

**Testimony to the U.S. House of Representatives Committee on Financial Services
March 25, 2009**

Thank you Chairman Frank, Ranking Member Bachus, and members of the Committee on Financial Services for inviting me to speak to you today. The United States and the world are enduring financial stresses never before seen in terms of their uniqueness and complexity. I applaud Congress for exploring ways to help get credit flowing to jump start the economy.

My name is Richard S. Berg, and I am the CEO of Performance Trust Capital Partners, LLC. I co-founded Performance Trust in 1994 as a broker-dealer specializing in evaluating the risks and rewards of fixed income cash flows, including mortgage-backed securities. Our customer base consists of community-based financial institutions who lend to businesses and individuals throughout the United States. I believe that we have a front row seat to help identify and explain some of the issues facing the financial markets as they relate to mortgage lending and mortgage-backed securities.

Performance Trust did not engineer, create, or underwrite any securitized assets or sell any at origination. In the interest of full disclosure, we have sold private label mortgage-backed securities to our clients. The vast majority of purchases were made subsequent to the start of this crisis at discounted to deeply discounted dollar prices. We did not transact in any subprime or affordable ARM products.

We view investing from a long term perspective. Our philosophy of investing is about measuring interest rate risk and reward in different rate scenarios, as well as credit risk and reward in different economic or default scenarios. We typically do not predict any scenario to occur, but rather look for asymmetrical risk reward opportunities. Actual results for the scenario that occurred are then compared to the projected returns.

As a frequent industry speaker as well as market commentator, I have encountered many other executives and market participants who have insights to the extraordinary problems and dislocations in the credit and stock markets. Unfortunately, there is no “silver bullet” to immediately fix our problems. The issues are complex and interrelated, much like a Rubik’s cube—just when you think you have one side solved the other sides of the face change. Sometimes the best way to solve a very complicated problem is to begin by asking the question, “What is not working?” If we eliminate things that are not working, we have a better chance of finding things that will work.

As I speak around the United States and on the financial news stations, no phrase evokes more emotion than the phrase “toxic assets.” News commentators, accountants, regulators, and even politicians cite toxic assets as a significant reason we are in this mess. For the past

few months I have asked bankers, accountants, the media, and traders this question: “**What is the definition of a toxic asset?**” This is actually a trillion dollar question. Not surprisingly, there is no clear cut definition of a toxic asset. In fact, the definition depends on whom you are asking. This is very problematic. As Congress and Treasury form plans for removing toxic assets off the books of financial institutions through tax payer assistance in order to get credit flowing again, we need to correctly define toxic assets.

We do acknowledge there are bad assets, credit impaired securities and poorly run banks. However, I am here today to tell you that in some cases, we are incorrectly defining toxic assets. Many assets labeled toxic are not that toxic and in some cases may not be toxic at all. To put it another way, millions of performing mortgage loans are now considered “toxic” because they are placed in the same security as some non-performing loans. If one in ten loans goes bad, the other nine performing loans also get called toxic.

Why is this the case? One of the keys to understanding the toxic problem can be found in recognizing how the use of letter ratings hard coded into investment policies, regulations, and counterparty agreements can become an automatic mechanism for labeling assets as toxic. In the regulated world of financial institutions and insurance companies, there are current policies in place that attempt to identify toxic assets, or at least plant a red flag for an accountant, examiner, regulator, or counterparty when they review the books of one of these institutions. For these institutions, toxic assets are typically identified by the credit ratings provided by an outside Nationally Recognized Statistical Ratings Organization (“NRSRO”) such as Moodys, Standard & Poors, or Fitch. As you may recall, the ratings scale typically ranges from AAA, AA, A, BBB, BB, B, CCC, CC, C, down to D (default). Most regulations for financial institutions and insurance companies set BBB as the lowest rung for investment grade. Corporate bonds below investment grade are referred to as junk, where as mortgages and other structured debt below investment grade are often called toxic.

As a simplified example, consider a Private Label Mortgage-Backed Security (“PMBS”) issued in 2006 (see also Exhibit 1). Suppose that a lender originated 1,000 first lien mortgage loans in 2006 to credit worthy borrowers, sold these loans in the marketplace, which were then packaged into a mortgage-backed security. Traditionally, a bank or insurance company would be a typical buyer for the safest class (tranche), the AAA security built off these loans.

Three years later, in 2009, given that the housing market and the economy have deteriorated, more than the originally expected amount of borrowers are going into delinquency and are likely headed for default. Suppose for the sake of argument that we *know* that enough loans will go bad so that the investor of this AAA security now will not receive the full 100% of the contractual cash flows, but rather receive 99% of that security’s contractual cash flows. The impact on the yield for the bank or insurance company is minimal, perhaps dropping from 6.00% to 5.95%.

I believe that everyone in this room would agree that while this is not ideal, this asset is clearly not toxic, but rather remains a very high quality one. However, I am not sure that everyone would be aware that once this security is not expected to return 100% of the contractual cash flow, it would now be rated CCC and be considered toxic. Stated another way, the full 100% of this asset backed by a thousand individual loans is considered toxic because a very small percentage of loans default.

Surely, the risk of such a security should not be viewed as exactly the same as a CCC rated corporate bond, say for example, a CCC rated Lehman Brothers senior debenture. This speaks to the definition of what a rating really reflects (see Exhibit 2). When the rating agencies provide a rating on a mortgage-backed security, it is a measure of “default” risk, that is the risk of not receiving 100 cents on the dollar. However, the rating is silent on the magnitude of expected losses. On a security backed by hundreds of loans, a single extra loan going bad can be the tipping point that causes the rating to drop from investment grade to non-investment grade. The incremental economic impact is minimal but rating implications can be significant. Many former AAA senior class PMBS securities are in such a position. Not all are expected to return 99% but even under harsh scenarios, a large majority is expected to return 90% or more.

