reach different rating opinions on the same security. In either case, none of the conclusions or ratings should be considered "wrong" because they were all derived from reasonable assumptions at the start.

At the end of the day, it is tempting to conclude that the only "correct" analysis is the one that most closely matches the outcome in the real world. Such a conclusion is dangerous. It presupposes that there was only one correct way of analyzing a securitization in the first place. It ignores the fact that reasonable people can come to different conclusions because they start with different (though reasonable) modeling assumptions. It ignores the fact that securitizations embody a non-trivial level of complexity.

## Transparency of Rating Methodologies

Credit rating methodologies for MBS and CDOs are extremely transparent. That is not to say that they are simple. Quite the contrary, they are intricate and complex. Nonetheless, they are transparent.

The transparency of rating methodologies for MBS and CDOs is evident from a number of sources. First, and most important, is the voluminous body of reports and technical papers that the rating agencies publish to describe and update their methodologies. The reports and papers may make for tedious reading, but they are thorough.

Second, the major rating agencies make their quantitative models for MBS and CDOs available to market participants. Market participants can acquire complete familiarity with the quantitative models by experimenting with them to their hearts' content. S&P's *LEVELS*® is perhaps the best known of the rating agency mortgage models. Moody's competing model is called *Moody's Mortgage Metrics*. For CDOs, S&P's model is called *CDO Evaluator* and Moody's is called *CDOROM*™. All of these products are described on the rating agency websites and can be licensed from the rating agencies.

Third, the steady turnover of rating agency analytic staff – who take jobs with investors, issuers, and investment banks – spreads hands-on knowledge of rating methodologies beyond the confines of the rating agencies. Front line rating analysts ordinarily work at a rating agency for two to four years. That means that each year *hundreds* of analysts leave the rating agencies and carry first-hand knowledge of rating methodologies to their new jobs.

Fourth, the transparency of rating methodologies for MBS and CDOs is evident from the spirited, and sometimes contentious, public debate over those methodologies. Securitization researchers have published numerous reports over the years evaluating, challenging, or critiquing rating agency methodologies for MBS and CDOs. I have written a substantial volume of such reports myself.[5] Other researchers who have tackled the subject include Douglas Lucas of UBS,[6] Rod Dubitsky of Credit Suisse,[7] and Arturo Cifuentes of Pressprich (and formerly of Wachovia).[8]

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[5] Examples include the following: Adelson, *Bond Rating Confusion*, JOURNAL OF STRUCTURED FINANCE (Winter 2007); Adelson, *Rating Shopping – Now the Consequences*. Nomura fixed income research (16 Feb 2006); Adelson and Manzi, *CMBS Credit Migrations 2005 Update*, Nomura fixed income research (30 Nov 2005) ; Adelson and Bartlett, *ABS Credit Migration Update*, JOURNAL OF STRUCTURED FINANCE (Fall 2005); Adelson, *CDO and ABS Underperformance: A Correlation Story*, JOURNAL OF FIXED INCOME (December 2003); Adelson, *NERA Study of Structured Finance Ratings – Market Implications*, Nomura fixed income research, (6 Nov 2003); Adelson, Hoyt, and Manzi, *CMBS Watchlistings, Downgrades, and Surveillance*, Nomura fixed income research (2 Oct 2003); Adelson and Hoyt, *CMBS Credit Migrations*, JOURNAL OF PORTFOLIO MANAGEMENT (Special Real Estate, Fall 2003), Adelson and Hoyt, *Temporal Aspects of CMBS Downgrades and Surveillance*, Nomura fixed income research, (1 Jul 2003); Adelson and Villanueva, *Oops… They Did It Again – Jumbo MBS Credit Enhancement Levels Keep Falling*, Nomura fixed income research (2 Apr 2003); Villanueva, Adelson, and Leonard, *Jumbo MBS Credit Support Continues to Reach New Lows*, Nomura fixed income research (27 Mar 2002); Adelson, Sun, Nikoulis, and Manzi, *ABS Credit Migrations*, Nomura fixed income research (updated 5 Mar 2002); Villanueva, Adelson, and Leonard, *Jumbo MBS Credit Enhancement: More of the Same, or Less?*, Nomura fixed income research, (5 Dec 2001); Adelson, Villanueva, and Leonard, *Jumbo MBS: Where's the Credit Enhancement?*, Nomura fixed income research (12 Jul 2001).

