Memo

Re: SEC Roundtable Discussion on the Credit Ratings Agencies (CRAs)
From: Paul A. Ullman

Background:

I have spent my entire twenty seven year career in the asset-backed (ABS) and mortgage-backed (MBS) securities markets. First ('82-'89), I worked at Salomon Brothers Inc. as a salesperson and trader. Then ('90-'97) I was at Hyperion Capital and Alliance Capital Management with portfolio responsibilities for their respective specialty MBS and ABS investment management businesses. For the last eleven years, I have been President and CIO of a MBS/ABS focused hedge fund company called HFH Group LLC. Very recently, several partners and I have formed an Agency MBS REIT called Madison Square Capital Inc. of which I am CEO.

I am writing as follow up to the roundtable discussion on the credit rating agencies held at SEC headquarters on April 15, 2009. The form of my memo is to summarize what I believe to be the important responses to Chairman Shapiro's introductory questions and further to offer my opinion on these same questions.

It is my view that the preconditions to the present financial difficulties were an insufficient regulatory framework that failed to mandate useful and standardized financial transparency (particularly in the structured finance marketplace) and permitted excessive leverage of poorly underwritten NRSRO rated mortgage-backed and asset-backed securities.

Personally, I am interested in entering the discussion as an experienced operator without conflict with the constituencies discussed below.

Executive Summary

Practical solutions to the systemic problems revealed by the current credit and liquidity crisis are needed. Many of these systemic problems are directly related to poor transaction transparency, poor credit underwriting by investment managers, a deeply flawed system of NRSRO rating (particularly with respect to the AAA rating category) and excessive leverage of NRSRO rated AAA securities. In brief, I argue for SEC action that would demand: 1. Far greater information disclosure by loan originators as part of the public securitization process; 2. Changes to the NRSRO fee negotiation and payment structure; 3. Changes to the regulatory capital charges for rated securities; 4. Changes to what is acceptable with respect to NRSRO ratings; 5. Changes to the type of disclosure that investment managers must provide their investors. It is my view that the most efficient method of altering the system to reduce systemic risk is at the margin, rather than wholesale structural change that may be difficult to implement.

Initial Questions Posed By Chairman Shapiro

1. Does one form of a rating agency business model represent a better way of managing conflicts of interest than another?

2. Do users of ratings have all the information they need to make the most informed decisions?

3. a. Should the government foster increased competition in the rating agency business?
   b. Should the government abolish the NRSRO designation?
   c. Should the government end or limit its reliance on NRSROs?
   d. Should the government force the NRSROs to assume additional liability for their actions?

4. Are there some securities products that are so inherently complicated or risky that ratings are at best meaningless or worse, misleading?

5. Should investors re-examine the way that they look at ratings to ensure that the ratings represent the beginning of due diligence and not the end?

Question One:
Does one form of a rating agency business model represent a better way of managing conflicts of interest than another?

There was broad but not universal agreement that a subscriber based revenue model is less conflict prone than an issuer pay system. There was also broad agreement that a subscriber pay system has imbedded in it limitations and biases as well.

My view:
1. The issuer pay system is now, and always has been, much more profitable for the NRSROs than the subscriber pay system because issuers are willing to pay more money to allow them a capital markets execution than subscribers are willing to pay for independent primary and secondary market research. However, the special nature of MBS and ABS allowed NRSROs to earn windfall profits rating structured finance new issues versus corporate and municipal transactions.

2. The large profits that the NRSROs earned over the last ten years drove them to rate securities they should not have, and further, to rate securities higher than they should have, particularly in the structured MBS and ABS.

3. Managing the conflicts that are inherent in the NRSRO business model, of whatever sort, is the job of the SEC. The companies themselves are profit minded enterprises and should be expected to behave accordingly.

History:
There is a crucial difference between corporate and municipal NRSRO ratings on one hand and MBS and ABS NRSRO ratings on the other. In the first instance, ratings are based upon a definable balance sheet or income statement of the rated entity, as well as a view on its medium term profitability and/or revenue streams. In MBS and ABS the ratings are built upon statistical models that, in many cases, project loan cash flows for as long as thirty years.

It has recently been the case that the major NRSRO became willing to build cash flow models, with which to rate securities, without sufficient historical data to calibrate their model assumptions. This was definitively the case with many newer residential loan types, but was also the case with other loan categories such as commercial franchises and medical care receivables.

