



Credit Rating Agencies and the Financial Crisis of 2007-2008: What Went Wrong—and Will it Happen Again?

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**Labaton
Sucharow**



Program Overview

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- The Role of Credit Rating Agencies in the Financial Crisis
 - Lisa Lindsley (American Federation of State, County, and Municipal Employees)
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 - Michael Stocker, Esq. (Labaton Sucharow LLP)
- Credit Rating Agencies: From Information Providers to Gatekeepers and Back Again
 - Barbara Roper (Consumer Federation of America)



Mechanics of Credit Ratings

Sean Egan
President and Founding Principal
Egan-Jones Ratings Company



Background

- History and purpose of credit rating agencies
- Gatekeeper function
- Rating process
- Payment structure



NRSROs

- Nationally Recognized Statistical Rating Organization
- A firm recognized by the SEC as a rating firm
- Annual review by the SEC
- Restrictions on actions and activities
- Ratings treated as opinions

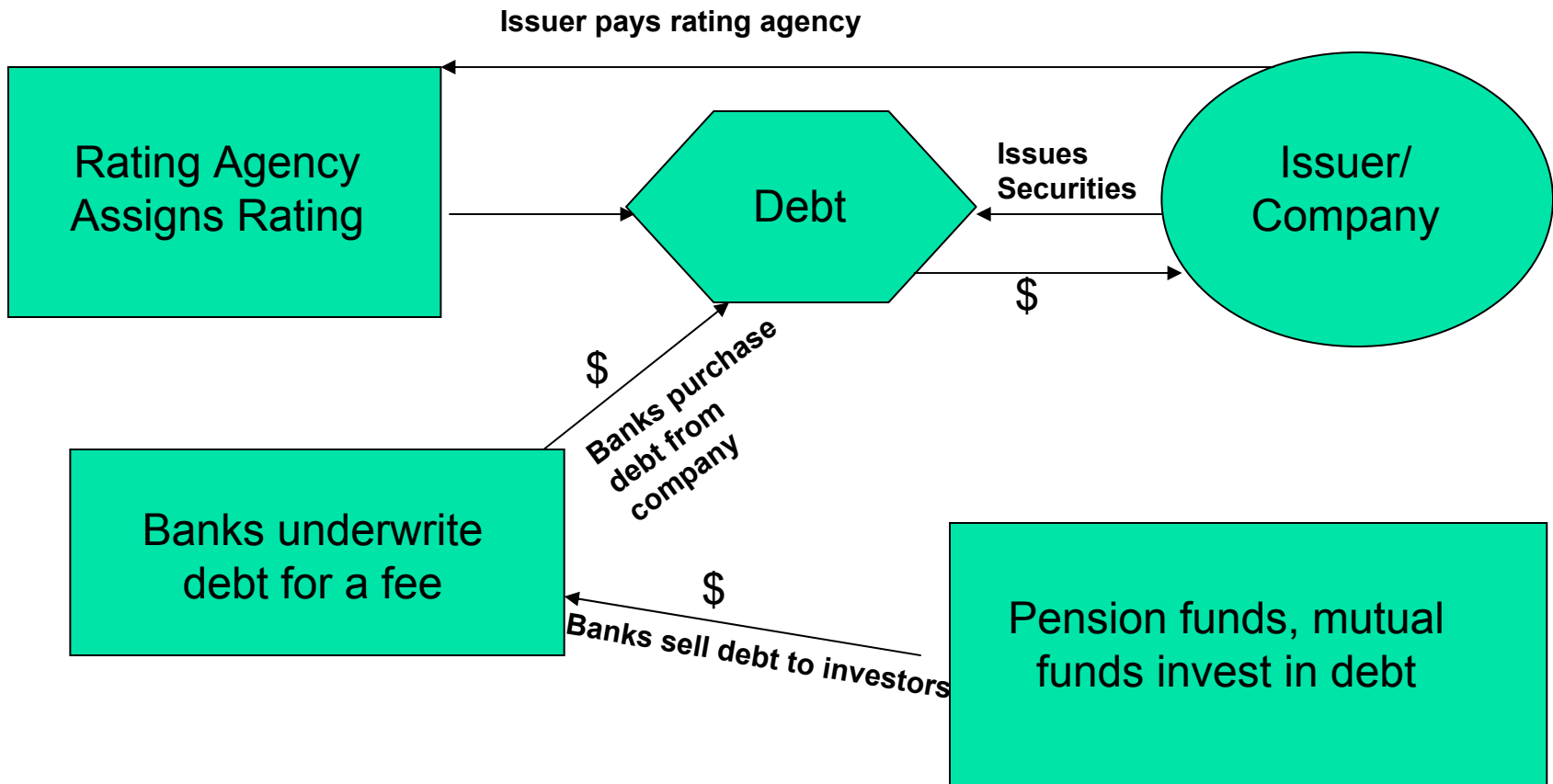


The Rating Process

- Initiation or updating of rating