[6] *See, e.g.*, Lucas, D., et al., *Why Is My Synthetic CDO Rated By Only One Rating Agency? …and… Why Is It Rated By This Particular Rating Agency?*, UBS CDO Insight (31 Mar 2006).

[7] *See, e.g.*, Dubitsky, R., et al., *A Day of Reckoning: Unprecedented Negative Rating Actions*, Credit Suisse fixed income research (12 Jul 2007)

[8] *See, e.g.*, Cifuentes, A. and Katsaros, G., *The One-Factor Gaussian Copula Applied To CDOs: Just Say NO (Or, If You See A Correlation Smile, She Is Laughing At Your "Results")*, working paper (9 May 2007); *see also*, Chen, N., et al., *The Young and the Restless: Correlation Drama at the Big Three Rating Agencies*, Wachovia Securities structured products research (22 Feb 2005); Lancaster, P., et al., *Default and Loss Games: Taking Another Look at CMBS Conduit Performance*, Wachovia Securities structured products research (9 Mar 2006).

Finally, strong evidence of transparency comes for the widespread discussion and debate of rating methodologies and alternative analytic approaches at the securitization industry's major conferences. At those events, presenters and panelists frequently discuss areas of concern on the credit landscape. Then, members of the audience discuss those matters further as they socialize between sessions and during the leisure activities.

Here are two concrete examples: First, the rating methodologies for rating MBS and CDOs rely extensively on quantitative models. The models in turn, rely on assumptions and have inherent limitations based on the data from which they are developed (*i.e.*, the range of their development samples). The limitations often come from the fact that a model may be used to predict future results for new products that have never actually experienced stressful conditions. For example, most of the data available for developing and calibrating MBS rating models comes from our recent period of rising home prices and benign economic conditions. Most of the data relates to basic, mainstream mortgage loans, rather than loans with multiple exotic features and risk factors.

Data covering times of stress is scarce. So is data relating to loans with multiple risk factors, such as loans with both high loan-to-value ratios and no documentation of borrower income. Nonetheless, rating models are called on to estimate the performance of such loans under stressful conditions. Although the models produce reasonable estimates of performance under stressful conditions, they are not the *only* reasonable estimates. Market participants have been able to "disagree" with rating models by using alternative assumptions or by ascribing less confidence to the models' estimates for stressful conditions. Many have done so and have tailored their investment strategies accordingly.

Second, the situation with CDO ratings is likewise unsurprising. The recently watchlisted CDOs are those that specialized in the riskiest pieces of sub-prime MBS deals. In essence, each one concentrated the riskiest classes from many sub-prime MBS deals into a CDO transaction. As in the MBS area, various commentators over the past several years have proposed using assumptions and approaches for estimating CDO risk that differed from the rating agency methodologies. Like the rating methodologies, those alternative approaches were well known by market participants in the sector, including investors.

Interestingly, this is not the first time that the CDO area has hurt itself badly by piling on exposure to a single sector. During the tech bubble, CDOs were eager buyers of junk bonds from tech companies. The subsequent troubles in the high yield bond market were amplified in the CDO sector and resulted in record numbers of CDO downgrades in 2002. Today, five years later, the trouble comes to CDOs not from the tech sector but from the sub-prime mortgage sector. In technical terms, the assets backing the CDOs displayed higher correlation than the rating agencies had assumed in their models. While the rating agencies carefully chose their correlation assumptions, those assumptions have been one of the most hotly debated aspects of CDO analysis *for years!* The fact that the real world did not behave according to a model and its underlying assumptions is simply not surprising to experienced professionals in the CDO area.