The process to bring a structured finance MBS or ABS transaction to market is also different than the process to bring a corporate security to market. In structured finance, typically, a broker/dealer initiates a transaction in order to securitize a loan position in which they frequently have a financial stake as a principal. Historically, the rating agencies have worked with a corporate or municipal issuer directly in order to facilitate a financing. The broker/dealer is typically involved as agent in these corporate/municipal transactions not as principal.

During the period of 1997-2007 the market saw the rise and fall of originate and securitize businesses based upon commercial franchise loans, manufactured housing loans, airplane leases, medical receivables, structured finance CDOs as well as a myriad of new residential mortgage loan types. All of these differing types of loans, leases or receivables were either rated for the first time by the NRSROs during this period, or the NRSROs began to allow a greater than historic percentage of the deal structure to be rated AAA.

The business of creating and distributing new securities, particularly MBS, ABS and CMBS, became one the central drivers of broker/dealer profitability over this same ten year period. It is in the structured finance markets that the NRSROs have the most power because the new issue process is model dependent, and these models are under the control of the NRSROs.

Policy Implications:
In the structured finance markets, the broker/dealer will always push for greater ratings leverage and the NRSROs have a financial incentive to comply. Thus, the SEC should mandate a change to the payment structure for rating a new security issue, particularly those in the structured finance securities markets such as MBS

and ABS, from an "issuer pay" to a "user/purchaser pay" model in order to break the financial relationship between the broker/dealer community and the NRSROs.

For example, the proposal for an alternative NRSRO payment methodology submitted by Mayree Clark and Andrew Jones, in my opinion, would help to accomplish this objective.

They suggest that the fee revenue associated with the rating of a new issue be directed to a NRSRO by the investment managers who purchase the new issue, rather that the Wall Street dealer who initiates the new deal process. This change puts the investment manager in charge of the ratings process rather than the dealer. Their proposal also importantly suggests that additional ongoing ratings fees (including a fee at maturity) be collected from the issuer (including derivatives) and that this additional revenue also be allocated by current investors to the NRSRO of their choice. Allowing the investment managers who own a deal to allocate the pool of revenue associated with its rating better aligns the process at the beginning, and over the course of time. Presumably, the investment managers who have the allocation choice, will allocate the revenue to whichever NRSRO that provides the most "value added" either in initial or subsequent deal specific research.

I personally would go a step further and impose restrictions on the ability of the broker/dealer community to ever engage in fee discussions with an NRSRO. The NRSROs will therefore be forced to always consult with the investment manager community as to the size and scope of their fees, as well as the scope of their ratings activities. (There is a good article in this month's Bloomberg Magazine on the pricing power of the NRSROs.)

These changes will not eliminate conflicts; rather, it seems that in the user/purchaser pay system the incentives are better aligned. An even better system would be for the investment managers to pay for the rating themselves (as opposed to the investor) but this system may prove too controversial to implement. (See my response to Question Five)

The user/purchaser pay payment structure may have the effect of complicating the process of "financial innovation" as it will be more time consuming for a broker/dealer to organize a pool of investment managers willing to initiate a new type of structured transaction. However, at this point, it is hard to find a compelling reason for additional financial innovation in the structured finance marketplace.

Question Two:
Do users of ratings have all the information they need to make the most informed decisions?

There was broad agreement that substantial additional information needs to be provided to the market at every stage of the ratings process.

Specifically, it was suggested that all information that an underwriter or issuer provides to one or several NRSROs, as part of the initial ratings process, should be made available to all NRSROs as well as the marketplace at large. This information sharing is particularly needed in the structured finance marketplace. It was suggested, with broad agreement, that this additional information be made available to the market in a standardized format such that investors can easily compare deals. One participant referred to a monthly or quarterly information release for structured finance deals akin to a 10-K or 10-Q.

My view:
While servicer reports are available for most structured finance deals post close the information contained is not standardized nor complete for residential MBS and ABS deals. Furthermore, the information available to potential purchasers in the new issue process is woefully inadequate. Information disclosure for CMBS transactions pre and post close, in contrast, is quite good and can be used as a model for other parts of the structured finance world. CMBS investors have the information needed to re-underwrite the transaction, if they wish. MBS and ABS investors do not currently have the information to that standard.

It is my opinion that a NRSRO rating should not be allowed without very precise, standardized information released to the public from the originator that is, essentially, the complete underwriting file used to purchase or originate the loans. This file should also contain very extensive representations concerning the potential existence of fraud and what steps the originator took to lower its impact.

The problems associated with NRSRO information dissemination as enumerated in the SEC staff’s “Summary Report of … Credit Rating Agencies” dated July 2008 are very accurately described but are not broadly recognized by the market and go to the heart of what it means for an individual security to carry a NRSRO AAA rating.

