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Chairman Reed, Ranking Member Crapo and distinguished members of the Subcommittee, my name is Ann Rutledge. You have asked about the current conditions in the mortgage and asset-backed securities markets. You want to hear whether today's impediments to capital formation and liquidity are going to resolve themselves based on reforms or best practices in use today—or whether other mechanisms or perhaps policy initiatives need to be added to the mix, to reignite securitization. As an independent consultant and, at times, critic, of securitization market practices, I am deeply honored that you have asked me to testify.

You may not have heard of R&R Consulting before now. We are a seven-person structured finance boutique co-founded by me and my partner, Sylvain Raynes. I resigned from Moody's Investors Service's Structured Finance Group at the end of 1999, when it was becoming clear that Moody's was shedding its franchise-defining commitment to research and becoming a ratings factory. It was also clear that this was happening at a moment in the market's development when thought leadership was becoming more important than ever. I saw the mission of R&R as a continuation of the role Moody's was moving away from, thought leadership. Our business vision was to serve the market by refining and unifying the techniques we learned at Moody's into a single framework of analysis that could be used on all asset classes, at all points in time, to obtain consistent, reliable, capital-efficient results.

I believe today that the goal of a unified framework of analysis is where the securitization market still must go if we are going to (a) restore investor trust in the securitization markets and (b) address, head-on, the needs of the real economy for capital. Many people have commented on the need to rebuild



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investor trust. However, I don't hear nearly enough discussion about how to channel funds into the real economy with securitization.

The assumption seems to be that all will be well once the market comes back. However, as we commented in *Elements of Structured Finance*,<sup>1</sup> structured finance and securitization marshaled unimaginable quantities of money before—but to what end? It is difficult to base a persuasive economic case for securitization on what has been achieved so far. Moreover, we have been too occupied with making money and mourning the loss of the big money machine to acknowledge that the micro-structure of the securitization market is badly broken. If we want it to come back, we must be prepared to accept certain changes in the way it works—beginning with the fact that we need to understand how it works. We cannot delegate the work of understanding it to others, any more than we can delegate the work of understanding the foundation of our civil society to others. Once we understand what the market can and cannot do, the changes that need to be made will seem very fundamental and achievable. I would like to talk to you from my reform-oriented perspective about what is precious and worth preserving about this market, where the challenges lie, what reforms are working, and what still needs to be done.

***The Good News: Bragging Rights; Thought and Financial Leadership and the Economy Restored***

Securitization is a quintessential American innovation, a melding together of financial innovations from our 19<sup>th</sup> Century railroad crisis experience and our 20<sup>th</sup> Century savings & loan crisis experience. So, let's pat ourselves on the back before we ask—which innovations? First, the discovery that, in insolvency, the

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<sup>1</sup> Rutledge, Ann and Sylvain Raynes, *Elements of Structured Finance*, Oxford University Press, May 2010.



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railroad company's capital structure could be restructured to make both the debt and equity investors better off. Second, credit ratings: a key for investors to discern relative value in securities issued from complex structures like railroad bonds (and securitizations). Third, cash flow modeling technologies based on a different set of metrics than those used in options markets, developed by engineers and information specialists no longer needed for the Cold War effort, and made ubiquitous by the affordable (also quintessentially American) PC and spreadsheet software.

Substantively, securitization enables investors to look beyond public corporate finance disclosures to find additional evidence of value or risk through a close analysis of company financial receivables—private data. Where value can be found, it can be monetized without adding to company or system risk using standard securitization structuring techniques and a feedback loop. Part of the value that is discovered can be returned, to reward the producers who have created the value and help them continue to grow. America's credibility and thought leadership in finance have taken a severe beating as a result of the credit crisis. Nowhere is our fall from grace more apparent than in China, where I taught a securitization course last month. But, an America that can rebuild its economy with sustainable securitization markets while building incentives for producers in the capital-intensive sectors of the economy will, forcibly, continue to lead the world financially too.

Securitization works where traditional corporate finance does not, because it is less stylized and more capable of using a variety of data types. What this means in practical terms is that securitization holds promise as a means of channeling capital towards our SME sector and our social priorities—education, health care and the arts—where traditional corporate finance tools are ill-suited. Securitization also has



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a beneficial financial impact because it accelerates the speed and accuracy with which capital circulates between lenders and borrowers. Let me illustrate this point with reference to the health care industry. Beyond the question of delivery of basic health care services, there is the funding problem caused by inefficiencies in the cash cycle of hospitals. The establishment of a system of registering title to health care receivables and discounting them using a uniform set of standards could release billions of dollars of much-needed capital to hospitals, particularly if the insurance companies were given incentives to make early claims payment. R&R estimates that bona fide health care securitization is a \$1.5 Trillion dollar a year market.