One would think that the high degree of *actual* transparency of rating methodologies for MBS and CDOs would make misconceptions about transparency unlikely. Obviously, this is not

the case. A few vocal critics have complained that the methodologies lack transparency. The complaints stem from just a few origins. First, some market participants, particularly those who have suffered disappointing results, want to blame someone else for their misfortunes. They try to use the rating agencies as scapegoats.

Second, although the rating methodologies are transparent, it takes a lot of work and technical expertise to fully understand them. Some market participants do not perceive the transparency because either (i) they are not willing to do the work or (ii) they lack sufficient technical expertise. By way of analogy consider this: the methodology for diagnosing and repairing a car's automatic transmission is fully transparent. Yet, the methodology appears completely opaque to individuals who are not already skilled auto mechanics.

Third, some of the recent commentary on the subject of transparency appears to originate from individuals who are not actual participants in the securitization market. They do not appear to be involved in buying, selling, structuring, or analyzing MBS or CDOs. Commentary from such individuals on the subject of transparency should be taken with a grain of salt. Such individuals *naturally* would not find the methodologies to be transparent because they have never acquired the relevant technical background to understand them. To reiterate a key point: although the rating methodologies are not rocket science, neither are they trivially simple. Instead, rating methodologies lie in the middle ground, where experience and technical knowledge are necessary but also ultimately within the reach of most professionals; like becoming a proficient chess or Scrabble® player.

## Timeliness of Recent Downgrades

A few market participants have accused the rating agencies of having been too slow to downgrade sub-prime MBS that they ultimately downgraded in early July. However, those professionals mistakenly ignore the fact that rating agencies need to continually strike a balance between being "trigger happy" and being "asleep at the switch." Had the rating agencies taken their actions in March or April, they would have been acting too soon. Had they waited until September or October, they would have been too late. Acting as they did, in early July, was just right, because by then there was enough actual performance data to conclude that the credit quality of the deals had deteriorated and that there was not just a temporary anomaly.

It is always easy to criticize with the benefit of hindsight. Whatever the rating agencies do, professionals on one side of the market or the other will find fault with it. If rating agencies are quicker to downgrade, they will cause more "false alarms" (downgrades that get reversed within a short time). Investors that already own the affected bonds, as well as the issuers and their bankers, will be dissatisfied. If rating agencies are slower to downgrade, investors who buy the securities shortly before the rating action will argue that the action should have been quicker and that if it had been they would have decided not to invest.

## Conflicts of Interest

Rating agencies face potential conflicts of interest because they accept payment from companies about whose bonds they provide opinions. One kind of potential conflict is the same

one faced by most publishing companies. For example, *Motor Trend* magazine offers opinions about cars *and* receives advertising revenue from the manufacturers. In the current issue, *Motor Trend* evaluates the Honda Accord EX-L against the Toyota Camry SE. In another article the magazine compares the Porsche 911 GT3 RS, the Chevrolet Corvette Z06, the Dodge Viper SRT-10, and the Lamborghini Murciélago LP640. Does the presence of commercial relationships with the manufactures (*i.e.*, advertising) *necessarily* taint the magazine's product reviews? Obviously it does not. Indeed, in the comparison of powerful sports cars, the magazine found that *none* of the four cars achieved the top speed claimed by its manufacturer.

On the other hand, it is unrealistic to ignore the possibility of a taint. The issue of conflicts arises even in medical journals:

> Many societies depend on income from their journal to support other initiatives of interest to the membership. Income is increasingly dependent on advertising revenue – thus, there may be subtle but real pressures to please the industry partners with content and editorial position. This pressure is the accepted reason for the dismissal of at least one high-profile Editor-in-Chief who did not do as the society wished.[9]

I am not aware of any instance where a rating agency gave a higher (or lower) rating to securities of a specific issuer because that issuer (or any of its competitors) paid substantial rating fees to the rating agency. Accordingly, rating agencies should be expected to handle these kinds of conflicts of interest in the same manner that other publishing companies do. If they fail to do so, they should be called to account for the failure. Until then, they should be left to handle the "advertising" type of potential conflict in the same manner that they have done so for almost 100 years.

