CreditSights

Rating Agency Reform: Talking Points on Disclosure

- **Deal disclosure: data and documents**
- **Competition and absolute information barriers**
- **Surveillance vs. new issue**
- **Real reform vs. Trojan Horse for status quo**
- **The Quality Question**

Structured Finance Disclosure

- "You cannot make bricks without straw" in ratings either. New ratings industry entrants would be happy to work hard to harvest the straw, but you cannot *hide* the straw.
- Disclosure is a core competency of the SEC and an area where the SEC can make an immediate and valuable contribution to the quality of information in the structured finance marketplace that will also have direct benefits on enhancing competition in the rating agency industry over time. This can be done without burdensome oversight and excessive costs.
- There is a clear parallel between Reg FD disclosure for companies and the need for disclosure of structured finance data and related documentation. The move naturally will face the same opposition from the same parties that benefit from unlevel information flows, less efficient markets, and the inherent benefits of no checks and balances.
- A whole range of data and documents serve as the raw materials for ratings of structured finance products. The incumbent NRSROs and the underwriters will seek to control such disclosure and will oppose initiatives calling for transparency.
- In structured finance—from CMBS to CDOs (whether synthetic or cash or hybrid) to such specialized CDO subsets as CLOs (Collateralized Loan Obligations)—you need certain inputs for effective ratings. Those inputs are currently caught in a closed information loop controlled by underwriters and the incumbent rating agencies. We have already seen the downside of weak transparency.
- The analytical framework and information needs vary by structure and needs to extend across more asset classes than a narrow Reg AB view of plain vanilla deals. Different assets require different disclosure.
- In the case of structured finance and certain private bank loans, "information" and restricted disclosure by itself creates an absolute and complete barrier to high quality competition.
- Ratings criteria transparency is no substitute for transparency of deal structure, asset pools, and ongoing maintenance disclosure of any changes in assets and related risks.
- The information is readily available with "push-button technology" even though there will be the usual elaborate explanations why such additional disclosure would be "burdensome and costly."

Surveillance vs. New Issue Disclosure

- The market critically needs information on legacy deals and notably the CDO deals of the 2006-2007 origination wave that still plagues the financial system.
- The proposal to only include limited disclosure on future new issue deals would be a crippling setback to reform and investor transparency as well as precluding any meaningful, high quality competition in structured finance ratings.
- New-issue-only disclosure offers negligible value to *real reform* and ignores the reality that all future ratings criteria will be dependent on continuous reassessment of current outstanding deals and asset pools.
- Future new issue ratings products require ongoing refinement of such variables as correlation, loss exposure, and structural subordination risks across diverse asset pools. New rating agencies, research firms, regulators, and academics should all be evaluating such data pools.
- In other words, failure to include outstanding deals in this initiative dooms the proposal to marginal value and only strengthens the hands of those who would undermine competition and limit the ability to launch new, high quality ratings and analytical products. It is an attempt to keep the information flow under the captive control of the underwriters and incumbent CRAs.
- Regardless of the necessity of ongoing asset quality and deal surveillance, the whole proposal seems to make the leap that *new issue* ratings are the main product offerings as opposed to deal maintenance and more information-intensive asset class research that also might seek to differentiate across various structures.
- Using "new issue" as the only guidepost for disclosure ignores the critical need for surveillance, the use of such products in "marks" (or for audit or regulatory inputs), and broader evaluation of asset classes. Given the magnitude of the crisis, making much of the structured disclosure available publicly would be optimal and not just restricting it to level the equivalent disclosure needs of NRSROs.
- Some disclosure could be restricted to meet the needs of NRSRO "equivalent disclosure" needs and could require a hybrid approach including nondisclosure agreements (For example, the financial statements of private companies with loans in CLOs), but deal documents and components should be public.

CLOs and Disclosure: A Basic Example

- CLOs are a very important asset class for more NRSROs and research firms to track *immediately* with high-information-content research and ratings products. This is necessary for asset surveillance purposes given the complexity of the underlying assets and given the massive loan maturity schedules ahead. For example, the maturity bubble even just from 2012 to 2014 is greater than the size of the TARP program and is daunting with all of the refinancing risk it entails.
- Aspiring NRSROs cannot get complete disclosure at this point while the street, select institutional CLO and loan investors, and the incumbent rating agencies can. The information playing field is unlevel and third party recipients of information are essentially determined by the street.
- The barriers are insurmountable and fortified by the strategic interests of the underwriters, incumbent rating agencies, and in the case of private loan documents by the private equity firms themselves. A notable challenge is the basic ability to

retrieve single name leveraged loan information to evaluate the private holdings in CLOs.

