The Role of Ratings

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Credit Market Turmoil of 2007-08: Implications for Public Policy

Main Point 1

A primary cause of the recent credit market turmoil was overdependence on credit ratings and credit rating agencies.

Main Point 2

Without overdependence the complex financial instruments at the center of the crisis could, and would not, have been created or sold.

Main Point 3

Long-term sustainable policy measures should take into account both regulatory and behavioral overdependence on ratings.

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Overview

- Theory: where credit ratings fit

- The role of ratings in the crisis

- Reform proposals

Reverse Disclaimer

Economy.com

In November 2005, the Company acquired Economy.com, a leading independent provider of economic research and data services. The acquisition will deepen Moody's analytical capabilities to broader areas of economic and demographic research, expand the range of products and services offered to institutional customers and introduce new customers to Moody's. It will provide Economy.com with access to Moody's extensive client base, deep product marketing capabilities and other resources needed to expand its business. **The purchase price was not material and the near term impact to operations and cash flows is not expected to be material.**

Source: Moody's Form 10-K, Feb. 29, 2008

Theory I: Reputational Intermediaries

Pure Gov't Rater	Pure Private Rater
USDA	Good Housekeeping
	Financial Publishers
	Economy.com

Theory I: Reputational Capital

"We're in the integrity business: People pay us to be objective, to be independent and to forcefully tell it like it is." John Bohn, Jr., President, Moody's (1995)

"Ratings are of value only so long as they are credible." S&P Debt Ratings Criteria (1986)


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Theory II: Regulatory Licenses

