

CDOs And Their Ratings: Chronicle Of A Foretold Disaster

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June 4, 2007

The collateralized debt obligation market has been a success. What 10 years ago consisted of a handful of transactions supported by high-yield bonds has evolved into a \$2 trillion monster. If we add to that the current diversity of the investor base, plus the enormous variety of CDO vehicles, this market would be unrecognizable to an early-'90s participant.

The rating agencies have played a large part in the success of CDOs. When the concept came into being, they quickly recognized its value and responded by developing sound methods to analyze them. The legitimacy of ratings gave this market an important boost at its inception (a critical factor most CDO fans tend to forget). Additionally, some toxic concepts that a few bankers attempted to smuggle into early CDOs were properly stopped. Most people remain unaware of this situation; after all, nobody sees the aborted transactions. But these actions were crucial in preventing an early disaster that could have tainted, or worse, impaired forever, the progress of a perfectly reasonable investment concept. Lately, however, the contributions of the ratings agencies have been more questionable.

The Decline Of CDO Ratings

Some institutions collapse in a Berlin Wall-type manner: quick and clear-cut. Others follow a Roman Empire-type of decay: slow and less dramatic. The agencies, actually their CDO ratings, are experiencing a Roman Empire-type of decay, which is slow and difficult to pin down in terms of its origin and causes. Was it the adoption of the Gaussian copula? Or the advent of resecuritization, a concept difficult to model since small errors at the underlying assets level propagate like a plague at the CDO-squared level? Or maybe it was the success of the market that lured away the agencies' best-prepared minds to more lucrative jobs elsewhere. Who knows? What matters is that the trouble is difficult to ignore.

Nobody would argue that rating methods should be frozen in time and oblivious to evolution. But sometimes what the agencies have attempted to portray as "improvement" has the strong flavor of "emergency patch," akin to a software company repeatedly releasing an operating system full of glitches. For example, **Moody's Investors Service** admitted that default rates for sovereign bonds have been lower than those of similarly rated corporate bonds. Also recently, **Standard & Poor's** changed its default probabilities for investment-grade corporate bonds and speculative-grade bonds by more than 50% in some cases. Moody's also "refined" its loan rating approach, introducing a method that resulted in changes, on average, of more than one notch. At the same time **Fitch Ratings** revealed a new set of loan recovery rates. These anomalies have prompted adjustments to their methods of analysis.

Not unexpectedly, correlation (a trendy but dubious concept) has been at the center of most "improvements". Moody's introduced in May 2004 new correlation assumptions just to refine them six months later. Meanwhile, Fitch continuously re-issued updated correlation assumptions. Not to be left out, in December 2005 S&P changed its correlation assumptions and was forced to put on watch for downgrade 35 tranches of 18 U.S. CDOs. The list goes on and on.

But these are only symptoms. The disease itself manifested in spades in a Moody's report released in 2005 and then again in 2006. Both showed that there had been almost no difference in performance, judged by impairment rate, between BB-rated CDO tranches and BBB tranches. Two observations: (1) it is incredible that this major faux pas had not been noticed; and (2) we suspect, although we have not seen data to this effect, that S&P-rated BB tranches and BBB tranches would show the same anomaly since Moody's CDO ratings and S&P's are highly consistent.

Market Impact

This blunder has profound market implications. The failure to distinguish between AAA and AA or between BB and B ratings is not a major crime but merely an indiscretion. However, the failure to distinguish between BBB and BB is a sin of severe consequences. Here's why: Many investors are subject to ratings-driven requirements in terms of what they can or cannot buy (often BB or below is off-limits). Many structured investment vehicles are required to liquidate assets whose ratings fall below BBB. In addition,

many institutions are subjected to capital requirements that are ratings-driven and are fairly onerous for non-investment grade assets. In short, whether an asset is BB or BBB (and more importantly, the failure to distinguish between these two categories) can have important implications for the holder of that asset, regardless of whether that holder believes in the rating or not. Additionally, this anomaly introduces an important imperfection in the secondary market of CDO tranches, a market that has yet to achieve the liquidity of other, more mature markets.

Breakdown Of The System

The breakdown of the CDO ratings system occurred around the March to May 2007 timeframe. Up until that time, the market believed the ratings (with only minor disagreements) based on the high correlation between rating and price for newly issued CDO tranches. Not anymore: recently, in the same week we have seen BBB tranches priced as tight as LIBOR + 140 bps and as wide as LIBOR + 1000 bps. These differences have not been restricted to BBB tranches. At the single-A and BB level the price discrepancies have been as large as 400 basis points.

This is unheard of. Differences of that magnitude voice an unequivocal message: the market does not believe the ratings. It is always possible that the market is wrong and the ratings are right. But the evidence for this is scarce.

Some observers have expressed the opinion that the rating agencies are the most ill-prepared participants in the CDO market. We do not share that view. We reserve that label for a well-known class of institutional investors who like to substitute analytical and independent thinking by endless (and meaningless) committee meetings, memos and "internal" procedures -- in short, effective mechanisms to diffuse responsibility when something goes wrong. The rating agencies, on the other hand, make their views public, so their mistakes are noticed by everybody. The reality is that the agencies are probably struggling to catch up with a market they helped to create, but whose creativity and momentum they cannot control.

A Move Away From Ratings Reliance

In any event, CDO players are moving toward ignoring ratings. This tendency has been reinforced by the fact that many investors are sophisticated enough to make up their own minds without requiring anybody's assistance -- all in all, signs of an evolved and no longer

"alternative" market. That said, the rating agencies still enjoy a frightening dictatorial power.

Consider the following hypothetical situation. Suppose you had the choice of living in two places identical except for their tax codes, Castaglia and Macondo.

In Castaglia you pay taxes on a rising scale determined by your annual income. Macondo has the same tax rates, except that the applicable rate depends on whether you belong to socioeconomic class A, B or C. The class is determined by certain private companies whose operation is unregulated, but whose existence the government of Macondo has to allow. Moreover, these entities have the right to change the rules to determine your class whenever they like, and their methods can be kept secret and cannot be challenged.

Would you prefer to live in Castaglia or in Macondo?

Unfortunately, many CDO market participants live in a Macondo-type environment. A number of "rules and regulations" in terms of capital requirements or the ability to purchase a given instrument, both in the U.S. and overseas (think Basel II, for instance) are rating-dependent. They depend on whether a given asset is rated BBB or BB, AA or A -- that is, an array of letters whose meaning the agencies define and control. Therefore, since the definition of BBB or BB, or AA or A could be quite elastic, elusive, full of inconsistencies and worse, changed at will by the agencies, the idea of enacting laws that are dependent on the ratings is simply madness. In fact, this is tantamount to giving a few private companies the right to legislate. Of course, this is not the fault of the rating agencies. It is the fault of some ill-advised regulators and politicians who, while in all likelihood acting in good faith, created a dangerous regulatory framework.

Reform Is Needed

This issue is serious and remedial action is much needed. To fix the situation, the proper authorities would have to come to their senses and enact some enlightened legislation. Failure to control this "externality" -- the regulatory power of the rating agencies and the negative influence of their misjudgments -- can badly affect the CDO market by introducing anomalies and inefficiencies.

The ability to solve this issue will depend on a combination of luck, good will, intelligence and the ability to manage special interest groups. All in all,

a low probability event. Perhaps a major disaster will be required before the idea of abandoning rating-dependent rules and regulations is embraced. Until that happens, all CDO-world citizens will be forced to live in a Macondo-type of environment. And while magical realism is fascinating from a literary point of view, it is less so from a free-markets perspective.

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