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UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES, SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

The Role of Credit Rating Agencies in the Structured Finance Market

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Chairman Kanjorski, Ranking Member Pryce: I am here as an investor and participant in the Residential Mortgage Backed Securities (RMBS) market. From my experience with the unfolding credit crisis I have formed the view that the current credit rating agency regime is flawed on both a systemic and process specific level.

I am the portfolio manager for the Hayman Capital Master Fund, and I am a co-manager of the Subprime Credit Strategies Funds I & II. I also act as a mortgage credit portfolio advisor to several other asset management firms. In total, I manage or advise over $4 billion of investments in the RMBS market. I also serve as a Director of the ABS Credit Derivatives Users Association.

Inherent Conflicts of Interest

The Nationally Recognized Statistical Ratings Organizations (NRSROs) have become a ubiquitous presence in the fixed income market. The enormous proliferation of fixed income products, especially in the structured finance area over the last 10 years has seen an explosion in the need for ratings of these products. As the size of the marketplace grew, along with an influx of new participants the need for a universally accepted ratings regime intensified. The primary NRSROs have seen strong growth during this period as they met the need for bond issuers to provide a stamp of credit approval that would allow them to market their products around the world.

Unfortunately the relationship between the bond issuers and the NRSROs presents a fundamental conflict of interest because the NRSROs are dependent on the issuers for their revenues. The bond issuers, as seller's of risk, have an incentive to see that the risk they are selling is priced as cheaply as possible – in the marketplace this means obtaining as high a rating as possible – because once they sell the bonds they are relieved of any risk burden. It is this incentive, and the fact that they work closely with, and provide payment to, the NRSROs that places into question the objectivity of the ratings provided by the NRSROs. The ultimate holders of the risk, the buyers of these bonds, have the most at stake in accurately pricing risk, but instead rely upon the ratings bought and paid for by the sellers.

It would be like cattle ranchers paying the Department of Agriculture to rate the quality and safety of their beef. It would undermine the integrity of the system by casting doubt on the impartiality of the body that the ultimate buyer relies upon to keep them safe from harm. But as it is becoming increasingly clear as each month passes, Subprime credit has become the mad cow disease of structured finance. Nobody knows who consumed the infected product and nobody has any real faith in the NRSRO that gave it a clean bill of health.

<u>Mezzanine CDO's – Defying Belief</u>

Sometime in the late 1990's the Asset Backed Security Collateralized Debt Obligation (ABS CDO) was born. It was originally a compilation of a variety of asset classes ranging from aircraft receivables to mortgages. Original correlation assumptions on the assets within these structures were not based on any empirical data, but simply reflected the best guess of the NRSROs. The success of these products drove changes to the asset compilations and by late 2003 ABS CDOs were comprised almost entirely of Subprime mortgages. It is my belief, based upon conversations with various structured finance marketing groups at bulge bracket broker-dealers, that NRSROs did not alter their correlation assumptions despite the homogenization of the collateral underpinning ABS CDOs.

While there are many forms of RMBS out there, the Mezzanine Collateralized Debt Obligation (Mezzanine CDO), CDO Squared and all their respective derivations in the marketplace stand out as the most egregious example of what went wrong. A Mezzanine

CDO is an elaborately structured product that is derived from a more run of the mill mortgage securitization. Within a typical Subprime securitization the top 80% of the capital structure is generally rated AAA, and the bottom 4-6% is over-collateralization. The next 3-4% immediately above the over-collateralization, just above the bottom of the capital structure, represents the mezzanine tranches. There has always been demand for the AAA tranches, but the mezzanine tranches were less popular because of their higher risk profile and the inability of many buyers to hold them due to their low credit rating. Sometime in 2003, US institutional investors stopped buying these mezzanine tranches. The NRSROs and Wall Street needed to keep their highly profitable (over $6 billion of underwriting fees in 2006 alone) Subprime securitization machine running, so they figured out how to collect the unwanted mezzanine tranches into a new vehicle. Within this new vehicle, the tranches were re-bundled, marked up, and re-rated. Through the alchemy of Mezzanine CDOs this re-bundling process magically allowed the top 80% of the capital structure to be rated AAA. This magic came despite the underlying securities remaining mostly among the lowest rated tranches of the original Subprime securitizations. The justification for this process was that the securities were sufficiently diversified, both geographically and by originator, that their principal and interest payments could be restructured to prioritize the top of the newly created capital structure. Whereas in reality the underlying collateral remained a homogenous asset class whose default probability was highly correlated and therefore their risk was dramatically understated.

