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Introduction

This document is a working draft prepared by staff from the Federal Reserve Bank of New York, the Federal Reserve Board of Governors, and the Office of the Comptroller of the Currency. It is intended to provide analysis and offer policy alternatives for consideration by the principals of the President's Working Group on Financial Markets. We expect further comments and revisions following dissemination to other agencies within the PWG, prior to review by their principals.

This paper discusses the basic principles that should underpin the efforts of regulators and market participants to produce the reforms necessary to promote a sound and durable securitization market, consistent with the objectives of the G20 and other national supervisors and multilateral organizations.[1] In the years leading up to the financial crisis that began in mid-2007, securitization markets were a significant provider of credit to households and businesses globally, and were especially important in the area of mortgage finance. As illustrated by the figure (1) below, the issuance of new securitizations in the US has fallen dramatically, especially in non-agency mortgage markets, in part as a response to large losses and concerns about asset quality. As credit markets more broadly have improved, the new issue market for asset classes with strong performance has somewhat recovered, and there are also signs of life in asset classes with weak performance at the core of the financial crisis. While we expect that the market will respond to recent events by imposing adequate discipline on underwriting, structuring, and pricing for the near future, it is clearly necessary to use insights from the recent financial crisis to shape an agenda for regulatory reform before the key lessons have been forgotten.

The analysis and research developed by staff concluded there are six key questions the PWG should consider in an effort to ensure an economically sound and robust securitization market is available as a source of funding for financial institutions. The following questions should help regulators develop appropriate guidelines including risk management, underwriting, and capital requirements for securitization transactions.

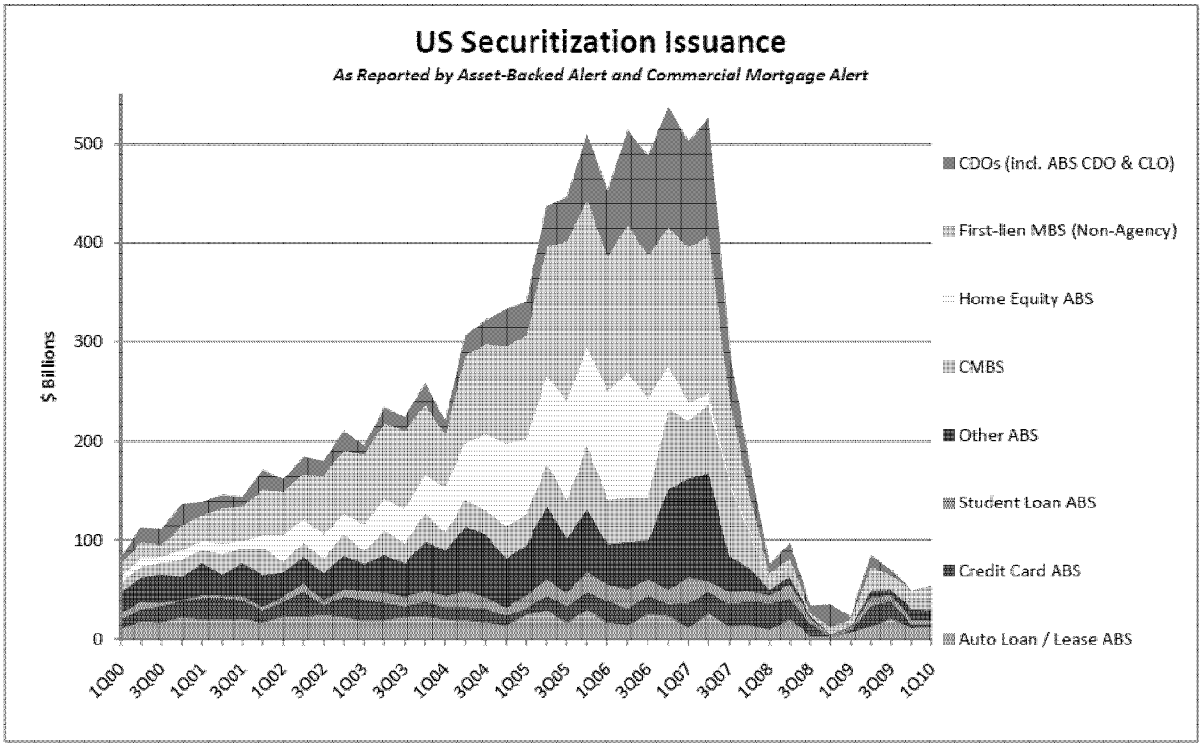
1. How do the PWG agencies move forward in a coordinated fashion to address outstanding issues associated with reform of the securitization markets and ensure the highest level of domestic and global consistency?
2. Is required risk retention an effective and practical policy option?