This vision for securitization as a funding solution for tough sectors may be grand, but in order to carry it out, the market needs to sharpen its proverbial pencil. Historically, securitization has flourished primarily in consumer sectors, where no particular industry or modeling expertise is required for deals to come to market. Over-development of consumer markets is a generalized problem in securitization. In Russia, during 2007, the mortgage securitization markets developed so rapidly that primary mortgage bankers, already in scarce supply, became unaffordable to many banks. Ironically, mortgage lending activities declined as a result. And yet, Russia's real need for capital was in the SME sector, not homes.

The problems of unbalanced growth and the failure to clone securitization to new opportunities have a single, straightforward solution: skill development through training. The U.S. has many MBA programs and finance departments, but securitization is not taught in the vast majority of them—most certainly not by people who have deal experience. This shortage of teaching talent would disappear quickly if the securitization market made skill development more of a priority.



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### ***The Bad News: What Reinventing the Corporate Paradigm Does to Banks***

Before securitization, banks *were* the supply chain of capital. They made money by exploiting market discontinuities: small banks earned spread income from borrowers; regional banks earned spread income from small banks; and universal banks earned spread income from regional banks; etc.

Securitization knits the funding markets together into a seamless credit supply chain, where the cost of capital is no longer a function of the risk of the balance sheet it happens to be sitting on, but rather a function of the ultimate borrower's payment ability. It makes the borrower's payment ability more transparent, and it expands the market for the borrower's credit. Securitization did not cause the changes—deregulation, financial education and the internet caused them—but securitization is a solution to the problem of credit market inefficiency from which banks have benefited so long—as long as there have been banks and corporations. Securitization is an inconvenient reality for banks, because it erodes their information monopoly, so that they can no longer control the price of credit locally. Effectively it turns their core business from dealing to broking, which is much less profitable.

No one, perhaps, saw this paradigm shift for what it was in the first phase of the market, from 1976-1997. Those were very good years, with new asset types coming on stream, new structures, and so much surplus capital being released that had been locked up in the economy, everyone involved in securitization prospered. New consumer companies got startup capital easily; existing companies lowered their funding costs; investors enjoyed unprecedentedly low default rates, far below what the ratings implied; and at deal origination, professional services firms lined up for a sliver of the expected residual. It was, as Buck Henry tells Teri Garr in Steve Martin's ***The Absent-Minded Waiter***, “an



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incredible experience.” (In this comedy-short, Steve Martin as the absent-minded waiter commits every imaginable faux-pas but then hands Buck nearly \$10,000 in change before the bill is paid—precisely what Buck came for.)

In the late 1990s, as the credit risk premium and the surpluses disappeared, the strategy of securitizing banks shifted to exploiting different loopholes, in particular, those built into different rating methods. The endgame of this strategy was the subprime crisis. Although recounting what happened in detail is beyond the scope of this paper, it is not very hard to depict (see the figure below) or explain. The hard part is that once we explain it, we feel compelled to fix it, and there are no easy solutions for the banking industry other than to meet more the rigorous disclosure requirements that are coming into effect now.

But I would remind the Banking Committee that one of the most fertile periods of American financial innovation came in the mid-to-late 1980s, when regulatory tightening brought the trading of financial derivatives into exchanges and the swaps market was born. There is still much room for banks in America to innovate in credit engineering without operating as if credit were a zero sum game. Credit is not a zero sum game. Everybody benefits from responsible lending.

### ***Disclosure Disciplines***

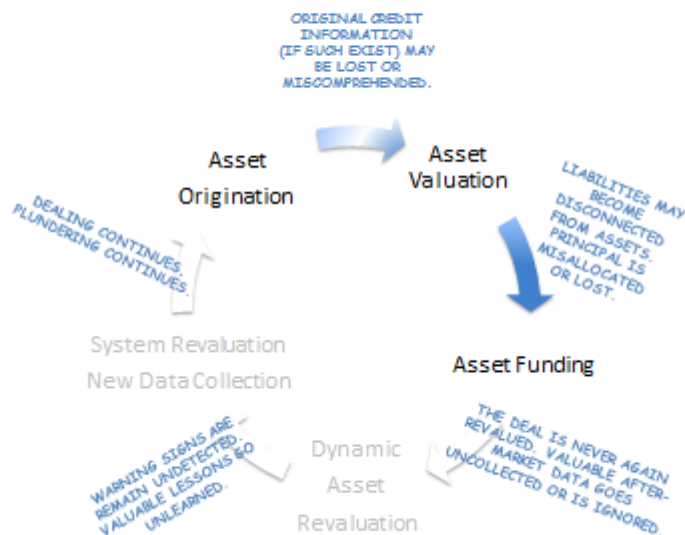
If securitization knits the credit markets together into a supply chain, the biggest challenge to securitization is sealing off the leaks as capital circulates through it. I believe there are two key places where the leakages occur. One is the disclosure problem. I believe Regulation AB does an excellent job of addressing the disclosure problem. As a former securitization analyst, I worked with Reg AB even before it was promulgated; and as a consultant, I have come to rely extensively on Reg AB as a