Pure Gov't Rater | Pure Private Rater

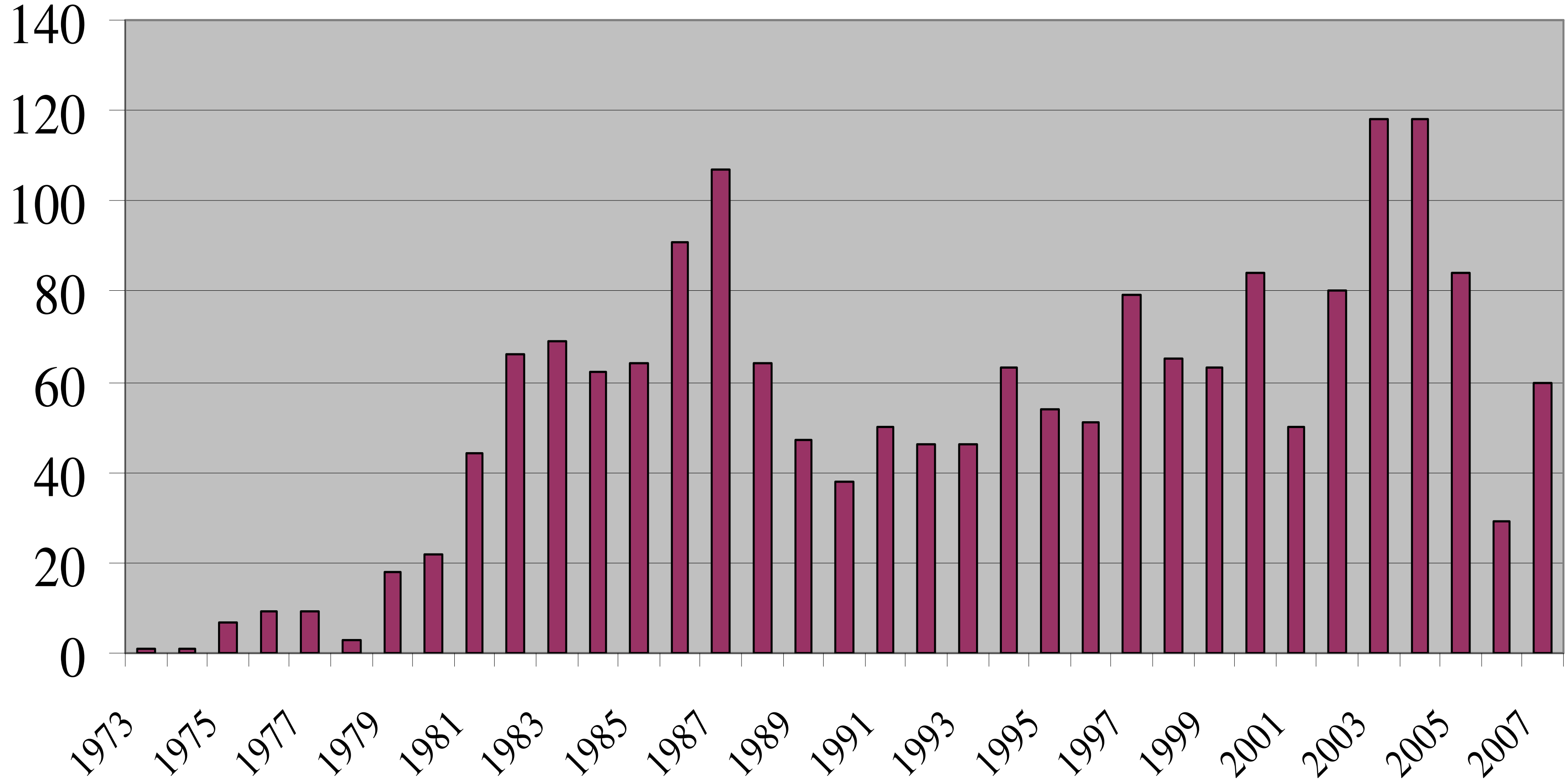
USDA

Good Housekeeping

Financial Publishers

Economy.com

Annual Federal Agency Decisions Based on NRSRO Status



Theory II: Regulatory Licenses

"Over the last three decades, we have embedded [the use] of credit ratings into our rule books. Recent events have awakened us to the unintended consequences of our behaviors. Credit ratings have become a crutch."

Paul Atkins, SEC Commissioner, June 2008

A Brief History

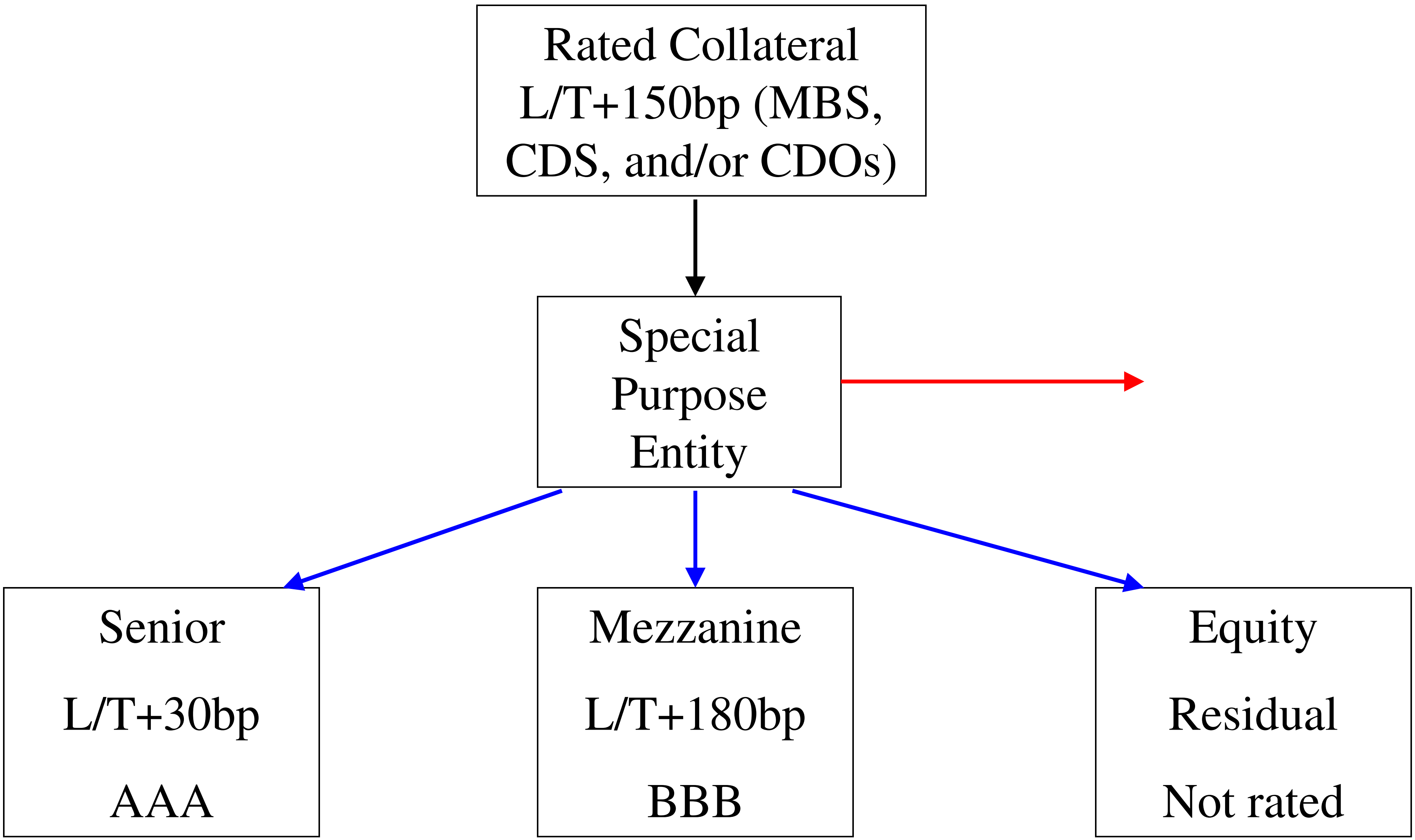
1975: broker-dealer rules

1970s/80s: Hickman/Milken and the investment grade “cliff”

