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Reducing reliance on credit rating agencies

Investor due diligence takes on larger role in managing securities portfolios

BY DOUGLAS LONG

THE NATION'S CREDIT-RATING AGENCIES HAVE BEEN GIVEN SOME REPRIEVE.

Uncertainty surrounding the repeal of Rule 436(g) in the Dodd-Frank Act froze new issuance activity temporarily as rating agencies refused to allow inclusion of their ratings in registration documentation. The rule exempted rating agencies from "expert" designation, preventing them from being held liable for the ratings they attach to securities. Its potential to detrimentally affect 2011 new issuance was effectively eliminated with the indefinite extension, or at least hold up, of the SEC's no-action position back in November. However, the vilification of the major ratings agencies seems to have abated somewhat as the rational view that they are, in fact, systemically important to a fully functioning securitization market takes hold.

The agencies have done a lot of soul-searching. They have taken huge strides to improve the integrity of ratings methodologies and their public perception.

But the shifting sands are yet to define a new, consistently applied role for these third-party independent evaluators — or what the legislators are trying to label "experts." Dodd-Frank recognizes that credit ratings played a role in the mismanagement of risk by large financial institutions and investors. But the cycle of incentive misalignment, the originate-to-distribute model and, fundamentally, investor propensity to not question the validity of ratings was as much, if not more, to blame. Just because the ratings houses were seen to be the experts, at no stage should that ever have suggested they knew it all. A rating is an expert opinion on creditworthiness, incorporating a view of future performance. It's not a fact imparted by an oracle. How often would you trust an opinion as fact without the counterpoint of independent understanding to make an informed and confident decision?

There is some divergence in U.S. reform with regard to the use of ratings, which makes it difficult to actively enforce investor due-diligence guidelines. Dodd-Frank aims to improve the quality and reliability of agencies' ratings by implementing internal and external control structures, increasing their liability exposure and promoting a more transparent rating process. However, at the same time, it seeks to eliminate almost any kind of reliance on external ratings by investors and regulators. These efforts pull in opposite directions, attempting to strengthen the ratings process while undermining the future importance of external ratings to the system.

LET BANKS RATE THEIR OWN

One solution under consideration by U.S. regulators in December was to let banks devise their own ratings for the securities they own, only loosely based on exter-

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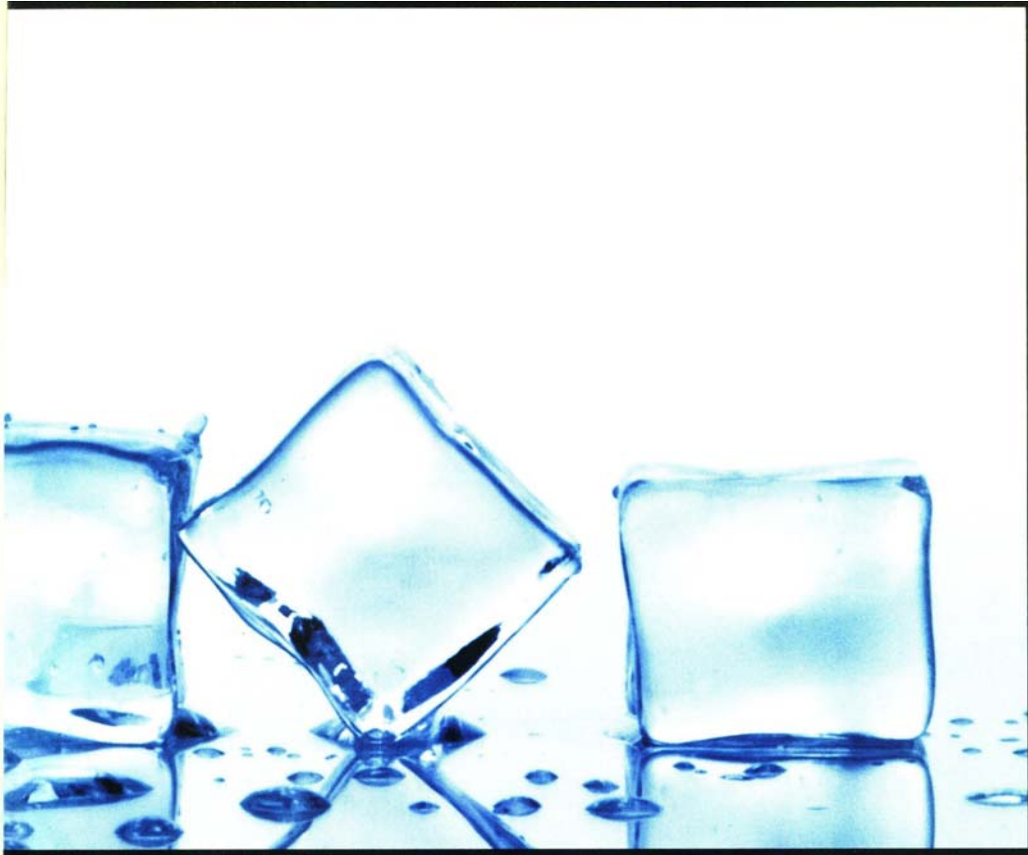