For example, it is extremely troubling that the NRSROs that rate MBS and ABS transactions accept, as standard practice and without precise and continuous due diligence, that the information provided by an originator or corporate entity on a structured finance transaction is free from significant misrepresentation, factual errors and/or fraud. The AAA rating has been accepted by the regulators and the public as indicative of a statistically insignificant chance of default. One major reason that the recent history of structured finance AAA ratings is so woeful is the existence of widespread fraud in the origination and packaging process. Fraud attacks the very foundation of a AAA rating and if the financial community and its regulators cannot be confident that this basic condition of a AAA rating is continuously assured then dramatic change is warranted for this reason alone.

Sadly, for reasons discussed above and below, fraud is only one of the reasons that the NRSRO ratings process has become so flawed.

Policy implications:
The market needs much more information from issuers to the broad investment community should be made available in a standardized, web friendly format. Use the CMBS market as a template. No new issue should be able to receive a NRSRO rating without it. More complete representations by the originators as to how they are dealing with fraud is also needed.

Question Three:

a. Should the government foster increased competition in the rating agency business?

b. Should the government abolish the NRSRO designation?

c. Should the government end or limit its reliance on NRSROs?

d. Should the government force the NRSROs to assume additional liability for their actions?

There was broad disagreement on these questions.

There was some anxiety expressed that if the government makes life too hard for the NRSROs then the business model stops working. It was also pointed out that if there are more CRAs that carry the NRSRO designation then the designation itself loses its meaning and the system will be in the same place than if there was no NRSRO designation at all.

The academics on the panel tended to believe that the government should abolish the NRSRO designation thereby forcing market participants to find credit information from any source it deems credible. It was suggested that this new system will have the effect of lowering systemic risk as the market theoretically becomes less dependent on a small group of government sponsored NRSRO champions. Other, more investor and issuer oriented participants, scoffed at this idea as wildly impractical and potentially dangerous.

Most non-CRA participants believed that the NRSROs should be subject to additional liability essentially as another way to regulate their behavior. The NRSROs pointed out that they are already subject to certain forms of liability. S&P pointed out that they are currently being sued. Moody's added that issuers sometimes sue them for lowering a credit rating. No one made any suggestion as to how additional liability could be imposed without it being so onerous that the CRA or NRSRO business model ceases to be attractive.

Several participants suggested that the SEC establish a separate CRA/NRSRO regulatory body that would be charged with the responsibility to manage the government's NRSRO exposure.

My view:
The web of Federal, State and local investment regulation that references NRSROs in general is not going to go away anytime soon. Thus, the government will be in the business of regulating the NRSROs for some time to come. Furthermore, the market needs a certain number of CRAs but not so many as their information disclosure becomes repetitive. Thus the CRA business model is prone to consolidation and oligopoly pricing. It is also practically impossible for any government agency to keep track of large numbers of NRSROs. I believe that the focus of the SEC should be on trying to improve the efficacy of NRSRO regulation rather than on its existence.

However, in order for regulation to be credible, the SEC has to be willing to both remove a NRSRO designation and to regulate the issuance, by the NRSROs, of certain ratings. In order for the SEC to be able to remove a NRSRO designation without systemic consequences, the reliance of the system to any one NRSRO has to be lower than it is now. I believe that the best way to lower systemic reliance on any given NRSRO, without having to manage many more NRSROs, is to either lower the importance of the rating itself or regulate its use, or both.

One fairly efficient way to lower the importance of the rating is for the SEC to publicly agree with the ratings agencies themselves that ratings are nothing more than an educated guess. I might go further to say that, in many cases, the guess is not that educated.

Additionally, the SEC should move to impose restrictions on the use of NRSRO rated securities, particularly those rated AAA. For instance, it does not seem credible any more for a regulated financial entity to hold only 1.6% of capital against a NRSRO rated AAA rated security. This percentage capital charge should be much higher, particularly given what we now know about how these AAA ratings were created as well as the sheer diversity of different types of AAA rated securities.

Currently, formerly AAA residential loan ABS trade at prices that range from 10% of par to 85% of par. How can all of these have the same regulatory capital charge?

Policy Implications:
Mandating higher capital thresholds will lower the systemic risk associated with NRSROs because the usefulness of the rating will be lower. In addition, the importance of the rating itself will be reduced because demand from levered financial institutions will be lower thereby reducing systemic leverage. It will quite possibly also be the case that AAA spreads will widen, which will allow investment managers to earn more money by investing in them. Hopefully, they will choose to reinvest some of that extra revenue into additional fixed income research capability.