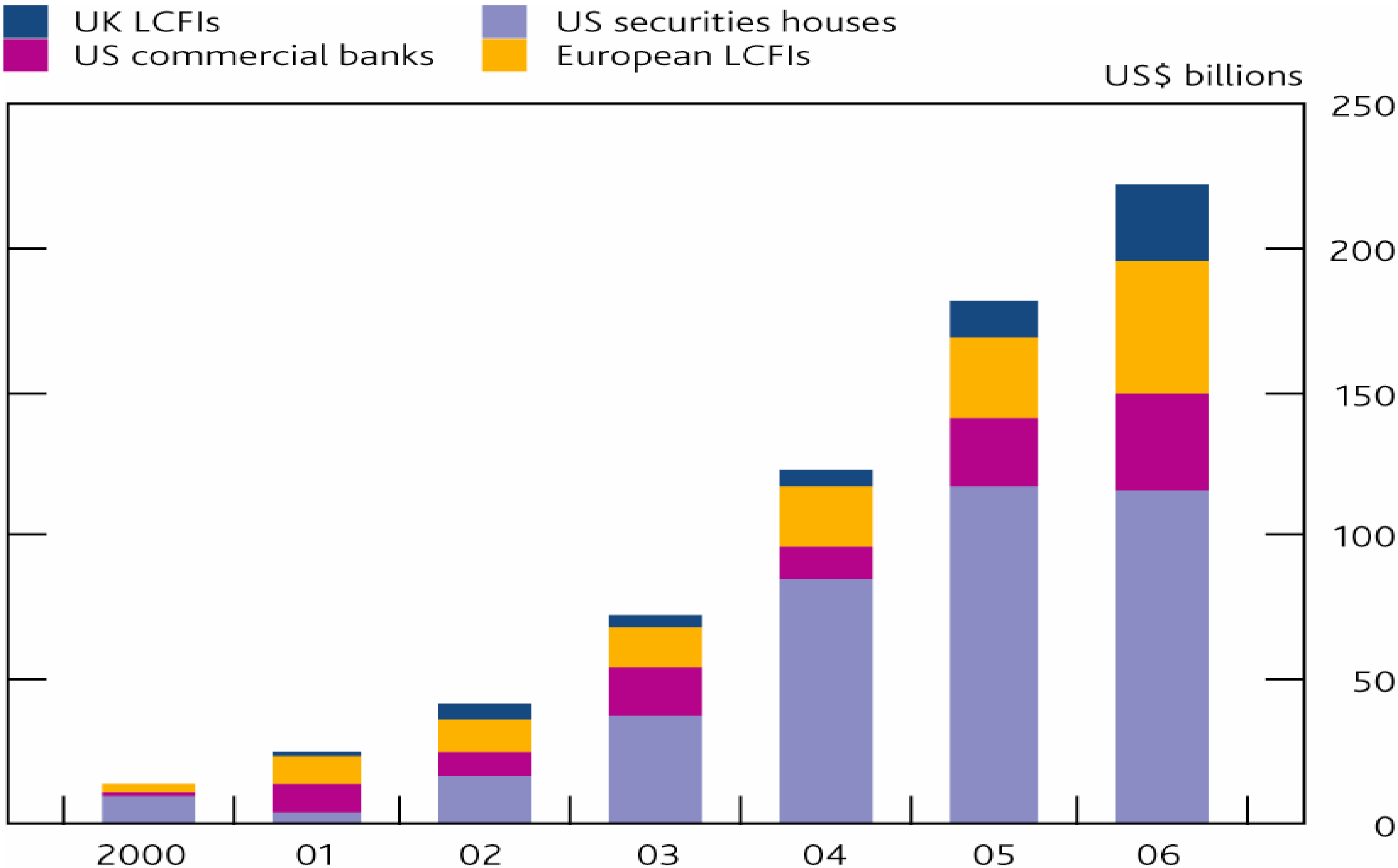
1990s: CBOs/structured notes for regulatory arbitrage