There is, however, another type of potential conflict of interest that can affect rating agencies. It is the potential conflict of interest that arises when rating agencies compete to win business from many issuers in a sector by generally loosening their rating standards for the entire sector. This practice has been termed *competitive laxity*. The credit rating industry is potentially vulnerable to the threat of competitive laxity in areas where issuers can engage in *rating shopping*. Rating shopping refers to the practice among issuers of presenting their transactions to multiple rating agencies and then selecting only some of them (usually one or two) based on which ones will permit the highest leverage and still grant the desired ratings.

It is indisputable that securitization issuers in the MBS, CMBS, and CDO areas engage in rating shopping. They do so openly. However, the degree to which rating shopping has promoted competitive laxity is not entirely clear. There is no conclusive evidence that the major rating agencies have ever succumbed to the effects of rating shopping and engaged in competitive laxity. In fact, even though rating shopping became rampant in the early 1990s, the major rating agencies achieved highly impressive track records during that time and in the years that followed.[10]

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[9] Smith, E., *Editorial Independence*, Canadian Journal of Cardiology, vol. 8, no. 6 (June 2002).

[10] Adelson and Bartlett, *ABS Credit Migration Update*, JOURNAL OF STRUCTURED FINANCE (Fall 2005); Adelson, Hoyt, and Manzi, *CMBS Watchlistings, Downgrades, and Surveillance*, Nomura fixed income research (2 Oct

Rating methodologies naturally evolve over time as business practices and deal structures change. Overall, the evolutionary process includes numerous small changes, some of which lean toward stricter standards while others lean toward looser standards. The incremental changes are not individually significant. Rather, the larger trend is what matters. Even so, a trend of looser standards may reflect a genuine change in a rating agency's point of view rather than a position influenced by a conflict of interest.

Consider the following: Suppose that one rating agency has a methodology that calls for an equity cushion of 10% in a certain type of deal. Suppose that a second rating agency has a methodology that calls for a cushion of 15% and that a third calls for a cushion of 20%. If deals of that type customarily carry two ratings, the issuers will always select the first and second rating agencies. The deals will have cushions of 15% because that it is stricter of the two requirements of the first two rating agencies. The 20% requirement of the third rating agency will not be visible in the market because that rating agency will never be selected to rate any deals. If the situation persists for many months (or even years) the analysts at the third rating agency may start to question their own position. They will come to observe widespread and long-standing acceptance of the 15% cushion by investors and other market participants. They will hold their position for a while, but eventually they will start to question themselves. They will ask whether they really know better than everyone else, who have accepted the 15% cushion as sufficient. In the end, the need to observe "a decent respect to the opinions of mankind"[11] will probably move them to abandon the 20% standard in favor of 15%. It is not clear whether such a scenario should be described as an instance of competitive laxity.

Now consider another example using the same facts except that both the second and third rating agencies initially have methodologies that call for a cushion of 15%. In this case, all three rating agencies will appear on deals because the 15% level is the lowest common denominator for having two ratings. All other things being equal, each rating agency would be hired to rate two-thirds of the deals (two agencies per deal). Now suppose that the second rating agency decides to change its methodology so that a cushion of 12% is enough. In that case, all the issuers will start choosing the first and second rating agencies for their deals. The deals will all have cushions of 12% and the third rating agency will have no presence in the sector. If the second rating agency changed its methodology to gain market share, then the example is one of competitive laxity

The best way to combat the threat of competitive laxity is to encourage rating agencies to openly challenge their competitors' ratings when they have differing opinions. In this way, the rating agencies keep each other honest by engaging in a public debate. The most powerful

