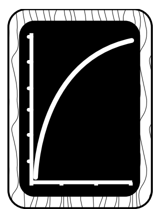

LEARNING CURVE®

Reason for Optimism in Rating Agency Reform

President **Barack Obama** last week signed into law the most extensive overhaul of the U.S. financial regulatory system in history. Rating agency reform, among the hotly debated issues leading up to the passage of the law, largely got punted down the road. That is good and bad news. While legislators missed an opportunity to formalize a new approach to rating securitizations that this industry has already begun to embrace, they thankfully did not create new rules that could have led to more problems.

The final bill leaves intact the business model in which issuers of residential mortgage-backed securities (RMBS) pay rating agencies for ratings. This aspect of the rating agency approach came under attack from critics citing conflicts of interest, leading to a proposal by Sen. **Al Franken** (D-Minn.) to have the **Securities and Exchange Commission** randomly assign rating agencies to transactions. That proposal was wisely left out of the final bill, and the issue was tabled for a two-year study by the SEC that could lead to structural changes down the road. The private sector should use this two-year reprieve to continue positive steps that have already been taken toward a more transparent process that better protects investors.

"Sen. Franken's much-talked-about proposal was left out of the final bill, and that's a good thing for the industry – nothing should be random about the rating agency process."

What was largely lost in the rancor surrounding rating agency reform were the steps that some of the major rating agencies already have taken – some mandated by an agreement with New York Attorney General **Andrew Cuomo** in 2008 – to address past mistakes. Although there is more work to be done, investors and other mortgage market participants have reason to be optimistic that we are on the right path toward a responsible return of securitizations.

Since 2007, when subprime securitizations were at their peak, I have advocated for independence in the due diligence process and for investors to have access to review results.

Mill Valley, C.A.-based **Redwood Trust** set a significant milestone for the industry in April by issuing the first, and so far only, publicly-rated private-label RMBS since the fall of 2008. The approach taken by Redwood Trust and **Moody's Investors Services**, which rated the $238 million prime jumbo deal, reflects the lessons learned over the past year and a half. My firm, **Allonhill**, performed due diligence on the deal and reported results directly to the rating agency, a significant change from the past. This is perhaps the single most important change in the rating agency process that we've seen in the past two years and something that should become the industry norm.

In 2008, rating agencies operating in New York were required to issue new rules to ensure MBS data is independent. Agencies operating outside of New York should follow suit. Under the new rules, if a third-party review firm (TPR) identifies a loan as having a defect, it is reported directly to the rating agency. In the past, data went back to the issuer, and the issuer decided if it was disclosed to the rating agency or if the loan should be removed from the pool.

Other aspects of the new securitization approach adopted by Moody's and others give investors reason to be optimistic. During the due diligence process, home prices are evaluated in a standardized manner and conflicting appraisals are dealt with systematically – something that was far less standardized in the past. All parties involved with loan-level reviews also now must provide signed documentation attesting that results accurately reflected what was found in review, and there was no outside influence or coercion.

As securitizations have started to reemerge, Allonhill has worked to interpret requirements that were merely outlines and sketches for how TPRs should do their jobs in order to bring investors something that the industry has long talked about but never before delivered: true transparency. We developed securitization guidelines for issuers, explaining in great detail how to meet new rating agency requirements, which call for better sampling methodology and error resolution procedures, stricter third-party review firm qualifications and ongoing monitoring of securities. Allonhill consulted with four of the leading rating agencies – **Standard & Poor's**, Moody's Investors Service, **Fitch Ratings** and **DBRS** – to ensure our securitization solution met their new requirements for public and private securitizations.

Careful analysis of these four firms shows:

Moody's and S&P have issued fairly detailed securitization

Total Securitization is now accepting submissions from industry professionals for the Learning Curve® section. For details and guidelines on writing a Learning Curve®, please call **Joy Wiltermuth** at (212) 224-3202.