2000s: search for investment grade collateral, more regulatory arbitrage

Role of Ratings in the Crisis: CDOs and SIVs

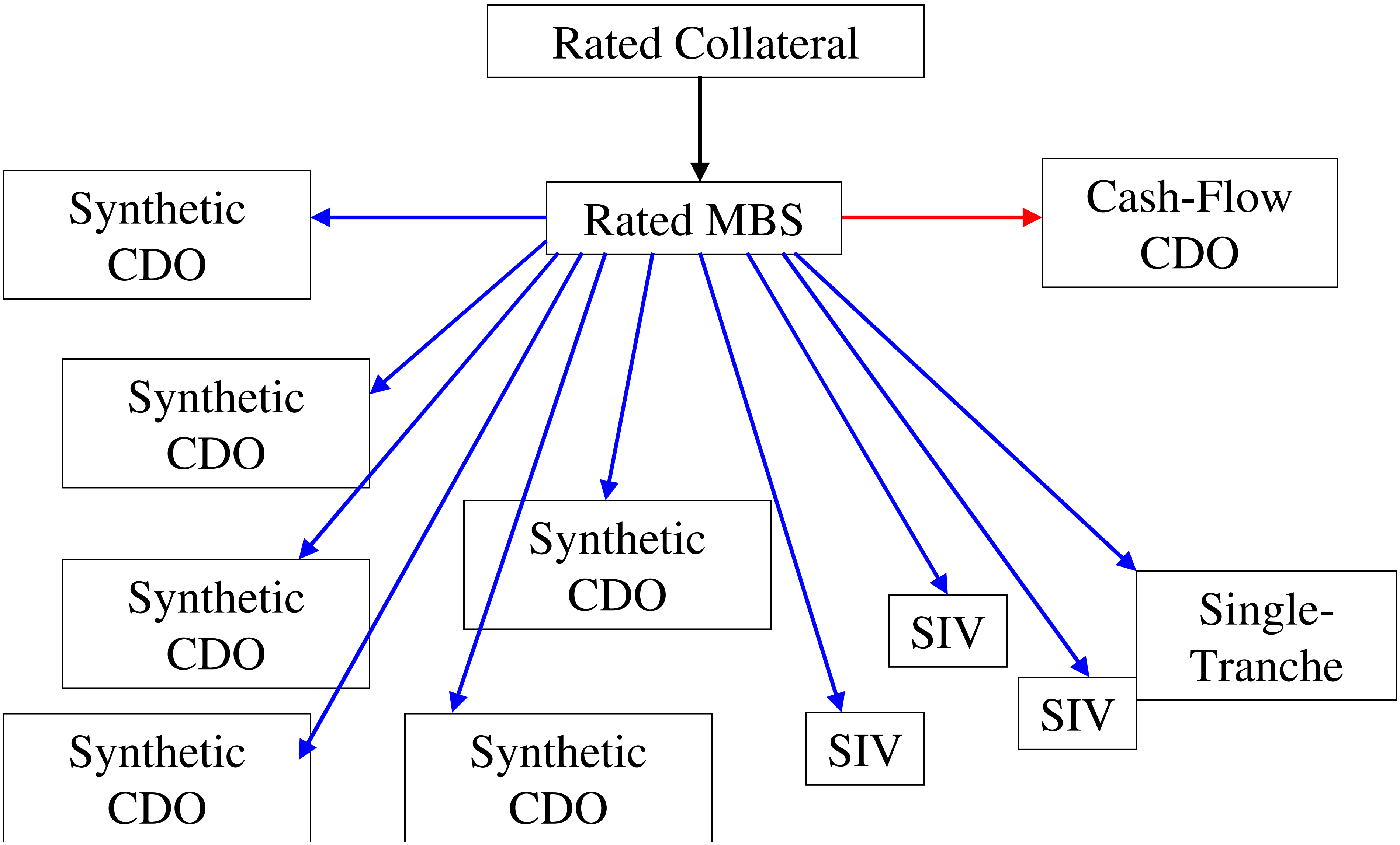


RMBS issues backed by sub-prime lending



Sources: Bank of England, Dealogic and Bank calculations, data include residential mortgage-backed securities (RMBS) backed by sub-prime and non first lien mortgages.

Role of Ratings in the Crisis: CDOs and SIVs



SEC Report

"One analyst expressed concern that her firm's model did not capture 'half' of the deal's risk, but that '***it could be structured by cows and we would rate it***.'"