[1] For reference, see the 25 September 2009 report by the Financial Stability Board to G20 leaders entitled "Improving Financial Regulation." http://www.financialstabilityboard.org/publications/r_090925b.pdf.

3. Are the current revisions to Basel 2, and the US implementation, consistent with prudent risk management at financial institutions and meaningful levels of intermediation through securitization?

4. How do we improve the way in which credit rating agencies factor into the reform of U.S. securitization markets?

5. How do we mitigate the additional risks associated with synthetic securitization exposures?



We start with the presumption that a financial system with a robust securitization market is more desirable than a financial system in which all credit is originated, serviced, risk managed and funded by regulated depository institutions. In particular, the prudent use of markets to transfer risk from lender balance sheets to investors is a powerful technology which can not only expand the availability of and cost of credit to end borrowers, but also reduce volatility of the financial system as a whole. To be specific, term asset-backed securitization (ABS) markets are valuable not only for diversifying an issuer's sources of funding, but also for creating opportunities to better manage asset-liability duration mismatch when compared with funding long-term loans with short-term deposits. Moreover, securitization involving effective credit risk transfer enables issuers to limit concentrations to borrowers and geographies on their balance sheets. In addition, securitization permits servicers to realize economies of scale not possible when limited to retaining loans on balance sheet. Finally, securitization transmits useful information to supervisors and investors of depository institutions, by providing third-party discipline and market pricing to otherwise opaque assets. These combined benefits should strengthen the overall durability of the U.S. financial system and promote financial stability globally.

It is worth noting that while originate-to-distribute securitization markets played an important role in the recent crisis, a growth of credit availability to the commercial and residential mortgage markets was actually extended by balance sheet lenders through second liens and mezzanine debt. Consequently, even if securitization were dramatically curtailed, the financial system would remain vulnerable to under-estimation of risk and the development of asset bubbles. Absent further regulatory measures, it is unlikely that credit cycles will be brought to an end by simply forcing depository institutions to keep originated loans on their balance sheets. But with appropriate regulatory reforms, securitization markets can significantly augment credit provision to the economy beyond what would be available if all assets were held on financial institution balance sheets without increasing the frequency or severity of credit cycles.

This document has three main elements. First, it reviews the key deficiencies in the non-agency securitization markets that contributed to the recent financial crisis. Second, it outlines the necessary features for a well-functioning securitization market. Third, it offers a framework for securitization market reform and a set of policy considerations that should to be addressed in order to achieve those reforms.

The Lessons from the Crisis for Securitization

There are two broad views of the causes of the recent financial crisis: one which focuses on incentive problems in securitization and another view which focuses more broadly on errors in risk management.

The former view highlights the role of incentive problems between different agents involved in the securitization of commercial and residential mortgage credit.

- Frictions created by misaligned incentives existed between the different levels of the securitization process, such as origination, assembly, structuring, syndication, distribution and servicing. For example, there was asymmetric information between the issuer and investor. The ability of other investors to free-ride off the screening and monitoring of any one investor leads to the under-provision of those activities. While the use of an intermediary like a rating agency can mitigate these frictions, this is less effective when they selected and paid by the issuer.
- Frictions existed between savers and asset managers. For example, the use of return benchmarks to evaluate asset manager performance creates well-known incentives for managers to purchase more risky securities, and use of peer evaluation in returns amplifies these incentives. However, the mitigation of this problem is possibly undermined by pressure to meet unrealistic return targets.
- Frictions existed between regulators and supervised institutions. Credit ratings are often embedded in regulation in order to mitigate this friction, validating investors' reliance on them as an adequate risk measure. Regulation that was inappropriately or inconsistently applied led to the creation of new risks that took advantage of regulatory, capital or liquidity arbitrage opportunities.