- Review of issuer/ issue
- Suggestion of rating
- Review and approval of rating
- Issuance and monitoring

Overview of Participants

(source: UFCW, a voice for working America)





Core Problems

US Senate Permanent Subcommittee on Investigations (Sen. Levin):

“The conflict of interest inherent in an issuer pay set-up is clear: rating agencies are incentivized to offer the highest ratings, as opposed to offering the most accurate ratings.”



Core Problems (continued)

US Senate Permanent Subcommittee on Investigations (Sen. Levin):

“The issuers and the investment banks engaged in ‘rating shopping’ choosing the rating agency that offers the highest ratings.”



Role of Credit Rating Agencies in the Financial Crisis

Lisa Lindsley

Director, Capital Strategies

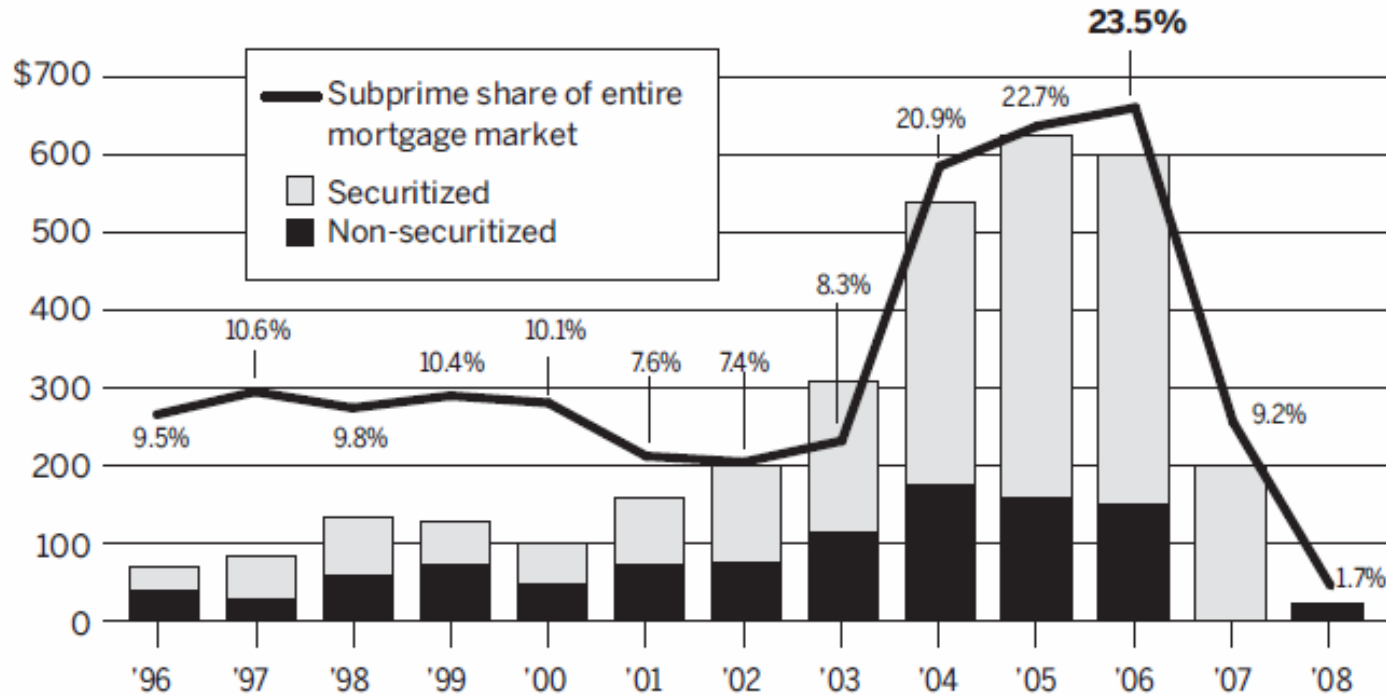
American Federation of State, County and Municipal Employees

April 21, 2011



Securitization that Fueled Subprime Bubble Depended on Ratings

IN BILLIONS OF DOLLARS



NOTE: Percent securitized is defined as subprime securities issued divided by originations in a given year. In 2007, securities issued exceeded originations.