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2003); Adelson and Hoyt, *CMBS Credit Migrations*, JOURNAL OF PORTFOLIO MANAGEMENT (Special Real Estate, Fall 2003), Adelson and Hoyt, *Temporal Aspects of CMBS Downgrades and Surveillance*, Nomura fixed income research, (1 Jul 2003); Adelson, Sun, Nikoulis, and Manzi, *ABS Credit Migrations*, Nomura fixed income research (updated 5 Mar 2002); *see also*, Hu, J., et al., *Default & Loss Rates of Structured Finance Securities: 1993-2006*, Moody's special comment (April 2007); Tung, J., et al., *Structured Finance Rating Transitions: 1983-2006*, Moody's special comment (January 2007); Vazza, D. et al., *Annual 2006 Global Corporate Default Study and Rating Transitions*, S&P special report, Appendix III (5 Feb 2007);

[11] Declaration of Independence (1776).

vehicle through which rating agencies can challenge their competitors' views is with *unsolicited ratings*. An unsolicited rating is one that an agency assigns without having been asked to do so by the issuer of the affected security. In fact, an issuer that has engaged in rating shopping typically would complain vocally about receiving an unsolicited rating. The issuer might assert that it was being "bullied" or "blackmailed" by the rating agency that assigned the unsolicited rating.

For many years, S&P and Moody's assigned unsolicited ratings on instruments in most areas of the fixed income capital markets. However, practices started to change in the mid-1990s. Around that time, some rating agencies declared that they would not assign unsolicited ratings to securities from securitizations.[12] That action was perceived favorably by issuers and bankers, and the remaining rating agencies faced pressure to stop issuing such ratings themselves. Eventually all the rating agencies stopped issuing unsolicited ratings on securitization securities. The rating industry's core method for policing itself had crumbled.

Interestingly, when Congress and the SEC have previously considered rating agency practices, they have focused on unsolicited ratings as a potential abuse of power by the rating agencies. Unfortunately, they ignored the critical role of unsolicited ratings as a check on the potential erosion of standards that might come from rating shopping.

To re-establish appropriate checks and balances to prevent the erosion of standards, Congress should consider encouraging or requiring each rating agency that holds the NRSRO designation to issue unsolicited ratings on at least 3%-5% of the securities or deals that are shopped away from it. Under such a framework, it would be impossible for any single rating agency to curry favor with issuers and bankers by refraining from the "hostile" practice of assigning unsolicited ratings.

## Conclusions

Securitization has become a large and beneficial feature of the American financial landscape. Credit ratings are important aids to investors in their decision-making process because they attempt to simplify the complex nature of credit risk into a one-dimensional measure. Nonetheless, the nature of credit risk in securitization is sufficiently complex that reasonable people starting with the same facts can reasonably reach different conclusions. This is partly why the existence of multiple rating agencies with differing rating methodologies is beneficial to the market.

The complexity of credit risk in securitization leads to complexity in rating methodologies. Accordingly, it takes substantial work and technical expertise to fully understand a rating agency's methodology in a given area. Despite an extremely high level of transparency of rating methodologies for MBS and CDOs, there is a persisting misconception that those methodologies are opaque black boxes.

[12] *See* Richard Cantor and Frank Packer, *The Credit Rating Industry*, 19 FRBNY Q. REV. 1, 4 (Summer-Fall 1994).

Monday-morning quarterbacks criticize a football team's strategy and performance with the benefit of hindsight. In similar fashion, certain market participants criticize rating agencies for being too quick or too slow to upgrade or downgrade ratings during periods of volatility. Those criticisms are generally unwarranted and unjustified because the rating agencies must continually strike a balance between being "trigger happy" and "asleep at the switch."

Finally, although conflicts of interest are a real issue, rating agencies have dealt with such conflicts appropriately for a long time. The main conflict that they face is the same one that other publishers handle through preserving editorial independence in the face of pressure from advertisers. The problem of competitive laxity is peculiar to the rating industry and it has been exacerbated by rating shopping. The industry's counterbalancing practice of assigning unsolicited ratings has been derailed in the area of securitizations. An appropriate equilibrium can be restored by encouraging or mandating a resumption of that practice.

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