
Monitoring the Monitor

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Bank earnings continue to be released this week. Overall, results seem to be deteriorating, with UBS, Citi, and Deutsche Bank announcing losses or expected losses that make earlier announcements by Bear Stearns, Goldman, Lehman, and Morgan Stanley seem tame. Merrill, B of A, and JP Morgan-Chase warned to expect more in upcoming releases. The vernacular is dour, with Citi characterizing their results as a “clear disappointment,” Deutsche Bank admitting “mistakes” during the credit boom, and UBSs’ “unsatisfactory results caused by a portfolio (and they are not unique here, just the only ones to admit that fact) whose composition may be substantially unknown.

Investors in this environment are right to be wary. In addition to mark-to-model irregularities investors have been watching for in mortgage-servicing rights (MSRs) and residual structured finance investments, investors are now watching for evidence of mark-to-market irregularities. Those include behaviors like trades that effectively “swap” securities in order to create a quote (you buy mine, I’ll buy yours, and we have a price to mark to), marking to one’s own transactions (the broker tells you there’s activity, but the quote you receive is your own transaction about to be executed), and co-guaranteed multiseller commercial paper conduits (you guarantee mine, I’ll guarantee yours). All of those are last-gasp efforts to stay afloat, and none are sustainable.

Amidst the earnings melee, there remains the now seemingly ever-present reluctance of the ratings agencies to rerate the residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs) that started the difficulties in the first place. While both Moody’s and S&P formally rerated a batch of 2006-vintage RMBS in June and July, there has not been an effort to continue the ratings “sweep.”¹

The market needs to be swept clean. If anyone still doubts the magnitude of the problem, Figure 1 shows that Moody’s 703 downgrades resulting from the June and July sweep affected half as many tranches as they downgraded in the previous *eighteen years*. Those 703 downgrades were more than four times the level of the next highest year, 1994. S&P posted similar results. Fitch’s 2006 sweep results will be announced in a conference call on October 4, 2007.

It is curious, however, that while the sweeps divulged substantial difficulties among subprime RMBS they were not extended further to comprehensively review 2006 second liens nor the 2005 and early 2007 vintages. Nor were the

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¹ Note that the agencies claims to surveillance before Congress do not constitute formal rerating, which results in a formal rating decision that is announced as an Affirmation, Upgrade, or Downgrade.

sweeps extended to a comprehensive review of CDO securities structured in those years. In fact, given the questioning in the House Committee on Financial

Figure 1: Moody's RMBS Downgrade History, 1988-June 30, 2007.

RMBS Downgrades By Reason, 1988-2006							
Year	Downgrade C/E	Servicing/ Administrative Irregularities	Structural Change	Structure	Tail-End Risk	Weak Perf	Total
1988	5	0	11	0	0	0	16
1989	0	0	0	0	0	0	0
1990	77	0	0	0	0	11	88
1991	126	0	0	0	0	11	137
1992	18	0	0	0	0	42	60
1993	77	0	0	0	0	73	150
1994	0	0	0	0	0	172	172
1995	0	0	0	0	0	110	110
1996	0	0	0	0	0	162	162
1997	0	0	0	0	0	16	16
1998	7	11	0	0	0	118	136
1999	0	18	0	0	0	113	131
2000	0	0	0	1	0	10	11
2001	0	0	0	0	0	0	0
2002	0	0	0	0	0	2	2
2003	0	0	0	0	0	21	21
2004	0	0	0	1	0	2	3
2005	0	0	1	0	0	80	81
2006	0	0	0	1	10	30	41
2007*	0	3	0	0	8	22	33
Total	310	32	12	3	18	995	1,370

*Through June 30.

Source: Moody's, "Rating Changes in the U.S. Residential Mortgage-Backed Securities Market: 2007 First Half Update, August 8, 2007.

Services hearings on the Ratings Agencies on September 27, 2007, it appears that some policymakers are concerned about the ratings agency's reputational effects of comprehensively sweeping the ratings and the economic knock-on effects. Hence, it appears that the ratings agencies are "too-big-to-fail." There is also concern that the structures they have rated, comprising primary funding for about 70% of consumer finance, are also too-big-to fail. That is because if the structures fail, the issuers, themselves, will also most likely fail. Lenders have previously found it very difficult, if not impossible, to curtail securitization without facing severe financial distress or, most likely, failure.

The situation leaves policymakers in a classic "Mexican standoff," in which the first one to pull the trigger will most likely also die. Hence, a calm negotiator is needed to sort out the problem.

The principals of the negotiation should be straightforward. First, a sweep is necessary to sort out the information problems that continue to cause economic and market distress. Second, the sweep must include all NRSROs, as exempting one for any reason would suggest absolution. Third, the sweep, itself, must be monitored to validate the veracity of the resulting rating grades.

The first two points are relatively straightforward. The third, however, requires that assignment of a monitor for the process, that is, a monitor for the monitors. Who can act as a monitor for the ratings agency sweep? The SEC was mandated to act as such a monitor in the Credit Improvement Act of 2006, but they have not yet assembled the manpower nor have they shown a clear intention to act in that role.

That leaves the Federal Reserve Board to step in as a monitor. Such a role is sensible since the Federal Reserve is the primary regulator of bank holding companies, under which many investment banks are organized according to Gramm-Leach-Bliley. The Federal Reserve also has the capability to act as such a monitor, having both the manpower and the existing expertise to do so. The

Federal Reserve also already has principals in place to monitor credit models without undue interference according to the Basel II rule of banking supervision.

The Federal Reserve stands ready to facilitate and monitor a rerating sweep. Let them make that sweep sooner, rather than later, so that investors can get on with their business and the economy can move away from the risky information problems that keep it on the precipice of serious recession.