From this view of the crisis, securitization reform should focus on resolving these incentive problems, as limited disclosure and poor underwriting are symptoms of a larger problem which must be addressed before it manifests itself in a different form in the future. Along these lines, the recent financial crisis looks very similar to smaller blow-ups over the last twenty years (i.e. a pattern of deteriorating underwriting standards, a rapid increase in securitization volume, and the entry of new issuers), and will likely happen again without more fundamental changes to the market.[2]

[2] For example, each of the following ABS sectors has gone through a similar credit cycle: franchise loans, manufactured housing, equipment leases, and home equity.

However, under an alternative perspective, the financial crisis was caused by widespread failures of risk management, and not just limited to securitization, as evidenced by the severe financial distress faced by balance sheet lenders and financial guarantors that did not face such agency problems. Under this view, it was not poor underwriting per se, but instead was over-optimism in investor beliefs about residential and commercial property values combined with the use of limited historical data to forecast borrower behavior.

- Investors experienced the "irrational exuberance" of the market. Abundant market liquidity exacerbated the lack of due diligence and failure of incentives by fostering artificially low spreads and investor complacency.
- Underwriters and regulators did not have an effective means for aggregating quality information to ensure well-performing loans. There were difficulties in matching information from different sources, such as servicing, tax and property, and consumer credit reports; this limited the ability of lenders to understand the complete risk profile of a borrower and consequently for regulators to aggregate this data.
- The deterioration in underwriting standards was also attributable in part to underwriter, and perhaps investor, over-reliance on and misunderstanding of FICO scores. Consumer credit reporting agencies were slow to respond to borrower fraud in the form of renting the FICO score of a prime borrower.
- Investors did not have access to sufficient information, resources, or time required to assess complexity of structured products to determine whether they were suitable for their portfolios, in part due to significant heterogeneity in documentation practices of underwriters as well as the insufficient information at the borrower level.
- For credit derivatives, there was limited public information because disclosure was voluntary. Regulators had insight only into institutions they supervised; no regulator had access to all of the books, making a comprehensive view of the marketplace impossible.
- The inability to accurately measure risk ultimately led to an inability to price risk. This problem was especially acute with respect to securities issued by "originate-to-distribute" issuers and sold to investors who relied upon ratings in assessing credit risk.
- Given the mispricing and miscalculation of risk, institutions did not appropriately account for their exposures, which led to increased leverage and risk being assumed by the financial system as a whole. As credit performance declined for both consumer and commercial credit obligations, third party credit and liquidity providers, such as monolines and banks that wrote liquidity puts, incurred very significant losses and had been paid almost nothing to assume such risks. Insufficient capital for securitization exposures was a significant miscalculation, both by regulators and by the market. One example would be traded securitized products, which were assigned relatively low capital charges, in part due to the overly optimistic liquidity assumption in internal

models compared with the capital required had these exposures been held in the hold-to-maturity banking book.

- Securitization transactions presented liquidity, reputation and other risks to their sponsoring institutions; securitization activities did not completely transfer all risks. In the case of SPE's and ABCP conduits, risks to the sponsor were not transparent to investors or analysts due to their off-balance sheet treatment under previous accounting rules. Under representations and warranties, investor claims caused sponsors to incur unplanned expenses to resolve claims.
- Contractual arrangements governing securitizations were unnecessarily complex and ambiguous and not always followed or enforced as originally contemplated, often to the detriment of risk transfer and market confidence in risk transfer. As the market deteriorated, some firms were willing to support their securitization transactions, while others chose to follow the terms of the original structure. For example, in residential mortgage backed securities, before the crisis loan modifications were considered a very small risk exposure. However, as a greater number of loans defaulted, the pressure on third parties and servicers to modify loans resulted in losses to investors. More importantly, the volume of request from third parties to support the modification process resulted in higher than anticipated servicer advances and loan buybacks under representations and warranties.

