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United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS

WASHINGTON, DC 20510-6075

June 6, 2011

Professor Steven L. Schwarcz
Stanley A. Star Professor of Law and Business
Duke University School of Law, Box 90360
Corner Science & Towerview
Durham, NC 27708-0360

Dear Professor Schwarcz:

Thank you for testifying before the Committee on Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment on May 18, 2011. In order to complete the hearing record, we would appreciate your answers to the enclosed questions as soon as possible. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Ms. Dawn L. Ratliff, the Committee's Chief Clerk. She will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a MS Word, WordPerfect or .pdf attachment to Dawn_Ratliff@banking.senate.gov.

If you have any questions about this letter, please contact Ms. Ratliff at (202)224-3043.

Sincerely,



Tim Johnson
Chairman

TJ/dr

“The State of Securitization Markets”
May 18, 2011

Questions for Professor Steven L. Schwarcz, Stanley A. Star Professor of Law and Business, Duke University School of Law, from Senator Reed:

1. In your written statement, you make reference to a kind of expectation gap of investors, where a triple-A rating equated to a certification of “iron-clad safety” and “investment-grade” meant “freedom from default.” Could you expand upon this concept? Is this expectation gap contributing to a lack of confidence in ratings? Should rating agencies continue to play role, and if so, how do we deal with this expectation gap?

2. One of the problems you note in your written statement is the “overreliance on mathematical modeling”. The SEC has proposed that ABS issuers file a waterfall program that demonstrates the flow of funds in a transaction. What do you think of this proposal?

Response of Professor Steven L. Schwarcz, Stanley A. Star Professor of Law and Business, Duke University School of Law, to Senator Reed re “The State of the Securitization Markets” May 18, 2011.

1. Senator Reed’s first follow-up question: In your written statement, you make reference to a kind of expectation gap of investors, where a triple-A rating equated to a certification of “iron-clad safety” and “investment-grade” meant “freedom from default.” Could you expand upon this concept? Is this expectation gap contributing to a lack of confidence in ratings? Should rating agencies continue to play a role, and if so, how do we deal with this expectation gap?

Response:

Could you expand upon this concept?

As you know, ratings are an assessment of the safety of payment on debt securities, with a triple-A rating being the highest and BBB- or higher ratings being historically called “investment grade”—meaning securities so rated are generally viewed as eligible for investment by banks, insurance companies, and savings and loan associations.¹ Rating agencies clearly perform a social good by assessing diverse information and issuing ratings based thereon, achieving an economy of scale. A problem occurs, however, when investors overrely on ratings as a shortcut for their own diligence and analysis. Investors are prone to overrely for two reasons.

First, there is a secondary-manager conflict, which I referenced more generally in my testimony. In the context of rating agencies, this conflict occurs when analysts employed by investors recommend that their firms invest in securities that are highly rated, without the analyst engaging in the analysis and diligence his or her job theoretically requires. This type of conflict can be mitigated by more closely aligning analyst (and other secondary-manager) compensation with the long-term interests of their firms.² As my testimony explained, this is an *intra-firm conflict*, quite unlike the traditional focus of scholars and politicians on conflicts between managers and shareholders. Dodd-Frank attempts to fix the traditional type of conflict but completely ignores the problem of secondary-management conflicts.

Second, in my experience investors do not always bother—or perhaps, because of the conflict referred to above, want—to learn the limitations of ratings. For example, ratings do not technically cover the risk of fraud but, instead, are based on the information received.³

¹ *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILLINOIS L. REV. 1, 7-8.

² *See Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs*, 26 YALE JOURNAL ON REGULATION 457 (2009), available at http://ssrn.com/abstract_id=1322536.

³ *Private Ordering of Public Markets*, *supra* note 1, at 6 & 6 n. 33. I do not think it would be practical to require rating agencies themselves to perform the due diligence needed to discern fraud; indeed, no amount of advance due diligence can ever eliminate fraud.

Is this expectation gap contributing to a lack of confidence in ratings?

This expectation gap may well be contributing to a lack of confidence in ratings. However, I believe the expectation gap is not caused by ratings per se or even by the ratings system as currently constituted. Rather, the gap is caused, as discussed above, by a combination of (i) the secondary-manager conflict and (ii) investor misunderstanding of what ratings provide. This combination of failures leads to variances between what investors “think” they’re investing in and what they’re actually investing in.

Should rating agencies continue to play a role, and if so, how do we deal with this expectation gap?

I believe that rating agencies should continue to play a role. As mentioned, they perform a social good by assessing diverse information and issuing ratings based thereon, achieving an economy of scale.

We could deal with this expectation gap in two ways:

- (a) Mitigate the secondary-manager conflict by more closely aligning analyst (and other secondary-manager) compensation with the long-term interests of their firms. Volume 26 of the YALE JOURNAL ON REGULATION examines, at pages 465-469, how to accomplish this.
- (b) Require investors to educate themselves about the limitations of ratings. As discussed above, the secondary-manager conflict itself undermines this education process; therefore mitigating that conflict is likely to mitigate this education failure.

2. Senator Reed’s second follow-up question: One of the problems you note in your written statement is the “overreliance on mathematical modeling”. The SEC has proposed that ABS issuers file a waterfall program that demonstrates the flow of funds in a transaction. What do you think of this proposal?

Response:

I do not think this proposal is needed. The materiality requirement of existing disclosure law already requires an explanation of waterfalls. In my experience, these explanations are generally clear and (insofar as they can be) straightforward.

I fear this proposal could even backfire. A mathematical program demonstrating the flow of funds could aggrandize the waterfall model, giving the model (as discussed in the next paragraph) greater credence than it deserves.

Sophisticated investors do not, in my experience, have a problem understanding waterfalls and funds flows. Rather, their problem is under-appreciation of how easy it can be—especially in non-traditional transactions involving complex and highly leveraged securitizations of asset-backed securities already issued in prior securitizations (what I called in my testimony “securitizations of securitizations”)—for relatively small errors in cash flow projections to significantly impact investor recoveries. To correct this under-appreciation, it would be helpful to require some sort of “sensitivity” analysis explaining

how the waterfall cash flows would change based on changes in collections on the underlying financial assets.⁴

Even a sensitivity analysis, however, is dependent on assessing how likely it is that collections on the underlying financial assets will change. No one can know that for sure, ex ante; there are simply too many variables and potentially unknown correlations. This illustrates a larger point: In complex financial markets, disclosure is necessary but almost always will be insufficient.⁵ For an analysis of how to attempt to respond to this insufficiency, see pages 238-245 of *Regulating Complexity in Financial Markets*.⁶

⁴ This might be done, for example, through a “Monte Carlo simulation.”

⁵ See, e.g., *Disclosure’s Failure in the Subprime Mortgage Crisis*, 2008 UTAH L. REV. 1109, available at http://ssrn.com/abstract_id=1113034; *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILLINOIS L. REV. 1, available at <http://ssrn.com/abstract=336685>. See also *Regulating Complexity in Financial Markets*, 87 WASHINGTON U. L. REV. 211, 221-25 (2009/2010), available at http://ssrn.com/abstract_id=1240863.

⁶ 87 WASHINGTON U. L. REV. 211, 238-45.