Source: SEC Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies, July 2008, at 12

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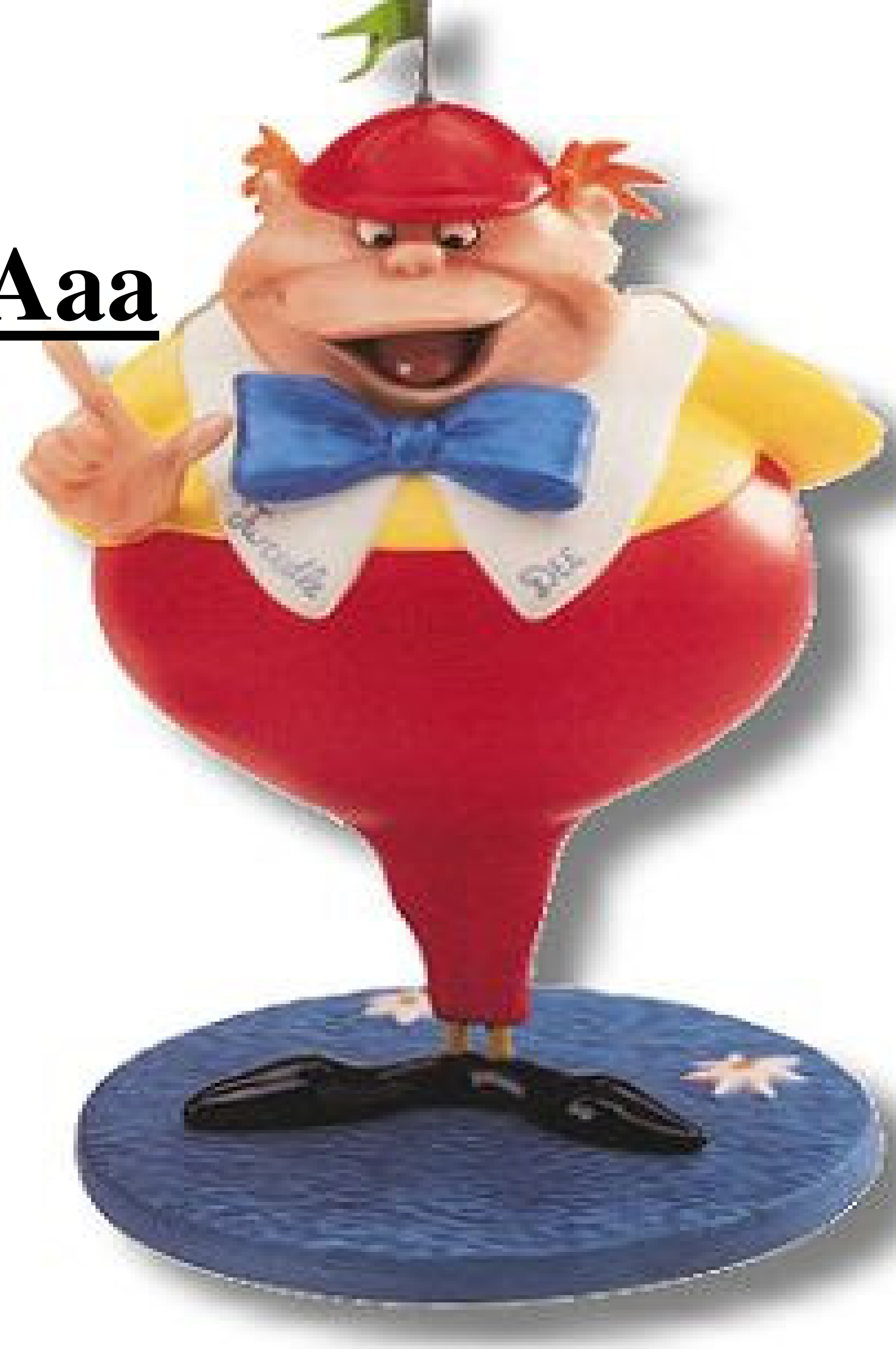
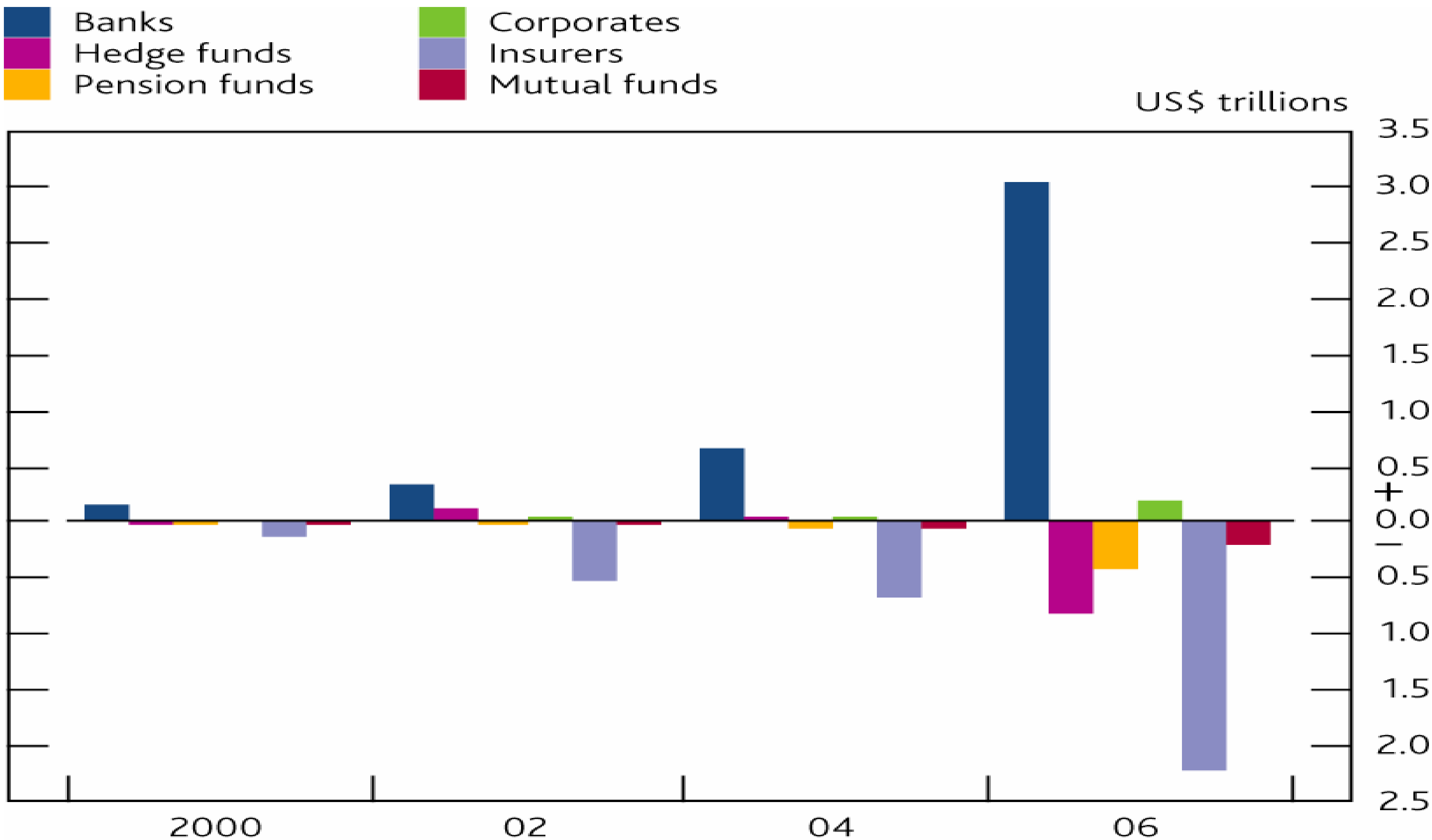