nal ratings. Focus is now shifting to investors as they are advised not to rely solely on ratings to know their investments, but are also pushed toward performing their own ongoing and independent understanding of asset creditworthiness and portfolio performance.

Meanwhile, European Union rules implemented on Dec. 7 mandate that all rating agencies promoting their evaluations for use in the region must apply for registration. As in the U.S., they, too, address conflicts of interest in the issuer-pays model and demand greater transparency in the disclosure of methodologies, internal models and key rating assumptions. The aim, as with new securities regulation at almost every level, is to give investors all the tools to perform better due diligence.

In Europe, the drivers for ratings quality and credit rating agencies' oversight are slightly different. External ratings are fundamental to the implementation of the Basel 2 enhancements. Getting the ratings process right is a must for the regulators in order to get the regulation back on track as a credible rulebook for capital measurement and bank capital standards.

The use of ratings is already more interwoven with the EU banking system than it is with the U.S. system. Ratings there are a standard measure to allocate bank capital for securitization and a basis for collateral eligibility in major funding tools such as the European Central Bank's Repo Facility and the Bank of England's Discount Window Facility. In the U.S., rating agency reform is actually preventing swift implementation of Basel 2-type rules on investors or mandating them to "know what they own."

The bottom line is that international reform all aims to improve the core aspects of investor due diligence. In Europe, the Basel 2 Securitization Framework Enhancements in particular will penalize bank investors that don't perform sufficient, ongoing due diligence in the analysis and stress testing of their structured finance portfolios.

So while ratings have been given the green light, any overreliance on these by an investor or rather, an insufficient understanding of the assumptions that form those judgments will now result in big capital charges.

DISCLOSURE AND TRANSPARENCY

In the U.S., the Dodd-Frank Act and the SEC's Reg AB show more of a drive toward enforcing issuer disclosure and transparency. While there is no legislation forcing investors to perform a standard level of due diligence, the lack of full rating agency backing, or commitment to use ratings within the regulatory framework, are a clear sign that investors must perform their own credit analysis to truly understand the securities in which they invest.

Anyone buying into securitizations from 2011 — even triple-A investors — will want to have a thorough understanding of the cash flows related to any tranche