SOURCE: Inside Mortgage Finance

FCIC Report, pg. 70, figure 5.2



Mortgage-Backed Securities (MBS) of Bundled Housing Loans are Rated Investment Grade

1 Originate

Lenders extend mortgages, including subprime and Alt-A loans.



Pool of Mortgages

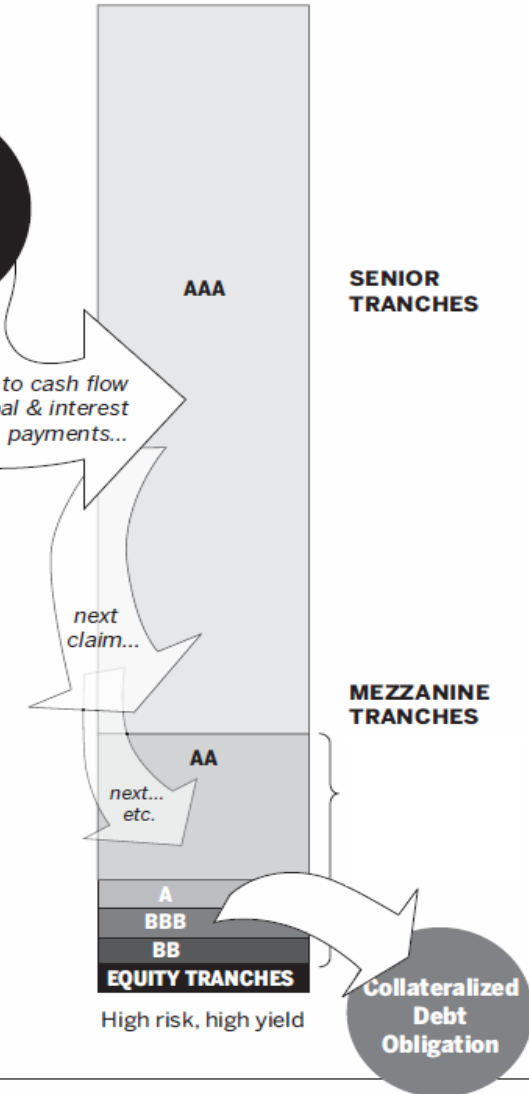
2 Pool

Securities firms purchase these loans and pool them.

3 Tranche

Residential mortgage-backed securities are sold to investors, giving them the right to the principal and interest from the mortgages. These securities are sold in tranches, or slices. The flow of cash determines the rating of the securities, with AAA tranches getting the first cut of principal and interest payments, then AA, then A, and so on.

RMBS TRANCHES
Low risk, low yield



FCIC Report, pg. 73, figure 5.3





MBS Packaged into Collateralized Debt Obligations also Rated Investment Grade

1. Purchase

The CDO manager and securities firm select and purchase assets, such as some of the lower-rated tranches of mortgage-backed securities.

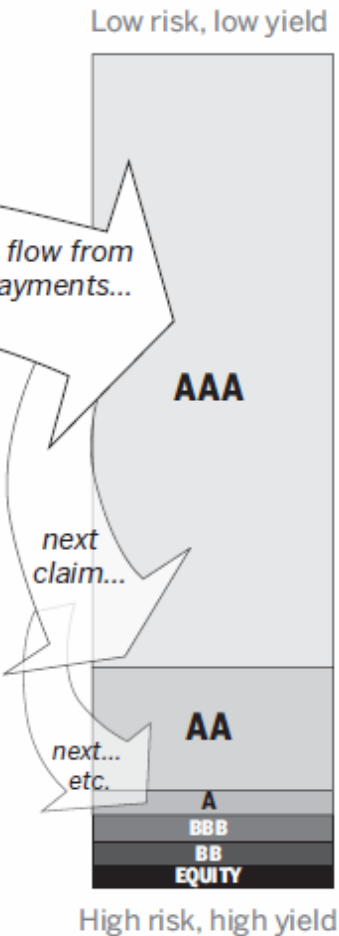


New pool of RMBS and other securities

2. Pool

The CDO manager and securities firm pool various assets in an attempt to get diversification benefits.