CDO 2006 Data

- 2006 cash flow CDO issuance doubled to $490 bn
- 2006 synthetic CDO issuance doubled to $450 bn
- Implications
  - Many mortgages bet on dozens of times
  - Zero sum game (winners, too)

Source: Bank of England, Financial Stability Report, April 2007, at 16

Credit protection by institution type



Sources: Bank of England; BBA and Bank calculations, net long and short positions.

Spread-for-rating comparison

Rating	Underlying	Spread
AAA	Corporate bonds	<5
AAA	Credit card ABS	15
AAA	iTraxx CDS index	22
AAA	CMBS	25
AAA	Cash-flow CDO	32
AAA	CPDO	200

Source: Bank of England, JPMorgan Chase & Co., From JPMorgan Chase & Co. (2006), Understanding CPDOs and Credit Derivatives Handbook, December.

Role of Rating Agencies: CDO Modeling

-Default probability

-Expected recovery

-Correlation

-Active management

-Strategic selection of collateral

S&P Default Rate Assumptions for CDOs

	ABS (all)	Corp Year 4	Corp Year 7	Corp Year 10
AAA	0.25%	0.19%	0.52%	0.99%
AA	0.50%	0.57%	1.20%	1.99%
A	1.00%	0.81%	1.81%	3.04%
BBB	2.00%	1.81%	3.94%	6.08%
BB	8.00%	9.49%	14.20%	17.47%
B	16.00%	21.45%	26.15%	28.45%

Source: S&P; Partnoy (2006)