Consequently, under this view, securitization reform does not have to deal with agency problems that were well-known to market participants, but instead can focus on improving risk management. For example, some market participants have suggested that greater transparency to investors combined with stronger risk governance at institutions of all types would have avoided many of the excesses which occurred during the recent financial boom and bust cycle.

In the end, there is compelling evidence to suggest truth to each of these points of view, implying that the recent crisis was caused by a combination of incentive problems as well as by failures in risk management practices. Consequently, a robust financial system, which includes a healthy securitization market, requires significant changes across the board, and implies that there is no single magic bullet to prevent another similar crisis. Thus, US regulators' attempts to retool supervision models and reevaluate disclosure requirements and international groups' efforts to strengthen capital and liquidity requirements applicable to large financial institutions will not suffice.

The Features of a Well-Functioning Market

A well-functioning securitization market should attract risk-aware investors to expand credit availability through the cycle while properly pricing for risk. Banks benefit from the diversified funding that is achieved through prudent use of securitization and retaining credit origination in the banking system is important for the longer term stability of U.S. financial markets. If credit origination moves to lighter or non-regulated portions of financial markets, it is difficult for public policy-makers to identify and react in a timely manner to changes in underwriting standards and investor tolerance or appetite for risk. To be effective, reforms should require high standards for origination, underwriting, and sale of securities, and servicing of the underlying assets, and foster development of a securitization market that provides:

- Risk Transfer: Make clear that the sale of credit risk of a pool of assets from a sponsor or issuer to an investor, whether synthetic or cash securitizations, is irreversible, subject to representations and warranties.
- Consistency: To the extent possible, given differences in legal regimes and degrees of regulation, encourage comparable rules and practices across jurisdictions and issuer types. Practices should be designed to discourage accounting, tax, or regulatory capital arbitrage.
- Alignment of Incentives: Structure compensation and fees so that participants, including servicers, are rewarded over time based on long-term performance of securities and their underlying assets. Separately, require sufficient capital to be at risk for failure to adhere to standards.
- Transparency: Provide investors with sufficient data to assess risk and make informed investment decisions independent of ratings agency analyses.
- Market information: Provide adequate and timely data to measure the stock and flow of credit, the adequacy of credit underwriting, structuring, and pricing, the performance of such credit, and identify the ultimate providers of funding and owners of credit risk.
- Investor Diligence: Emphasize obligation of investors, including relevant governance bodies, to put in place appropriate processes and develop the requisite level of sophistication to assess, measure and manage risk inherent in the securitizations.
- Consumer Protection: Provide clear information to borrowers on assets underlying securitizations to foster understanding of all terms and conditions, including changes to pricing and other consequences of stress to interest rates or collateral values.

The Three Pillars of Securitization

The features of a well-functioning securitization market can be grouped into three important pillars: issuer and servicer incentives, market discipline, and regulation.

The first pillar: incentives of the issuer or servicer to screen and monitor borrowers in the asset pool.
- Originators incentives can be aligned with investors through deferred issuer compensation, representations and warranties, and issuer risk retention.
- Servicer incentives can be aligned with investors through restrictions on servicer behavior in the pooling and servicing agreement and through compensation regimes.

The second pillar: the ability of the market, including investors and intermediaries, to accurately evaluate the risk of securities at issuance and over time.
- This requires that adequate and timely information be disclosed in a suitable format and purchased by investors with the capacity to measure and manage risk.
- The public sector can help solve coordination failures by the market, and facilitate agreement on standards for disclosure.

The third pillar: regulation, including the underwriting and servicing of credit, regulatory conditions for an issuer to achieve bankruptcy-remoteness, risk management practices of supervised financial intermediaries, and financial stability monitoring of markets by regulators.

The first pillar refers to the incentives of the issuer or servicer to screen and monitor borrowers in the asset pool. Originators may have an incentive to sell risky assets to third-party investors who do not have as much information as they do. Originator incentives can be aligned with those of investors through a number of mechanisms discussed below, including but not limited to deferred issuer compensation, issuer representations and warranties about underwriting, and issuer risk retention. On the servicing side, new standards must address the standard principal-agent problem associated with ensuring that the servicer, as an agent of investors, makes decisions in their collective best interest. These incentives can be aligned with those of investors through restrictions on servicer behavior in the pooling and servicing agreement as well as through compensation regimes.

