

# THE RATING AGENCY SYSTEM

BROKEN, FINE OR SERIOUSLY DISCONNECTED

The American Enterprise Institute

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# SERIOUS DISCONNECTS

- RATING AGENCY
- ISSUERS
- INVESTORS

# RATING AGENCY DISCONNECTS

- PHILOSOPHICAL
- PROFITS vs ANALYTICS
- INITIAL RATINGS vs SURVEILLANCE
- UNDERWRITING REVIEWS
- SERVICER REVIEWS

# PHILOSOPHICAL

## All AAAs Are [NOT] Equal

- CORPORATES
- Fundamental Credit Analysis
- Going Concern & Management Review
- Committee Votes
- RMBS
- Collateral Analysis  
FF X LS = CE
- Structured Analysis
- Committee is “QC”

# AAA PERFORMANCE

- Default vs Downgrade
- Structured default experience is better than Corporates
- Down Grades-Transition studies
  - Corporate down grades evolve
  - RMBS- “warnings” began in 2005, downgrades lumped in 2007. WHY?

# ANALYTICS vs PROFIT

- RMBS Rating Process

It's the collateral!

Economic models give FF

Historic analysis provide LS

Stressed scenarios yield CE

Models incorporate HPIs for LTV check

Tapes include 60 to more than 80 fields per loan

Data, and lots of it, drives the process

**THE DISCONNECT: MODEL BUILDING AND  
MAINTENANCE COSTS A LOT OF MONEY**

# INITIAL RATINGS & SURVEILLANCE

- Ratings at loan level vs Pool level surveillance
- Delinquency transitions 30/60/90 day
- Ratings volatility
- **Disconnect: Agencies do not use the rating model to re-rate securities under surveillance**

# UNDERWRITING REVIEWS

- By Products: Prime, Alt-A, Subprime, HELOC, etc.
- Check appropriateness of guidelines to products
- Quality of underwriting & management
- Strength to absorb Reps. & Warranties

- **DISCONNECTS:**

**REVIEW vs “APPLICATION”**

**“WHAT’S IN A NAME”: ALT-A EXPERIENCE**

# SERVICER REVIEWS

- Product specific
- “Quality” of process
- “Financial strength”
- Management
- Basic Pass/Fail system

**DISCONNECTS: NOT ALLOWED TO SCORE  
PERFORMANCE**

**MEASURING R&W LIABILITY COVERAGE**

# ISSUER DISCONNECTS

- “NAMING” POOLS
- DUE DILIGENCE & EXCEPTIONS
- VERACITY OF DATA
- REPS. & WARRANTIES

# INVESTOR DISCONNECTS

- LACK OF PURCHASE DISCIPLINE
- NO COMPREHENSIVE ANALYSIS
- DO NOT UNDERSTAND RATING AGENCY SURVEILLANCE
- “FIRST OUT THE DOOR” FALLACY
- CREDIT vs LIQUIDITY

# FIXING THE PROBLEM NOT THE BLAME

- Adequate disclosure (SEC?)
  - Third party due diligence report findings
  - UW performance scoring
- Credit Risk Management Information
  - Servicer performance scoring
  - Originator/Underwriter performance scoring

# FIXING THE PROBLEM NOT THE BLAME

- Rating Agencies should
  - Update models at least annually
  - Use the same loan level data
  - Use the same models for rating and surveillance
  - Publish surveillance criteria
- Issuers/servicers should provide loan level performance data to the public domain
- Investors should use their \$ votes to purchase securities that provide adequate disclosure and performance data.