The "BBB" Problem

2006 Vintage First and Second Lien Transactions

	Current Rtg/Last Rating Before WR											
Orig Rtg	**Aaa**	**Aa**	**A**	**Baa**	**Ba**	**B**	**Caa**	**Ca**	**C**	**Total UPG**	**Total DNG**	**Total Ratings**
Aaa	96.2% (2,212)	2.8% (65)	0.3% (6)	0.2% (5)	0.3% (8)	0.1% (3)					87	2,299
Aa		89.9% (1,295)	1.0% (15)	2.8% (40)	2.6% (37)	1.6% (23)	0.9% (13)	0.8% (11)	0.5% (7)	0	146	1,441
A			38.3% (565)	25.2% (372)	17.0% (251)	10.4% (154)	2.6% (38)	2.0% (30)	4.4% (65)	0	910	1,475
Baa				14.8% (224)	16.3% (247)	28.3% (428)	12.5% (189)	10.7% (161)	17.3% (262)	0	1,287	1,511
Ba					5.1% (28)	15.1% (83)	6.7% (37)	11.8% (65)	61.2% (336)	0	521	549
										0	2,951	7,275

Source: Moody's Investors Service, A Short Guide to Subprime, March 2008, at 3.

Summary of the Role of Ratings

"Some investors may not appreciate fully that ratings provide only a summary opinion on the riskiness of a product. And those with mandates restricting their investment to certain ratings bands may be attracted by higher-yielding products within those bands, without fully appreciating the associated risks."

Bank of England, Financial Stability Report, April 2007 at 6.

Reform Proposals

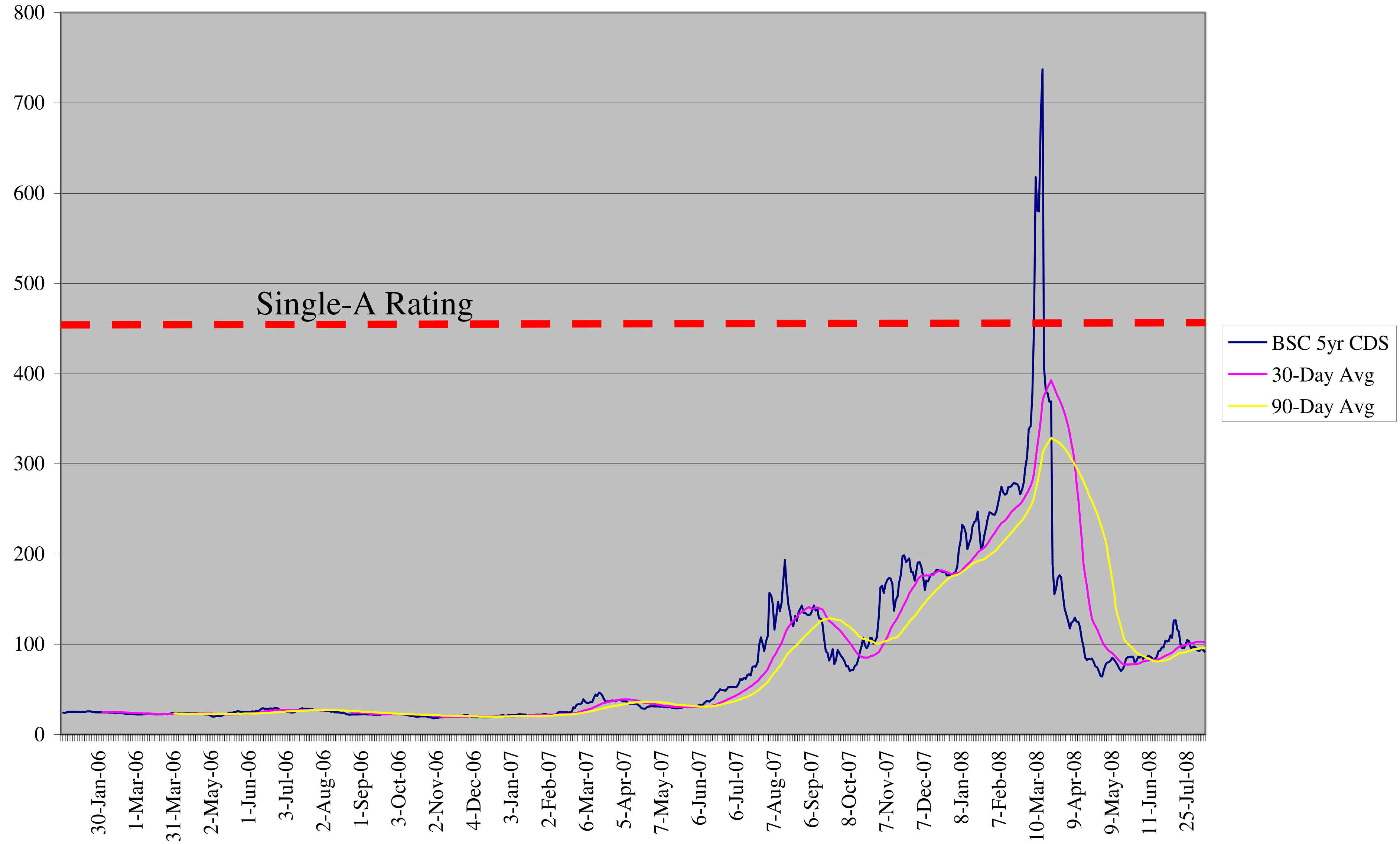
-Remove regulatory licenses

- SEC/Basel
- Market-based measures

-"Shock therapy"