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workable, well-designed information standard for this market. Reg AB speaks the language of securitization. It requires disclosure of all the material deal data elements needed for valuation.

### the Credit Supply Chain Gamed (2002-2008)



Reg AB makes it possible for investors to do for themselves what rating agencies do not do: continuous re-rating so that a conclusion can be drawn about how the deal worked out. Re-rating is important because the composition of risk and value in these deals can shift, sometimes very dramatically. For well-structured transactions, the risk decreases over time, but for improperly structured transactions, the deterioration can be sudden and shocking if one does not know how to continuously monitor and value the exposure.

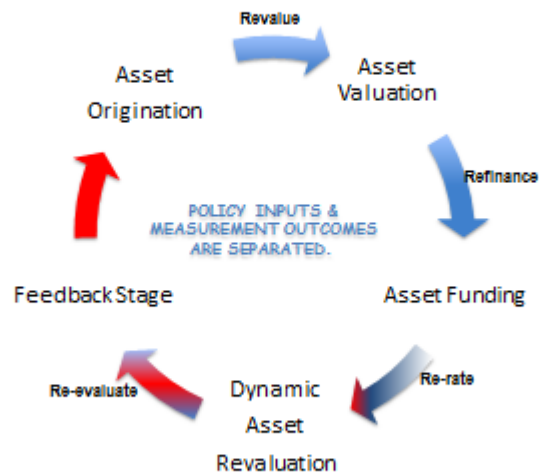


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Reg AB is currently being revised, and the SEC has said it wants to see cash flow model outputs posted as well as raw data elements. I believe that this requirement is an important mechanism by which the market can organize and communicate its thinking about value. Once a deal is structured, there is actually very little flexibility around the interpretation of the value proposition. Analysts may disagree on the path of future cash flows, but there is no reason to disagree about how the deal works, which is what the cash flow model outputs show. This requirement therefore reduces the “mystery of valuation” by one more important dimension.

## A SYSTEM WITH CHECKS & BALANCES THAT SHARES THE VALUE CREATED WITH THOSE WHO CREATE



### ***Discounting Disciplines***

There is one more mechanism (or policy item, perhaps) that I believe the securitization market needs if it is going to come back in a sustainable fashion. The rating scale for structured finance needs to be



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taken away from the rating agencies and it needs to be published, perhaps after discussion and consensus among the G20, so that everyone can know the technical definition of each notch on the rating scale.

The structured finance rating scale is fundamentally different than that for corporate finance. Perhaps you have not thought about securitization this way, but securitization is a kind of “discount window” for corporations to cash in their receivables at some blended rate, which can be expressed as the weighted average interest cost of the transaction in which the receivables are being refinanced.

Each notch on the scale corresponds to a level of asset impairment: AAA signifies impairment in only a very slight degree (when we worked at Moody’s, the numerical meaning was an average 0.06 BP loss of yield on the security), whereas AA signifies slightly more, A even more, etc., in exponential increments going down the scale to single-C. Effectively, the rating agencies are setting the levels of risk and leverage of the financial system.

That is a ridiculous situation. It is analogous to leaving the decision of how large an inch or a meter should be to the individual tailor. Government policy-makers should be making this decision, not rating agencies. The structured rating scale is the ultimate tool for calibrating the expansion of credit to the rate of economic growth. Although it has never been used that way before, this is a very good time to begin to learn how to synchronize the microstructure of the securitization credit markets with macroeconomic credit policy.

At the same time, the scale (and its revisions) should be made public so that anyone who cares about the health of the securitization markets can do their own analysis of outstanding deals. It is impossible,



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finally, for anyone including sophisticated investors to form an opinion about whether a structured rating is right without access to technical rating definitions. But, since most people do not rate securitizations, most people do not even realize they have been denied access to this crucial piece of market infrastructure. It is as if the City of New York (or Washington) enforced speed limits for driving in different districts but refused to disclose what the speed limits were. Circulation would not shut down, but considerable road efficiency and resilience would be lost as a result of drivers having to guess, constantly, whether or not they were driving at the legal speed.