The second pillar refers to the ability of the market to accurately evaluate the risk of securities at issuance and over time. Here, the market not only includes investors buying the securities, but also intermediaries that certify the securities to investors like credit rating agencies. The accurate evaluation of risk by the market generally requires that adequate and timely information be disclosed to investors in a suitable format, and securities be purchased by investors with the capacity and inclination to measure and manage risk. It is also important for third-parties acting as investor fiduciaries (e.g. asset managers, special servicers, credit rating agencies) to disclose potential conflicts of interest to investors, and to adequately disclose their interactions with market participants. For example, all investors should be aware of interactions between a CMBS special servicer and B-piece buyer, between an asset manager selecting the reference portfolio for a CDO and individual investors, or between an underwriter and a credit rating agency on ABS deal structure. In order for investors to make decisions independent of credit ratings, it is important for them to have access to the same information as the agencies, which requires significantly more granular detail on the asset pool than currently provided, access to cash flow models to understand the risk, and adequate time to conduct due diligence. The public sector can help solve coordination failures by the market, and facilitate agreement on standards for disclosure.

Investors in structured credit should be limited to institutions with adequate resources to perform independent due diligence on the underlying transactions. This principle should be reinforced through the supervision of risk management by regulated institutions, and by establishing benchmarks for best practices in the governance of investments for other institutions. On the latter point, the public sector can document best practices in structured credit risk management of supervised institutions as a benchmark for all investors to consider. Finally, effective market discipline may require a significant change to the business of credit ratings, given incentive problems created by the issuer-pays model. While there are a number of options, including increased prudential regulation of ratings and the deferral of issuer-paid compensation, an interesting option involves the transfer the choice of rating agencies from the issuer to an independent third party, which prevents the pressure on standards which comes from issuer rating shopping. As investors would ultimately pay for these services, the intermediary would remain aligned with their interests.

The third pillar of securitization refers to regulation, which includes regulation around the underwriting and servicing of credit, regulatory conditions for an issuer to achieve bankruptcy-remoteness, regulation of the risk management practices of supervised financial intermediaries, and financial stability monitoring of markets by regulators. Restrictions on loan origination and servicing are necessary to align investor incentives with those of the broader public, such as consumer protection regulation around minimum underwriting standards or prohibited servicing practices. Consumers need to be protected from predatory lending behavior and abusive servicing practices.

As a fundamental component to securitization is risk transfer, issuers need legal clarity on the conditions under which an asset pool has truly been sold to a trust, which can only be provided by the public sector. For example, insolvent depository institutions and insurance companies are generally resolved outside of the bankruptcy code by regulators with broad authority to repudiate contracts, which means securitizations sponsored by these institutions require regulatory approval to achieve true sale. When contemplating changes to prudential regulation, to the extent possible, given differences in legal regimes, comparable rules and practices across jurisdictions and issuer types should be developed. As the required consolidation under FAS 166/167 may not reflect the risk transfer, capital requirements should be calibrated to the real transfer of risk. Safe harbor from the broad authority granted to receivers to repudiate contracts should be focused on whether or not the transaction involved risk transfer, and should be simple enough to ascertain compliance. Regulators and the market need more information about positions and trading in order to better understand valuation and the distribution of risk. Simply increasing the scope of disclosure is not enough, as standardization is equally important, so information about risk and performance can be better aggregated.

Finally, it is important for regulators to more actively monitor the stability of financial markets, including but not limited to the adequacy of credit underwriting, structuring, and pricing, as well as understanding how risk has ultimately been distributed through the financial system. As it is impractical for regulators to monitor every new issue transaction, it is necessary for issuers to produce adequate and timely information about underwriting and structuring in a standardized format which is suitable for aggregation. In principle, this information should be produced for credit which resides on balance sheet of both supervised and unsupervised institutions as well as for credit embedded in securitizations. Beyond information about the quantity and terms of credit, the financial stability regulators need adequate information about who is ultimately funding this credit and/or who is holding the risk of default. There is an important principle of consistency, where regulation should not encourage the origination and servicing of credit outside of the regulated sector. In principle, all intermediaries should be subject to the same capital and disclosure regime.