 ©Institutional Investor News 2010. Reproduction requires publisher's prior permission.

requirements that result in independent data on transactions produced by a qualified TPR. While they differ in some key areas, they both have crafted an approach that digs deeper into transactions than in the past, ensuring investors that the data produced is factual and independent.

Fitch, too, has produced materials that indicate a strong core understanding of the review process for loans going into a securitization. But Fitch has not yet emerged as an active participant in the RMBS space, and its guidelines do not reflect as detailed an approach as Moody's and S&P.

DBRS is the only rating agency active in mortgage securitizations not bound by New York's new requirements calling for independent loan review. While the agency has developed a set of guidelines for its securitizations process, they only touch on the role of the due diligence process. To gain investor acceptance on publically-rated transactions, DBRS must develop its own methodology for TPRs that shows securitizations rated by DBRS consistently offer data reviewed independently and in accordance with published criteria that investors can obtain and review for themselves.

Sen. Franken's much-talked-about proposal was left out of the final bill, and that's a good thing for the industry – nothing should be random about the rating agency process. The industry should act aggressively to continue reforms already underway. Investors still don't have access to due diligence results, because of privacy concerns related to loan and borrower data. Statistical sampling methodology is virtually nonexistent in this industry, and rating agencies have only provided a first pass at a solution. There are many areas in the rating agency criteria that lead to contradictions and are subject to ongoing interpretation as individual loan situations arise. And the vast differences between rating agencies' definitions and outcomes have created tremendous inefficiencies and costs that have yet to be resolved.

Meanwhile, issuers should take note. Careful study of the criteria for loan data that drives ratings shows that what issuers really need to be shopping for isn't a rating agency but good loans to securitize. The criteria are stringent, and the requirements of the TPR will result in bad ratings for pools with bad loans.

Sue Allon

Sue Allon is founder and CEO of Allonhill, a Denver-based third-party review firm specializing in mortgage due diligence and credit risk management for institutional investors, private hedge funds, broker/dealers, government agencies, servicers and other mortgage service providers.

Excess Spread

Excess Spread includes stories from staff reports and other news sources from around the market. TS does not guarantee the completeness or accuracy of the stories gleaned from other sources, though they are believed to be reliable.

- The newly signed financial reform bill may "flash freeze" the asset-backed securitization market, according to **Tom Deutsche**, executive director of the **American Securitization Forum**. (*Bloomberg*, 7/21)

- The U.S. commercial mortgage-backed securities market appears to be reviving with some $1.4 billion in CMBS to be offered in coming weeks. (*The Wall Street Journal*, 7/20)

- Pensions funds that brought lawsuits against banks that underwrote mortgage-backed securities from which they suffered losses have had mixed results. (*The National Law Journal*, 7/21)

- Independent mortgage banks and their subsidiaries experienced a one-third decline in average profits from each loan they originated in the first quarter, according to the **Mortgage Bankers Association**. (*Mortgage Bankers Association*, 7/20)

- **S&P Valuation and Risk Strategies** has added several enhancements to valuation on its global credit portal, including the ability to search using "residential mortgage-backed securities" or "whole business securitizations" as the asset-class designation. (*Standard & Poor's*, 7/21)

- **MarGulf Management**, the U.S. real investments unit of Kuwait's **Markaz**, is looking to capitalize on distressed-debt opportunities in the U.S. (*AMEinfo*, 7/21)

- **Moody's Investors Service** has admitted it made a calculation error in rating an asset-backed securitization arranged by **Lloyds Banking Group**. (*Reuters*, 7/21)

- A 45% surge in automobile sales last month has **VTB-24**, the retail arm of **VTB Group**, considering an asset-backed securitization backed by car loans for the first such sale in four years. (*Bloomberg*, 7/20)

- U.K. banks are facing a £390 billion ($591.1 billion) funding gap in 2011 as they have to deal with an avalanche of maturing bonds and residential mortgage-backed securities that must be refinanced, according to **Nomura** analysts. (*The Telegraph*, 7/21)