First claim to cash flow from principal & interest payments...



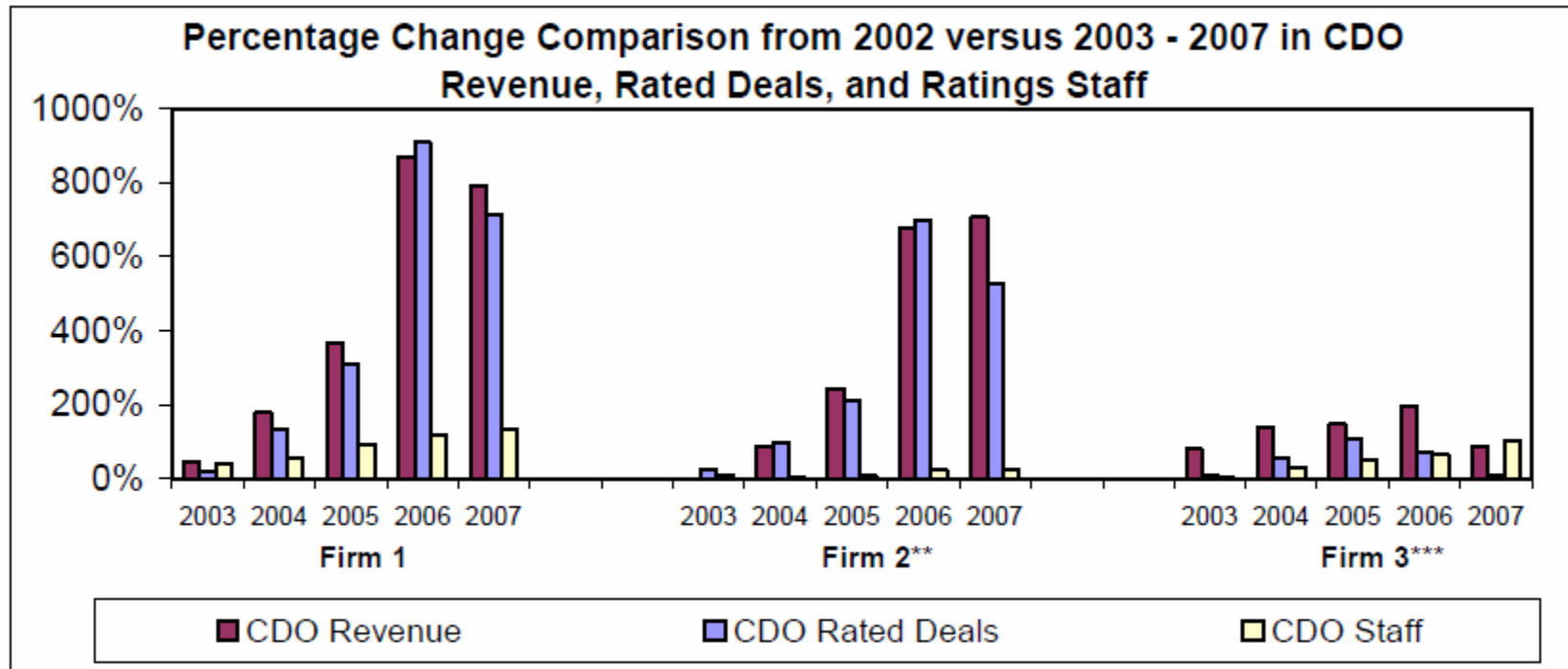
3. CDO tranches

Similar to mortgage-backed securities, the CDO issues securities in tranches that vary based on their place in the cash flow waterfall.

