

From: McDaniel, Raymond
Sent: Sunday, October 21, 2007 11:08 PM (GMT)
To: McDaniel, Raymond [REDACTED]
Subject: Credit Policy issues at Moody.doc
Attach: Credit Policy issues at Moody.doc

<<...>>

Credit Policy issues at Moody's suggested by the subprime/liquidity crisis

1 The management group has begun identifying issues and weaknesses that the organization needs to address. These are treated in very preliminary form in the Solutions document that has been included in the Directors Packet.

2 My purpose here is to offer a framework for how we are thinking about these challenges conceptually and note some of the initiatives being taken.

3 We will also need to conduct a careful post mortem of the experience

Conflict of interest

MARKET SHARE

4 In an increasing number of markets, Fitch is an acceptable substitute for either S&P or Moody's. In other markets, any one of the three is enough. With the loosening of the traditional duopoly, how do rating agencies compete?

5 Ideally, competition would be primarily on the basis of ratings quality, with a second component of price and a third component of service. Unfortunately, of the three competitive factors, rating quality is proving the least powerful given the long tail in measuring performance. Were that the extent of the problem --that it is hard to measure quality and hence price and service are disproportionately weighted -- it would pinch profitability, forcing rating agencies to spend more on service and take less in fees. But that is no different than for most other businesses and we can cope. The real problem is not that the market does underweights ratings quality but rather that, in some sectors, it actually penalizes quality by awarding rating mandates based on the lowest credit enhancement needed for the highest rating. Unchecked, competition on this basis can place the entire financial system at risk. It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want rating downgrades; short-sighted bankers labor short-sightedly to game the rating agencies for a few extra basis points on execution.

6 Moody's for years has struggled with this dilemma. On the one hand, we need to win the business and maintain market share, or we cease to be relevant. On the other hand, our reputation depends on maintaining ratings quality (or at least avoiding big visible mistakes). For the most part, we hand the dilemma off to the team MDs to solve. As head of corporate ratings, I offered my managers precious few suggestions on how to address this very tough problem, just assumed that they would strike an appropriate balance. I set both market share and rating quality objectives for my

MDs, while reminding them to square the circle within the bounds of the code of conduct.

7 Although the business does square the circle in some situations, the market share pressure persists in others. Moody's has erected safeguards to keep teams from too easily solving the market share problem by lowering standards. These protections do help protect credit quality.

(a) Ratings are assigned by committee, not individuals. (However, entire committees, entire departments, are susceptible to market share objectives.)

(b) Methodologies & criteria are published and thus put boundaries on rating committee discretion. (However, there is usually plenty of latitude within those boundaries to register market influence.)

(c) Strong culture of integrity; code of conduct etc.

8 We are adding several more safeguards

(d) No one with market share objectives may chair rating committee

(e) Tighter limits on the link between LOB revenue performance and individual compensation

9 This does NOT solve the problem though. The RMBS and CDO and SIV ratings are simply the latest instance of trying to hit perfect rating pitch in a noisy market place of competing interests.

RATING EROSION BY PERSUASION

10 Analysts and MDs are continually "pitched" by bankers, issuers, investors --all with reasonable arguments -- whose views can color credit judgment, sometimes improving it, other times degrading it (we "drink the kool-aid"). Coupled with strong internal emphasis on market share & margin focus, this does constitute a "risk" to ratings quality. Various protections are being set in place:

(f) A more independent credit policy function

(g) More cross-LOB participation in credit policy committees

(h) More cross-LOB rotation of managers or credit policy people

In addition, bad ratings must be perceived to have (much) worse consequences than market share slippage. Accountability is key. (It is also tricky to implement.)

RATING EROSION FROM SUCCESS

11 The RMBS & derivatives teams are comprised of conscientious bright people working long hours. They are highly desirous of getting the rating right.

12 But a certain complacency about ratings quality is inevitable after a prolonged period of rating success. For years these deals were seemingly overcollateralized (characterized by upgrades consistently and broadly outpacing downgrades), given rising housing prices and low interest rates and a decent economy. There seemed to be ample surplus even for a bad scenario. But, as it turned out, not enough for an extreme scenario.

13 Organizations often interpret past successes as evidencing their competence and the adequacy of their procedures rather than a run of good luck.

14 Failures motivate search for new methods and systems less likely to fail. In contrast, our 24 years of success rating RMBS may have induced managers to merely fine-tune the existing system - to make it more efficient, more profitable, cheaper, more versatile. Fine-tuning rarely raises the probability of success; in fact, it often makes success less certain.

INDEPENDENT REVIEW WITHIN MOODY'S

15 We are instituting periodic, independent review of: ratings, methodologies, models, assumptions, and data used in the rating process, with concerns referred back to the rating group for attention

16 We have been criticized for rating methodologies that are not sufficiently transparent. We publicly post methodologies and, in many cases, our models in an effort at transparency. In addition, we will now: (i) publish & discuss key assumptions, adequacy of supporting data, areas of greatest uncertainty; (ii) describe/dimension scenarios that would trigger loss for a structured tranche.

17 It is crucial that we bring the broadest credit judgment possible to market sectors and asset types. To do that better, we will look for ways to better track market pricing, liquidity, metrics, investor/trader sentiment to infuse our credit thinking with a more timely and dynamic sense of real world conditions.

18 Chris Mahoney has initiated the Global Financial Risks Perspectives series, to identify and discuss financial system risks and is developing a new annual process of identifying and publishing a "central scenario" for expected market and economic conditions, along with several stress scenarios. Each rating sector or region will

further develop or adapt these scenarios for use in industry outlooks, rating committees, and research. This should add coherence and substance to the assumptions that go into our ratings, as well as improving our transparency to the market.

THE NEED FOR INVESTMENT

19 Might under-funding put our ratings accuracy at risk? We should closely and regularly evaluate the adequacy of staffing, data system, models, methodologies, and credit oversight. One way to do that might be an independent rank ordering of rating groups in terms of resource adequacy. Concerns might be reported as part of Chester's quarterly ERM report.

20 To state the obvious, there will always be tension between funding ratings quality and hitting our margins.

21 Moody's Mortgage Model (M3) needs investment

22 Data & data systems in SFG and Banking need investment

23 From a credit policy perspective, we want to be in a position to JUST SAY NO to a market opportunity, when imperative to do so from a quality perspective. We have done that in the past (e.g. net interest margin securitizations; capital notes on SIVs; Canadian CP liquidity arrangements). How to do it more aggressively without simply exiting whole market sectors is an unsolved problem.

Other

24 Our Aaas are intended to be estimations of expected credit loss over the life of a security. In Fundamental this means that once in a very great while a single Aaa might default on an obligation and trigger a loss. But in SFG it means that a larger number of Aaas might realize a loss but at such low levels as a percentage of principle and interest that the loss is consistent with the rating. This can lead to greater volatility in the rating of a structured security. The market may find that volatility inconsistent with their expectations at the Aaa or Aa rating levels. We are looking for ways to respond.