A robust securitization market relies on significant changes to each of the three pillars described above. Given the need for comprehensive reform, the challenge is to identify the right reforms, assessing the efficacy and understanding the burden on market participants, which ultimately will be passed along to the borrower. Additionally, some types of assets may not be suitable for securitization and should remain on lender balance sheets.

Preliminary Policy Considerations

Securitization reforms are embedded in both the House and current Senate versions of financial reform bills, and are the focus of proposals by the FDIC and SEC. There are also a number of international efforts under way, included impending changes to the European CSD. In order to promote a sound and durable U.S. securitization market, and to prevent new counterproductive arbitrage opportunities, including the movement of credit origination and distribution activities to the fringes of the financial system, policy makers should collaborate and coordinate rulemaking to produce effective and lasting reforms. In the US, the PWG can assist in coordinating policy priorities and endorse initiatives designed to be both consistent with policy and complementary. Globally, the U.S. should take a leading role in new FSB efforts to coordinate policy making and implementation.

The PWG should consider the following questions:

1. How do the PWG agencies move forward in a coordinated fashion to address outstanding issues associated with reform of the securitization markets and ensure the highest level of domestic and global consistency?

Individually and collectively, the PWG agencies have responsibility for ensuring that the appropriate set of regulatory and supervisory reforms are identified and adopted in a timely manner. Public policy officials are debating various aspects of financial reform domestically and in other jurisdictions, and standard setters, such as FASB, the BCBS, IOSCO, etc. are also seeking to finalize outstanding proposals. In some cases, these proposed rules are redundant or inconsistent and these proposed rules have led to increased uncertainty for credit originators, securitization sponsors, asset servicers and investors.

For example, the SEC recently issued a proposed rule that addresses disclosures and structure considerations for asset-backed securities, as well as other conditions such as CEO certification. At the same time, the BCBS has established an expectation that banking supervisors in each jurisdiction will develop and implement requirements that must be met when banking companies wish to invest in securitizations. Further, the FDIC's recent ANPR providing clarification of standards or conditions for the safe harbor provided to securitization investors when a bank is placed in receivership includes another set of disclosure expectations. In each case, these standards or expectations for disclosure may or may not be consistent with legislative proposals under consideration in congress and may or may not be consistent with legislative proposals under consideration in other significant jurisdictions. At a minimum, the U.S. financial supervisory leadership should seek to ensure that redundancies are avoided and inconsistencies are resolved before finalization of the various outstanding proposals. Regulators, public policy makers, analysts, investors and other interested parties will benefit most from a securitization reform program that results in a strong, rational, and consistent set of standards and objectives for the U.S. securitization market.

2. Is required risk retention an effective/practical policy option?

While aligning originator incentives with those of investors is important, the current focus by policy makers on risk retention as the primary tool to improve the alignment of incentives may be overemphasized at the expense of a broader and more coordinated approach. There is neither strong theory nor empirical evidence linking the practice of risk retention to improved performance. Research has shown there is little difference in performance between sold and retained credit assets, with the notable exception of "no-doc" mortgage loans. In fact the principal threat to some securitizers during the crisis was the retention of too much, rather than too little, credit risk from securitizations.