FCIC Report, pg. 128, figure 8.1



Despite Record Revenues, Inadequate Resources Allocated



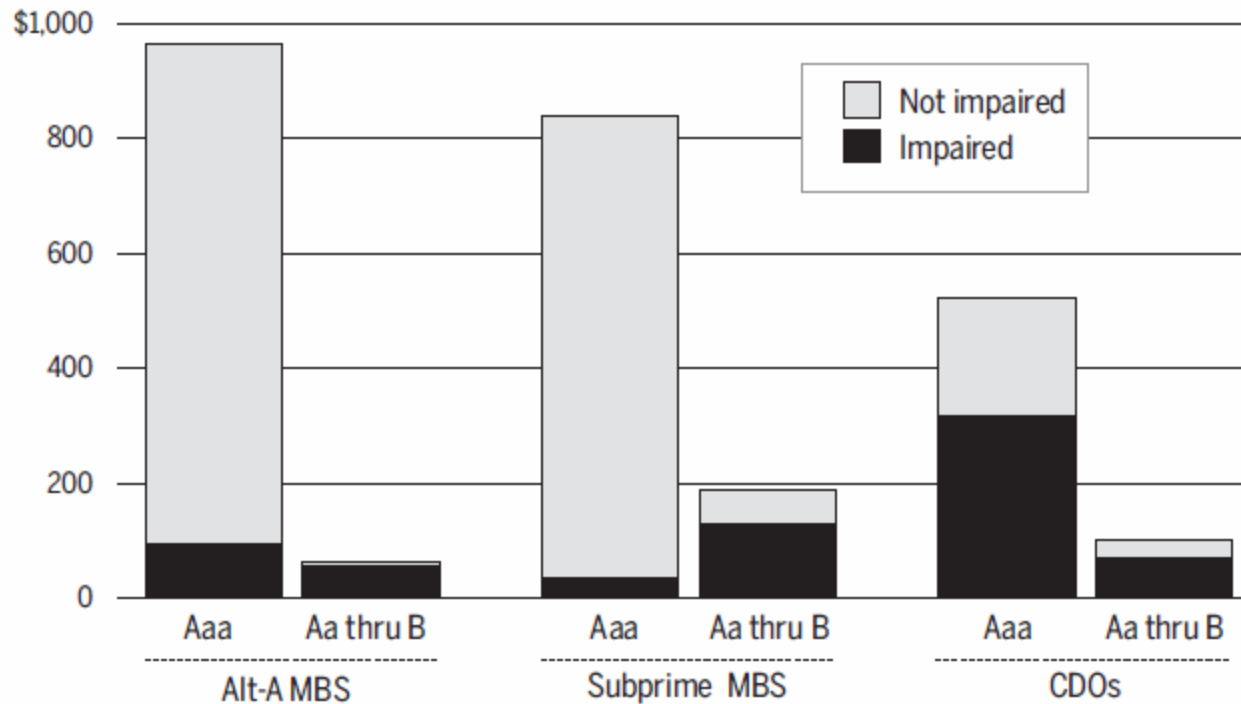
“...it could be structured by cows and we would rate it.”

“even bigger monster – the CDO market. Let’s hope we are all wealthy and retired by the time this house of cards falters.”



Impairment of 2005-2007 MBS & CDOs at year-end 2009, by initial rating

IN BILLIONS OF DOLLARS



SOURCE: Moody's Investors Service, "Special Comment: Default & Loss Rates of Structured Finance Securities: 1993-2009"; Moody's SFDRS.



Late Downgrades Exacerbate Crisis in Financial Markets

- January 2007 – nearly 10% of all subprime loans delinquent, an increase of 68% over prior year.
- First half 2007 – Moody's and S&P continue to issue AAA ratings for RMBS & CDO issues.
 - S&P issues 1,500 new RMBS ratings in first week of July '07
 - Moody's issues 675 new RMBS ratings week of July 5, 2007
- July 10, 2007 – Downgrades begin
 - S&P places \$7billion original value on watch for downgrade
 - Moody's downgrades \$5.2 billion original value RMBS



Financial Crisis Inquiry Commission: “...the Credit Rating Agencies abysmally failed in their mission to provide quality ratings on securities...”

“We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction. The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were obligated to use them, or regulatory capital standards were hinged on them. This crisis could not have happened without the rating agencies. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms.