- There are simple ingredients for CLOs such as CLO deal documents/updates, loan documents and related amendments to the underlying loan terms, and financial statements for the bank loan borrowers that do not publicly disclose (yet do so on a selective basis to some parties including the rating agencies and underwriters). All of this information is already in many different hands in the market quite literally at the push of a button. There are established platforms that house the data where it is readily available and would constitute low cost disclosure for this high margin business.
- There should be equivalent disclosure for all NRSROs although we believe much of this data should be available to the entire market. Analytical competition breeds a broader range of defensible views supported by details and assumptions. That in turn supports market making and promotes liquidity and more realistic marks.
- The "sophisticated investor" angle for limited disclosure of private high yield deals really does not apply here since the high risk assets are repackaged and sold to investors with a very high quality threshold. That means disclosure is needed or the assets should not be sold into the structures.

Credit Rating Industry as a "Natural Oligopoly" is Nonsense

- Is it really a natural oligopoly or an unnatural "partner monopoly" where the market sees limited choice and remains a price taker?
- There is nothing "natural" about the artificial barriers that have existed for more than three decades and how they have been translated into additional embedded commercial barriers.
- Anyone who believes this is a natural oligopoly ignores the fundamental economic law that massive profit margins attracts competition, brings in financial capital, and promotes the migration of intellectual capital to the industry. Regulators should recognize what impairs these natural, economically driven movements. Information and disclosure is one major impediment.
- The industry product and service mix is evolving so quickly that there are great opportunities for "assets" (people, technology, analytics, or entire firms) with comparative advantages. The major incumbents see that and are "running a stall" to get the pieces in place for first mover advantage in the next generation of ratings, research, and data products to be used in the post-crisis repair process. Their strategy is to exploit their entrenched pure ratings business to keep out large, well-capitalized financial media, content, and analytics players. They also will look to restrain growth of well positioned boutiques that might be acquisition fodder for larger strategic companies. Opposing the broader availability of structured finance information is a cornerstone of that strategy.
- Many boutiques and various "me too" issuer-pay ratings shoppers have failed to focus on scale and diversity of strategy to ride this wave of entry that can occur if the barriers are taken down. Greater information availability will change the profile and strategy of players in the market for the better.

<u>The Path to Competition</u>

- Boutiques growing up and/or rolling up.
- Beware the "medallion taxi model" where restrictive membership becomes the reward in itself. Viability and quality should be fought out in the marketplace. That medallion mentality has been evident in recent years from some of those named as NRSROs or those that have banked the "3-year holding period" under the CRA Act of 2006. Once in, they want others to stay out.
- Perhaps opening up provisional NRSRO status more broadly and allowing access to information as an incentive will support more high quality competition on a larger scale.
- The blurring of product lines attracts strategic players from data, analytics and content disciplines. The incumbent NRSROs are entering those disciplines. Well-positioned competitors from those disciplines will enter the space of Moody's, S&P, and Fitch if afforded the opportunity. Examples *could* include Thomson Reuters and Morningstar among many others. Potentials in the financial media, content, and analytics space include Bloomberg (especially in structured finance data and analytics that can in turn be used by other entrants in ratings and research), RiskMetrics, IDC, IHS, and Markit among others in different subsets of the content and analytics business.
- High margins and global evolution of the ratings, content, and analytics space attracts financial capital if regulatory certainty and a reasonable investment time horizon can be set and the right path to expansion provided. Information and disclosure is part of that path. The SEC holds the key to unlocking this disclosure.
- Information first and foremost benefits the owners of assets and meets the goal of reducing reliance on credit ratings, but it also serves the needs of those looking to offer a range of services to such investors including ratings, data, risk management tools, and analysis. The value goes well beyond the narrow one of competition in the credit ratings space.
- Evolution of the relatively young, pan-euro credit markets will drive investment in the industry as will the growth of the pan-Asian markets. Documented international resentment at the role of US-based CRAs (Fitch is viewed as a US firm regardless of Fimalac) will be a catalyst for some international entry that will require significant investment in a US credit presence given the US role as the largest credit market by far in the world. The convergence of global debt markets, rising cross-border issuance and securities sales, the rise of the global asset manager operating in multiple regions, and evolving global bank regulations will foster development of more CRAs outside the US who will also need to operate in the US.

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