Question Four:
Are there some securities products that are so inherently complicated or risky that ratings are at best meaningless or worse, misleading?

The investors on the panel indicated that there should not be a limitation of what can be rated but that perhaps the limitation should be on what can be purchased.

My View:
There should definitively be a prohibition on certain types of securities that can carry a NRSRO rating, as well as restrictions on their use. It is clear, in retrospect, that the complexity of certain classes of securities (i.e. CDOs) were well beyond the capability of a NRSRO to designate it AAA (or any other rating for that matter). Additionally, the conflicts associated with CDOs, and other forms of re-rated securities, are even greater than in the original ratings process. In fact it was NRSRO policy fifteen years ago that certain types of structured finance securities could not be rated AAA. AA was the highest rating category allowed. (There is a very good history and explanation of the evolution of structured finance in the book “The Analysis of Structured Securities” by Raynes and Rutledge.)

A related priority should be to eliminate a practice called: “ratings agency arbitrage” (RAA).

RAA is a profit making activity, historically conducted by the broker/dealer and hedge fund community, whereby NRSRO rated securities are repackaged into another NRSRO rated security. The RAA profit exists between the cost of accumulating NRSRO rated securities and the proceeds realized upon their sale in a different re-securitized form. The NRSROs have been open to accommodate this exercise as it provides them with more fee revenue. While the public can theoretically “benefit” from this activity through efficiency gains in the capital markets they are more likely to be hurt when the leverage that these re-securitizations produce is used in their portfolios without their knowledge, or as part of a leverage strategy by financial institutions. The CDO business is really nothing more than an exercise in RAA.

The key to RAA is the percentage of AAA that is allowed in a deal because AAA spreads are so tight relative to other credit classifications and they can be purchased so broadly. RAA is alive and well today. Formerly NRSRO AAA securities are currently being restructured to recreate new NRSRO AAA securities in order to increase latitude under regulatory capital guidelines for banks and insurance companies.

Policy Implications:
The SEC should mandate that any security that is composed of other NRSRO rated securities cannot carry a NRSRO rating. If this policy were in place five

years ago, a major part of the current financial crisis would simply never have occurred.

Question Five:
Should investors re-examine the way that they look at ratings to ensure that the ratings represent the beginning of due diligence and not the end?

Not a lot of debate on this point.

My View:
Security purchasers did not exercise the due diligence they should have, particularly given the conflicts that the NRSROs were known to be subject. It is easier, cheaper and quicker for investment managers to rely upon a NRSRO rating than to do their own credit work; particularly in the ABS/MBS marketplace. The reason is that it is very hard to develop a model for ABS/MBS collateral performance through time. Market participants need and want someone else to do it for them. Further, it is not clear that the ultimate investor is cognizant of their manager's lack of security due diligence.

Recently, the Federal Reserve decided to use S&P, Moody's and Fitch, only, to rate new TALF deals. Not only did the Federal Reserve have little confidence in its own ability to develop the appropriate ABS modeling, they also lacked the confidence that any NRSRO could either, other than the designated three.

Yet they wished to purchase AAA securities anyway for public policy reasons.

The behavior that the Federal Reserve exhibited in this regard is mirrored in the investment manager community broadly. Investment managers want to buy AAA rated securities because their investors demand them and regulatory guidelines (particularly the Basel II framework) subsidize their purchase. In fact, there has historically been more demand for AAA than available supply. Investment managers, as well as the regulatory authorities, continue to trust the AAA rating in the face of overwhelming evidence that they should not.

Why does this situation exist? One reason is inertia. Another reason, specific to the investment management community, is that third party security specific research is paid for directly by the investment manager, as opposed to their investor clients. It has been hard to justify large outlays for fixed income research, relative to assets, when the vast majority of NRSRO rated fixed income securities that are issued and purchased carry a AAA rating. The investment manager pays the cost of third party research out of their fee. In contrast, ratings, because they are imbedded in the cost of a new deal, are paid by the investor. In this sense, the issuer pay system is highly similar to a "soft dollar" research payment methodology in that the investment manager receives the benefit of research/ratings while the investor pays the fee.

Policy Implications:

First, investment managers should be required to establish credit procedures with respect to their NRSRO rated investments that should then be made available to their investors. Among other things, these credit procedures should focus on how the investment managers distinguish between various kinds of AAAs and how they "re-underwrite" the transactions. Second, the SEC, and other regulatory bodies, should start distinguishing between different kinds of AAAs with respect to regulatory capital standards. Third, new regulation should make it more difficult for a security to carry a AAA rating.