“In our report, you will read about the breakdowns at Moody’s, examined by the Commission as a case study. From 2000 to 2007, Moody’s rated nearly 45,000 mortgage-related securities as triple-A. This compares with six private-sector companies in the United States that carried this coveted rating in early 2010. In 2006 alone, Moody’s put its triple-A stamp of approval on 30 mortgage-related securities every working day. The results were disastrous: 83% of the mortgage securities rated triple-A that year ultimately were downgraded.

“You will also read about the forces at work behind the breakdowns at Moody’s, including the flawed computer models, the pressure from financial firms that paid for the ratings, the relentless drive for market share, the lack of resources to do the job despite record profits, and the absence of meaningful public oversight. And you will see that without the active participation of the rating agencies, the market for mortgage-related securities could not have been what it became.”



Resources

- http://hsgac.senate.gov/public/files/Financial_Crisis/042310Exhibits.pdf
- http://levin.senate.gov/newsroom/supporting/2011/PSI_WallStreetCrisis_041311.pdf
- <http://fcic.law.stanford.edu/report/>
- <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>



Efforts to Reform the Rating Process

Jeff Mahoney

General Counsel

Council of Institutional Investors



The Investors' Working Group*

- Problems Identified
 - Conflicts of interest
 - Lax regulatory oversight
 - Overreliance on ratings
 - Limited liability

* A Report by the Investors' Work Group, "U.S. Financial Regulatory Reform: The Investors' Perspective" (July 2009), available at [http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%27%20Working%20Group%20Report%20\(July%202009\).pdf](http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%27%20Working%20Group%20Report%20(July%202009).pdf).



Conflicts of Interest

- IWG Findings
 - Conflicted issuer-pays model
- IWG Recommendations
 - Establish executive-level compliance officers
 - Enhance disclosures
 - Pursue alternative compensation system
- Dodd-Frank Response
 - Studies
 - § 939D – GAO: Alternative business model
 - § 939F – SEC: Assigned ratings for structured finance products
 - § 939C – SEC: Management of other services
 - Compliance officers
 - § 932 – Expands responsibilities & disclosures



Lax Regulatory Oversight

- IWG Findings
 - Limited SEC oversight
- IWG Recommendations
 - Expand & strengthen SEC authority
- Dodd-Frank Response
 - § 932 – Establishes Office of Credit Ratings
 - § 932 – Expands SEC authority



Overreliance on Ratings

- IWG Findings
 - Referenced in statutes and regulations
 - Focused on by investors
- IWG Recommendations
 - Remove references over time
 - Reduce investor dependence
- Dodd-Frank Response
 - § 939 – Eliminates certain statutory references
 - § 939A – Directs regulators to review and substitute alternative standards



Limited Liability

- IWG Findings
 - Limited civil liability contributed to poor performance and conflicts of interest
- IWG Recommendations
 - Eliminate Rule 436(g)
- Dodd-Frank Response
 - § 933 – Modifies enforcement and penalty provisions of Exchange Act
 - § 933 – Modifies state of mind in securities fraud actions
 - § 939G – Eliminates Rule 436(g)



Current Controversy over NRSRO Liability

Michael Stocker

Partner

Labaton Sucharow LLP



Regulation AB

17 C.F.R. Subpart § 229.1120-Ratings

Disclose whether the issuance or sale of any class of offered securities is ***conditioned on the assignment of a rating*** by one or more rating agencies, whether or not NRSROs. ***If so, identify each rating agency and the minimum rating*** that must be assigned. Describe any arrangements to have such rating monitored while the asset-backed securities are outstanding.



Dodd-Frank Wall Street Reform and Consumer Protection Act

§939G. Effect of Rule 436(G).

Rule 436(g), promulgated by the Securities and Exchange Commission under the Securities Act of 1933 ***shall have no force or effect.***



SEC Rule 436(g)(1)

... the security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock **by a nationally recognized statistical rating organization ... *shall not be considered a part of the registration statement*** prepared or certified by a person within the meaning of sections 7 and 11 of the Act.
17 C.F.R. §230.436(g)(1).