In fact this correlation was further underestimated by an arbitrary decision to create the hereto unknown classification of "Midprime" borrowers by splitting up the existing Subprime category. Prior to this, Subprime was simply defined as loans made to borrowers with FICO scores below 660. Midprime was declared to be the top half of the Subprime spectrum, FICO scores between 625 and 660. This designation not only allowed NRSROs to use a second color in their CDO presentation pie charts but also allowed them to argue they were less correlated because they were a different asset class. This in turn allowed them to use more aggressive assumptions in their ratings models and deliver higher credit ratings to products containing both Midprime and Subprime loans even though they both were previously considered Subprime. With the stroke of a pen and some less than creative naming, Mezzanine CDOs were further able to mis-price and re-lever the riskiest tranches of Subprime RMBS securitizations. Interestingly enough, Moody's, just last week, issued a press release that eliminated the context of Midprime versus Subprime in ALL ABS CDOs. They did not say however if they were going to go back and re-rate previous transactions as all Subprime.

We have not seen AAA impairments yet on Mezzanine CDO's because the natural process takes between 12 and 24 months for the impairment process to be completed (from foreclosure to eventual sale and impairment). Due to the fact that some are trading in the marketplace at discounts of over 50% it is clear to me that global investors are losing faith in the NRSROs as we speak. I believe that this loss of faith is the primary reason that the Global Asset Backed Commercial Paper markets were frozen and required massive emergency action by Central Banks around the world.

<u>The Glaring Error - Inconsistency of Model Assumptions</u>

While the provision of AAA ratings to mezzanine tranches of subprime debt is the most egregious example of the flaws in the RMBS credit rating process, the clearest and most obvious error lies with the internal inconsistency of the application of model assumptions.

Each NRSRO has its own proprietary models which they rely upon to determine the projected performance of securities. Within the world of RMBS, two of the most important assumptions for any of these models are the estimation of Home Price Appreciation (HPA) and Loss Severities of loans that go into foreclosure over the course of the life of the security.

At least one of the NRSROs was using HPA assumptions of +6-8% for 2006, 2007 and 2008 in their models for securitizations underwritten in 2006 and in the first quarter of 2007. Sometime during the second quarter of 2007, referencing a detailed study of all major metropolitan statistical areas that they recently completed, they decided to dramatically reduce their HPA assumption and increase their Loss Severity assumption for the next few years. Therefore new securitizations were required to have much larger initial over-collateralization amounts. However these new model assumptions were only adopted prospectively, despite the fact that securitizations from previous years still rely on these assumptions about future economic outcomes. If the NRSROs change their model assumptions going forward, to avoid being duplicitous they should be required to change their existing ratings that rely on now outdated assumptions.

Put simply, they should be compelled to adhere to a single assumption (open to change and revision when new data comes to light) with regard to any of their inputs to their black-box models. In this example, it shouldn't matter when a security was rated, the HPA assumption for 2007 should be consistent across all models.

With Great Power Comes Great Responsibility

All participants in the fixed income market recognize the enormous power that NRSROs wield over pricing with their ability to bestow universally recognized ratings. This power has turned NRSROs into de facto regulatory bodies. This role is explicit in the reliance on NRSRO ratings as benchmarks for what is considered "investment grade" both for institutions with restricted mandates such as money market and pension funds as well as for institutions that must maintain minimum Capital Adequacy Requirements.

It is also implicit in many other markets where the possession of a top tier credit rating is an essential ingredient to the success of a business model. One such example of this is the mono-line insurance industry where a AAA rating is necessary to keep capital adequacy requirements at a low enough level to allow the hugely levered (some more than 100 times) balance sheets to function. The NRSROs know that a downgrade is tantamount to a death sentence for these companies, and thus become the implicit overseer of their viability.

I will tell you why and how regulators completely missed the epic size and depth of the problem in the credit markets today. An important concept to appreciate is that each securitization is essentially an off balance sheet bank. Like a regular bank there is a sliver of equity and 10-20 times leverage in a securitization or CDO and 20-40 times leverage in CDO Squared and Bespoke instruments. The booming securitization market has in reality been an extraordinary growth in off balance sheet banks. However the securitization market has no Federal and State banking regulators to monitor its behavior. The only bodies that provide oversight or implicit regulation are the NRSROs – bodies that are inherently biased towards their paymasters, the securitization firms. Without sufficient oversight, this highly levered, unregulated, off balance sheet securitization market and its problems will continue to have severe ramifications on global financial markets.

My belief is that the following two policy principles are an important step in addressing the issues I have raised above:

- Additional disclosure requirements for NRSROs to the SEC to ensure consistency of economic assumptions for models across all ratings. As well a requirement to re-rate securities relying on subsequently outdated model assumptions.

- Sponsoring and facilitating the creation of a “buy-side” credit rating consortium funded by a limited fee on each transaction in the fixed income market – similar to the SEC fee on equities securities transactions.

Ultimately something must be done to resolve the problem of a market that is forced to rely upon NRSROs that are only paid to rate securities, not downgrade them.