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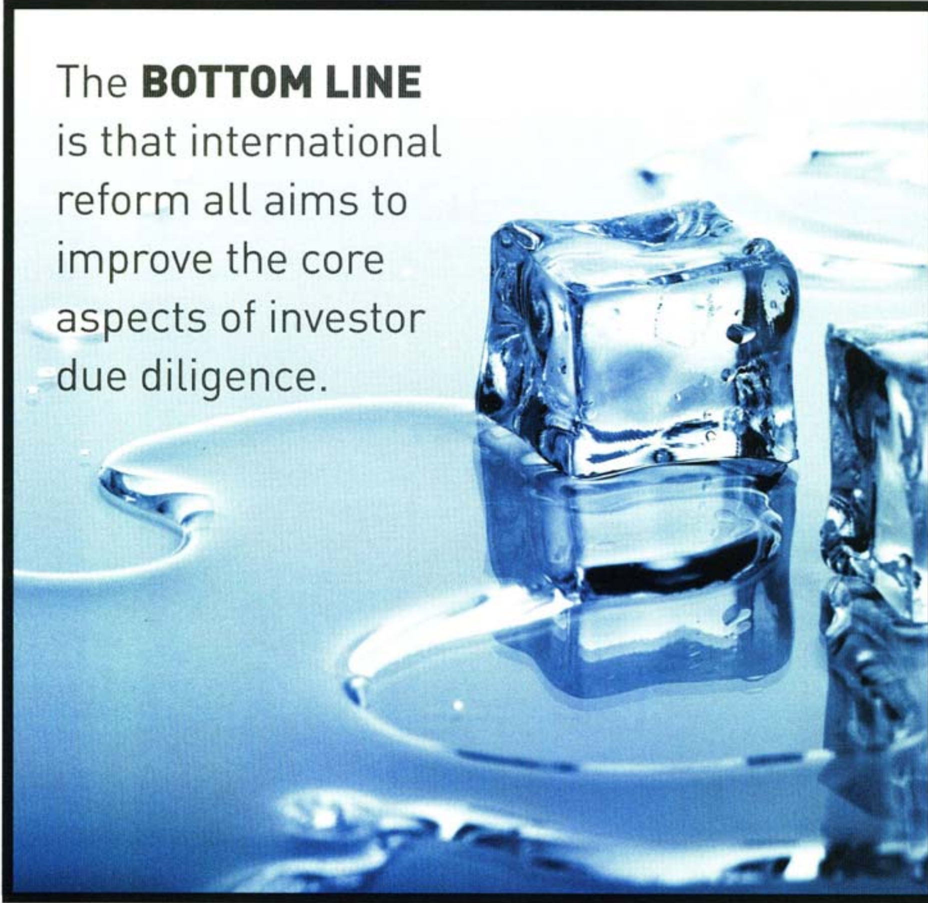

they invest in. This will be vital to satisfy the regulators and to have the conviction and confidence to be decisive in either investment or divestment.

Investors will need to understand the historical, current and forecasted performance of collateral and its effects on payments through the waterfall. If there is a concern about a pool of mortgages, investors need to be able to drill down to see loan performance at a more granular level. The U.S. is more mature than the EU in terms of the loan data, full cash flow models and collateral performance information available.

According to a recent Principia survey, more than 60% of U.S. and U.K. investors plan to increase their activity in the asset-backed securities and mortgage-backed securities markets in the next 12 months.

More than two-thirds of those stated that, with their current infrastructure, they were less than effective at accessing and physically managing the universe of information required to effectively and confidently analyze, manage and report on their structured finance portfolio.

With increasing disclosure and more standardized data available in the U.S. and Europe, investors are now looking to implement better ways to manage their operations, derive real meaning from the data available and consistently use it as a basis to inform their assumptions about the performance of assets.

As systemically important as ratings are, whatever the final model for their use, investors will not be able to place the same level of reliance on them.

Investors here and abroad are confronted with the challenges the new paradigm presents: How to bring all the new information from issuers, rating agencies and data vendors together in a single operational framework for their structured finance portfolios; how to do this in a way that ensures they can prove they know all of their investments at every stage of the lifecycle; how to manage their entire portfolio of ABS and MBS assets in a scalable way, now and in the future.

Only then can investors feel that they have truly reduced their reliance on ratings.

Ratings will however remain a valuable source of independent analysis and expert opinion — a benchmark from which to verify or disprove investors own analysis and assumptions.

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