Section 11 of Securities Act of 1933 Civil Liabilities on Account of False Registration Statement

a. Persons possessing cause of action; persons liable

In case any part of the registration statement ... contained ***an untrue statement of a material fact or omitted to state a material fact*** required to be stated therein or ***necessary to make the statements therein not misleading***, any person acquiring such security ... may, either at law or in equity... sue--

- (4) every accountant, engineer, or appraiser, or ***any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement,*** ... which purports to have been prepared or certified by him



Ford Letter to the SEC

... As you are aware, the Dodd-Frank Wall Street Reform and Consumer Protection Act provides that Rule 436(g) of the Securities Act of 1933 ... shall have no force and effect. Several of the **"nationally recognized statistical rating organizations" ("NRSROs") have indicated that they are not willing to provide their consent** to the inclusion of their names or ratings in registration statements or prospectuses ... As a result, **the Registrant is unable to comply with Rules 1103(a)(9) and 1120 of Regulation AB ...**

Accordingly, on behalf of the Sponsor and the Registrant, **I respectfully request from the Staff (the "Staff") of the Commission assurance that ... the Staff will not recommend enforcement action to the Commission ...**



SEC's No Action Letter dated 11/23/2010

... ***The division has determined to extend the no-action position*** to allow adequate time to complete the regulatory actions required by the Dodd-Frank Act. We are doing this to facilitate our consideration of whether and, if so, how those final regulatory actions should ***affect the Commission's disclosure requirements regarding credit ratings for asset-backed securities offerings*** the Division is extending the relief issued to you by letter dated July 22, 2010. Pending further notice, ***the Division will not recommend enforcement action to the Commission*** if an asset-backed securities issuer ... omits the ratings disclosure required by ... Regulation AB ...



Stivers Amendment to Dodd-Frank Act

§1. Restoration of Rule Relating to a Certain Exemption for Rating Agencies.

Effective as of the date of enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, ***Section 939G of such Act is repealed, and the regulation repealed by such section is restored or revived*** as if such section had not been enacted.

(Discussion draft of the Asset-Backed Market Stabilization Act)



From Information Providers to Gatekeepers and Back Again

Reducing Regulatory Reliance on Credit Ratings

Barbara Roper
Director of Investor Protection
Consumer Federation of America



From Information Providers to Gatekeepers

- **Origins as investor-paid information providers**

Credit rating agencies got their start in the early 1900s as information providers. Paid by investors who subscribed to their services, the ratings agencies compiled information that it would have been difficult or costly for their subscribers to compile on their own.

- **After the 1929 market crash, a more formal role**

Credit rating agencies first took on a more formal role in the financial system after the 1929 stock market crash. In an effort to limit speculative investments by banks and insurance companies, regulators began in the mid-30s to limit these financial institutions to investing only in “investment grade” securities, as determined by the rating agencies.



From Information Providers to Gatekeepers

- Nationally Recognized Statistical Rating Organizations

The collapse of the Penn Central railroad in 1970 led to a renewed concern about credit quality. To reduce the risk exposure of securities firms, the Securities and Exchange Commission (SEC) incorporated credit ratings into the net capital requirements for broker-dealers.

To ensure that only credible ratings were used for this purpose, the SEC in 1975 introduced the concept of Nationally Recognized Statistical Rating Organization (NRSRO), and grandfathered in the three large firms – Moody's Investor Service, Standard & Poor's, and Fitch Ratings.



From Information Providers to Gatekeepers

- Growing reliance without increased regulation

Following the SEC's action, credit ratings were increasingly incorporated in statutes at the federal and state level.

Investment guidelines for pension funds, endowment funds, and other private entities also came to rely on the ratings.

As a result, credit rating agencies became the quasi-official arbiters of credit risk throughout the financial system.

Although they were recognized by the SEC through a "no action" letter process, NRSROs were not subject to new regulatory requirements in keeping with their expanded role.



From Information Providers to Gatekeepers

- In financial crisis, ratings agencies fail to fulfill their gatekeeper function

Because they both determined the ability of institutions to purchase mortgage-backed securities (MBS) and, in a market characterized by inadequate disclosure, served as virtually the only source of information about their risks, NRSROs were the ultimate gatekeepers in the MBS market.

Unfortunately, putting profits over professionalism, they failed to fulfill their gatekeeper function. The ensuing financial collapse fully revealed for the first time the extent of the systemic risk that undue reliance on ratings had produced.