Given the introduction of FAS 166/167 and associated bank capital rules, even low levels of required risk retention could now significantly limit the ability of issuers to actually transfer risk. In addition, risk retention could possibly blunt incentives for market participants to conduct their own due diligence, and might increase the perception of issuer recourse, a historical problem which regulators have had to address. Finally, even if the mechanism could have a positive impact on incentives, the form and amount of risk retention likely varies significantly by asset class, and could change over time with financial innovation, which creates significant scope for arbitrage, and places a significant burden on regulators. If pursued, it might be advisable to limit required risk retention to asset pools and transactions that are underwritten or structured significantly outside of historical experience. For more typical transactions, there are a number of other mechanisms which likely have similar efficacy but are not as likely to have unintended consequences. For example, if residential and commercial mortgage loans were underwritten to a set of uniform federal standards, this line of defense might diminish the need for risk retention. In addition, requiring the originator to defer and subordinate a meaningful fraction of their compensation to the repayment of principal on the senior tranche could be a powerful disincentive to dumping mispriced assets into the market. While representations and warranties are a potentially important mechanism, they can be a blunt way of aligning incentives. For example, extending the window through which an originator must repurchase defaulted loans from three months to twelve months is expensive, as it limits the ability of the originator to transfer risk associated with early payment defaults not driven by fraud. In principle, an effective mechanism should address unexpected performance given economic conditions, and not limit risk transfer when economic conditions are simply worse than expected. As mentioned earlier, one suggestion along these lines that we believe may be worth considering is to introduce minimum underwriting standards by asset class. Since a significant amount of residential and commercial credit was underwritten outside of historical benchmarks for prudent lending in these sectors, it makes sense to consider a broad range of solutions and seek to adopt the set of measures that properly aligns incentives across the full spectrum of stakeholders. Such an approach obviously requires a great deal of coordination, and thus is appropriately an issue for consideration by the PWG.

3. Are the current revisions to Basel 2, and the US implementation, consistent with prudent risk management at financial institutions and meaningful levels of intermediation through securitization?

Recent revisions to the Basel 2 framework have increased capital for a number of activities at the core of the financial crisis: re-securitization exposures, liquidity puts to ABCP conduits, and securitization exposures in the trading book.

One area of possible concern is the use of new accounting rules related to consolidation for assessing capital requirements. When issued in 2009, accounting standard setters advised that the rules for consolidation were focused on the characteristic of control and were not necessarily designed to be sensitive to risk transference. While it is clear that some forms of securitization involve limited risk transfer (i.e. credit card master trusts), assessing capital charges against exposures when there is clear legal risk transfer may discourage the use of securitization to transfer risk, and possibly encourage the use of credit derivatives to achieve the same regulatory capital outcome. To the extent that capital rules are unduly punitive and possibly inadequately risk sensitive, activity will flow to institutions not subject to capital rules or sensitive to the accounting treatment. The first non-agency RMBS transaction in over two years was an illustration of this point, as bank-originated whole loans were sold to an unregulated REIT for securitization.

Another area of concern is related to the use of banking book capital charges for trading book securitization exposures that will result in a dramatic increase in required risk-based capital, with the possibility of banks facing lower capital charges for unhedged trading book securitization exposures than for hedged exposures. While existing capital requirements likely overstated the trading liquidity of securitization exposures in a stressful environment, it is possible that the proposed regime has gone too far in the other direction.

4. How do we improve the way in which credit rating agencies factor into the reform of U.S. securitization markets?

Since the 1970s, credit rating agencies (CRAs) have operated on an "issuer-pays" basis, where most CRA revenue is earned via a payment for each rating opinion from the issuer of the rated security. This model creates a potential agency problem: the CRA may have incentives to issue overly-optimistic ratings in return for higher fees or a higher market share of new business. These incentive problems are likely to be intensified when issuers can "shop around" amongst competing CRAs, and for products that are structured rather than for general debentures of a corporation.

The main check on this behavior is CRA reputation, namely that observed rating errors will lead to a loss of trust in ratings in the future, reducing future CRA revenues. For relatively stable, unstructured, asset classes like corporate bonds, reputation and regulatory oversight may be sufficient to discourage rating shopping and inflation. But the rapid growth of structured finance products in the 2000s arguably created an environment where incentives for good behavior were significantly weakened. This boom significantly changed CRA's revenue mix. For example, by 2006, 44% of Moody's revenue came from rating structured products, coinciding with an increase in total revenues from $159m in 2000 to $705m in 2006. During such a boom, CRA incentives are likely to be skewed more towards maximizing current revenue, rather than preserving reputational capital.[3] Recent empirical work finds some support for the view that incentive problems weakened rating standards during the structured finance credit boom.[4]

In recent years the SEC has attempted to improve competition in the credit rating business by issuing Nationally Recognized Statistical Rating Organization (NRSRO) status to a number of new firms, including DBRS, Egan-Jones and A.M. Best. However, academic research suggests greater competition is unlikely to solve the incentive problems described above, and in fact may exacerbate them, by creating more scope for rating shopping across CRAs. Consistent with this view, Becker and Milbourn (2010) find that the entry of Fitch into the market for corporate bond ratings worsened the subsequent quality of ratings issued by Moody's and S&P.