- Split structured finance
- Litigation
- Disclosure
- Market-based measures

Bear Stears 5-year CDS Market Spreads (bp) (Source: Markit)



Source: Markit Group Limited

Litigation – First Amendment

Amendment I. Freedom of Religion, Press, Expression. Ratified 12/15/1791.

Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.

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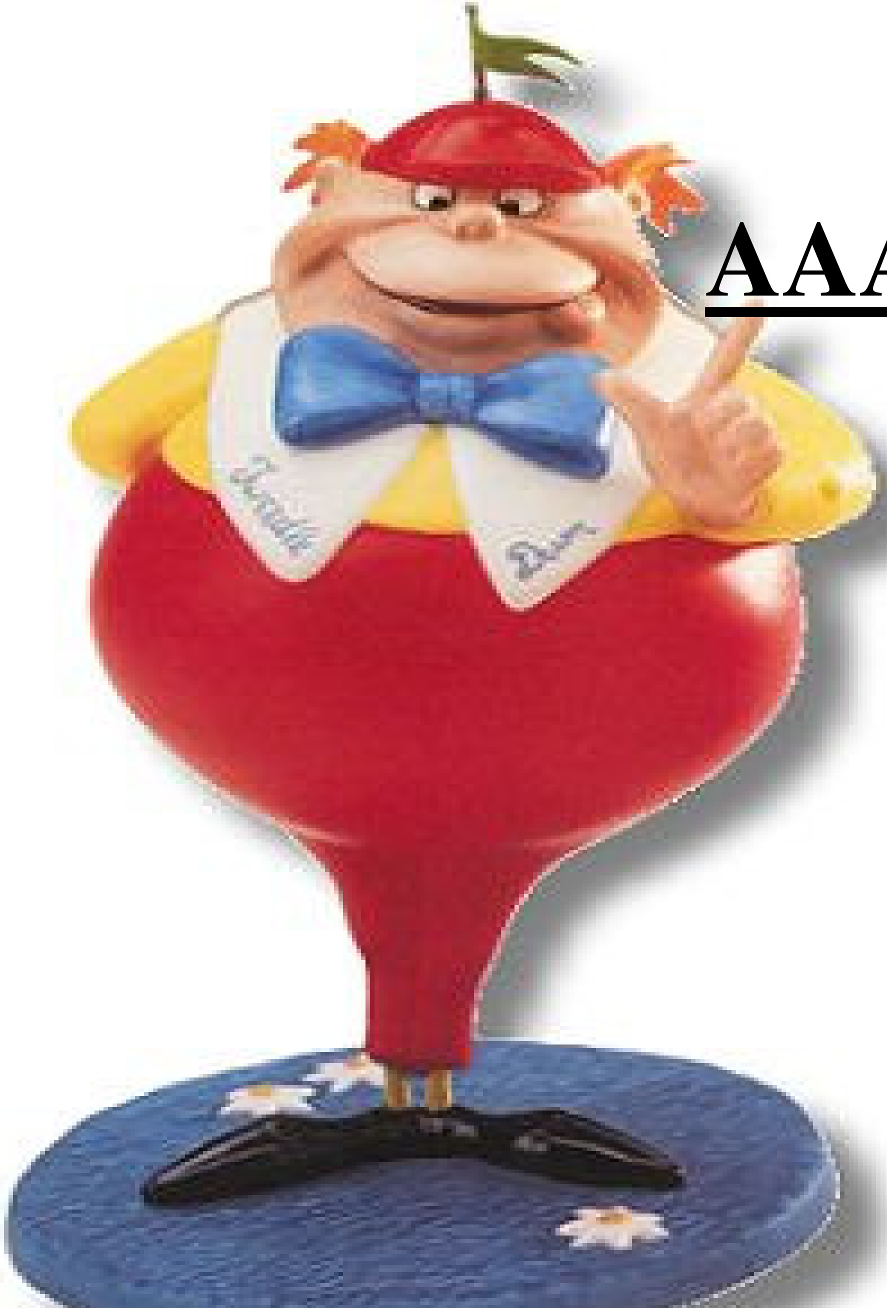

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