... And Back Again

- Dodd-Frank Act Adopts Multi-Faceted Reforms

In its approach to credit rating agency reform, the Dodd-Frank Act attempts both to restore credit rating agency reliability and to reduce the financial system's vulnerability to ratings failures. It does this by:

- Enhancing regulatory oversight of ratings agencies
- Increasing rating agency legal accountability
- Strengthening (modestly) rating agency independence and improving corporate governance at rating agencies
- Making ratings more transparent
- Reducing regulatory reliance on ratings



... And Back Again

- Removing rating references from financial statutes

Section 939 of the Dodd-Frank Act strikes references to ratings from various federal financial statutes:

- The Federal Deposit Insurance Act
- The Federal Housing Enterprises Financial Safety and Soundness Act
- The Investment Company Act
- Revised Statutes of the United States
- The Securities Exchange Act
- World Bank Discussions

In most cases, it substitutes a reference to alternative “standards of credit-worthiness” to be established by regulators. It allows two years from enactment for those amendments to take effect.



... And Back Again

- Removing ratings references from regulations

Section 939A of Dodd-Frank gives each federal agency one year from enactment:

- to review its regulations to identify references to credit ratings and to the use of assessments of credit risk;
- to modify the regulations identified by the review to remove any reference to or requirement of reliance on credit ratings; and
- to substitute a standard of credit-worthiness that the agency determines is appropriate.



... And Back Again

- Removing ratings references from regulations (cont.)

Each regulator is encouraged to establish, to the extent feasible, uniform standards of credit-worthiness for use by the agency, taking into account the entities regulated by the agency and the purposes for which the standards of credit-worthiness would be used.

Each regulator is required to report back to Congress on the results of its review and the modifications made.



... And Back Again

- Regulatory efforts to date

The SEC and the federal banking regulators have begun the rule-making process to replace references to ratings.

- Proposed revisions to Reg AB
- Proposed revisions to money market fund rules
- Proposed revisions to risk-based capital standards



... And Back Again

- Regulation AB

In April 2010, the SEC proposed changes to Regulation AB that would, among other things, add four new criteria for asset-backed securities to qualify for sale through shelf-registration:

- CEO certification
- Risk retention
- Third-party review of repurchase obligations
- Periodic reporting

In addition, the revised rule would provide greater transparency with regard to assets underlying the securities and more timely disclosure so that investors receive better information on which to base an investment decision.



... And Back Again

- Money market mutual fund rules

In March, the SEC re-proposed changes to rules regarding money market mutual funds to eliminate references to ratings. Under that proposal:

- Money market mutual funds would no longer be limited to holding investment grade securities.
- The obligation of fund boards or their delegates to make their own assessment of credit-worthiness is reemphasized, but would not fundamentally change.
- Funds would be free to consider ratings as one factor in making that assessment, but they would not be required to do so. Nor does the rule specify other factors they would be required to consider.



... And Back Again

- Risk-based capital standards

In August 2010, the OCC, Federal Reserve, FDIC and OTS issued an Advance Notice of Proposed Rulemaking identifying the areas in the agencies' risk-based capital standards that make reference to credit ratings.

- The agencies sought suggestions regarding alternative credit-worthiness standards.
- One challenge, Basel III relies extensively on credit ratings to assign risk weights to various exposures.



... And Back Again

- What these proposals have in common

Since these regulatory changes all remain in the proposal stage, we do not know what the final outcome will be. But they do have several features in common:

- None actually specifies any alternative measures of credit-worthiness, as the legislation appears to intend, although the bank regulators may still do so with regard to capital standards.
- Instead, all place a premium on the ability of investors and financial institutions to conduct their own, independent assessments of credit quality.
- All would continue to permit ratings to be used as a factor in measuring credit-worthiness.



... And Back Again

- What does that mean for the future of rating agencies?

Even after we've purged all references to ratings from our financial laws and regulations, credit ratings are almost certain to continue to play a significant role in measuring credit risk.

Indeed, unless regulators do more to identify additional, alternative measures of credit quality, it is not clear that ratings' role will diminish significantly.

That makes the other provisions in Dodd-Frank designed to improve rating quality all the more important.



From Information Providers to Gatekeepers and Back Again

- Conclusion

The market needs reliable measures of credit risk. If we are really going to reduce our reliance on credit rating agencies to provide that assessment, far more thought needs to go into identifying additional, alternative measures of credit risk. In the meantime, regulators must not stint in their efforts to make credit rating agencies more independent, better regulated, and more accountable and to make credit ratings more transparent and more reliable.