3 This intuition has been modeled theoretically in several recent academic papers, including Mathis, McAndrews and Rochet (2009) and Bolton, Freixas and Shapiro (2009) that predict rating standards are likely to deteriorate when the volume of issuance of opaque securities is high.

4 Ashcraft, Goldsmith-Pinkham and Vickery (2010) find that risk-adjusted MBS credit ratings became progressively less conservative at the peak of the mortgage boom between early 2005 and mid 2007. Griffin and Tang (2009) find that CRAs applied judgmental adjustments to CDO model ratings. They show these adjustments increased the fraction of highly rated securities, but reduced the informational quality of ratings. Benmelech and Dlugosz (2009) document large recent downgrades on structured finance securities, and show that securities rated by a single CRA were downgraded more heavily ex-post, perhaps consistent with rating shopping.

What are the realistic policy options for improving credit rating agencies? First, the required disclosure of all communication between issuers and credit rating agencies can be an effective check on issuer rating shopping. In particular, this model was used by the Federal Reserve during the implementation of Enhanced Credit Review for the Term Asset-Backed Securities Lending Facility (TALF). The ability of investors to see the same information as the credit rating agencies, and to be able to watch issuers shop away from a CRA with higher credit enhancement expectations could significantly enhance market discipline of issuers, especially in the face of greater competition by new rating agencies.

Second, given the scale of the recent mistakes, credit rating agencies should face significant supervision and regulation of the substance of their ratings, both at issue and over time, as well as public disclosures about rating criteria and historical performance. For example, loans programs which lack adequate historical performance data simply should not be involved in securitization.

Finally, given the public discussion about the role of the issuer-pays model, it would seem prudent to study alternative compensation models. While an investor-pays model may be impractical, it is not the only alternative. For example, the use of an independent third-party to select rating agencies might be a viable alternative.[5]

5. How do we mitigate the additional risks associated with synthetic securitization exposures?

Synthetic securitizations represent evidence of the financial innovation that can occur when financial markets are allowed to continually evolve and develop, but their introduction in the securitization market also reflects the importance developing a set of strong, sustainable market oversight expectations with clear responsibilities and accountability. Securitization derivatives can assist in the management of risk exposures but can also amplify the risks within the financial system. For example, synthetic structures can easily generate highly-rated debt

[5] Under a platform pays model, security issuers do not interact with rating agencies directly. Instead, an issuer seeking a rating would contact a central platform, which controls the entire rating process. The platform selects one or more NRSROs to provide the rating, and pays each NRSRO out of the up-front fee it receives from the security issuer. The choice of which CRAs are selected could take into account the performance of past rating opinions, and the platform would also have the power to revoke the license of a CRA whose ratings are shown to perform poorly. The platform would be charged with representing the joint interests of issuers and investors. The platform would probably need to be a monopoly, to avoid rating shopping across platforms. The DTC is a potential candidate institution to operate the platform, since it is a not-for-profit cooperative that is regulated by the Federal Reserve, jointly owned by financial firms that both issue and invest in fixed income securities, and has expertise in fixed income markets.

instruments that embed very complex correlation risks that even sophisticated trading desks cannot actively hedge. In addition, it is often difficult to understand the performance of the referenced assets within synthetic structures or determine the ultimate bearer of the risk. One mitigant could be enhancing the required disclosure of synthetic deals. For example, offering materials could disclose the party that selects or provides input to the selection of the synthetically referenced collateral pool. The underwriter should also state the amount of collateral that was created by its own trading desk. In addition, the underwriter should register or disclose the entire amount of synthetically created exposure created through total return swaps, credit linked notes, credit default swaps or 144a issuances.