Because financial institution and insurance company regulations often have hard coded a security’s rating into policy language, a CCC rating may trigger cascading negative actions or reactions by accountants, regulators, counterparties and investors. As you may recall in the recent FASB hearing, a CCC security would typically cause a security to become other than temporarily impaired (“OTTI”) from an accounting perspective. In this current example, even though the credit loss might only be 1%, the previous mark-to-market requirements for many institutions have contributed to massive write downs.

For a financial institution and insurance company, securities held that are rated below investment grade are often considered substandard and therefore “classified” as such. Institutions with too many classified assets may be viewed as “troubled.” In the provided example, should an institution own \$10 million of this CCC rated security, the entire \$10 million may be classified as substandard. Incidentally, if the institution had exposure to these loans in an unsecuritized form and held them in their loan portfolio, only the portion of the loans that were non-performing would be automatically considered substandard or impaired.

The required capital for below investment grade (typically substandard) assets increases as well. For example, the risk-based capital required for a bank that owns the previous AAA but now CCC rated security is 500% greater. An insurance company has a similar capital “tax” for lower rated assets. Besides the negative effect on capital, asset downgrades affect the liquidity and other counterparty agreements that have hard coded the letter ratings provided by NRSROs into the language.

The idea of third party credit evaluation began more than one hundred years ago. Regulators, investors, and creditors have used third party opinions of credit quality for many years. For the most part, this third party system has served us well. As we see it, the problem stems from the fact that we are trying to apply a corporate ratings scale to structured products. Long ago the companies supplying an opinion about the credit worthiness of an issuer or “obligor” did so by assigning a letter rating ranging from AAA to D. The letter rating is supposed to indicate the probability of default of the obligor. Although BBB is the lowest investment grade rating, a B rating is actually the lowest rating assigned to an obligor who is still expected to pay its obligation.

The financial world has become a more complicated place since the inception of the letter ratings scale, and we now have multiple obligor securities like today’s structured products (mortgage loans, auto loans, student loans, trust preferred obligations, CLOs, CDOs, etc.). In order to remain consistent and uniform with previous practice and existing regulations, virtually all longer term products (beyond one year), whether they be single obligor or multiple obligor securities utilize the existing letter scale established decades ago. While there are advantages to using the same scale, the disadvantages far outweigh the advantages in this market environment. For instance a CCC rated corporate bond has very different, and in most cases much greater principal at risk than a CCC rated multiple obligor mortgage-backed security. In addition, in the case of single obligor securities, an obligor either makes 100% of the payment or 0%, that is there are no partial defaults. Multiple obligor securities can have partial defaults. Thus, single obligor and multiple obligor securities have very different risks. Unfortunately, because of the reliance on the rating, they are treated much the same for accounting and regulatory purposes.

For multiple obligor securities, a better and more accurate ratings scale would be some type of percentage rating that indicates actual dollars at risk. This makes sense, since the issuer is only a trust that passes through payments received from many hundreds, if not thousands of homeowners. In reality, one *should* expect partial defaults for a multiple obligor security, and in my opinion a simple letter rating does not fit the actual risk analytics or structure.

What is the Rubik’s cube effect or systemic effect of ratings downgrades, especially amongst financial institutions and insurance companies? In my opinion, the systemic effect is huge, and significantly contributing to the downward spiral we are now witnessing. Unfortunately, credit ratings are hard coded into many of our current regulations, capital calculations, counterparty agreements, collateral agreements, and investment policies. As an institution creeps closer to mandatory regulatory or policy minimums in these areas, it has less tolerance for any risk taking and will hoard more cash.

How then do we fix this problem so that banks can get back to lending to credit worthy borrowers? The complete solution would be to change the way multiple obligor securities are rated. I would immediately revamp the letter based scale to a numerical based scale for multiple obligor securities. If a security is rated CCC, it is treated as toxic. What if the

rating instead was 99% (expected recovery of 99% of contractual cash flow) rather than a letter rating of CCC? Clearly if a security is rated 99%, then if I purchased it at 100 cents on the dollar I am exposed to some small amount of expected loss (1%). However, if I purchased it at 70 cents on the dollar, I currently have little exposure to loss. Even if a security had a rating of 85% it would be low risk at a purchase price at 70 cents on the dollar. Such a numerically based rating system would moderate the cliff diving effect caused from the current letter rating system of a multiple obligor security that is close to “default” but has only a small proportion of loans that are truly “speculative” or toxic. Policies, regulations, counterparty agreements, and collateral agreements could be set to haircut a security based on the new numerical based system. This numerical based risk assessment and data already exists in the NRSROs’ models and evaluation tools

In summary, there are toxic assets, but many assets currently called toxic are not. Use of a single obligor type rating scale for multiple obligor securities is problematic on several fronts, most notably that billions of dollars of current paying loans are now considered toxic by virtue of ratings downgrades. Some of these problems can be minimized with a change in the way certain accounting and regulatory documents are interpreted. We strongly believe that a critical step to restore credit markets is a revamp of the rating system for multiple obligor securities like mortgage-backed securities. Unless a major change is made, it will be very difficult to clean up previously issued securities – those already downgraded, or those feared to be downgraded in the future – without significant government assistance. The current discussion involving loan modifications will certainly cause a whole new round of downgrades and create more toxic assets if this ratings issue for multiple obligor securities is not addressed.

Likewise, going forward market participants will likely permanently avoid any multiple obligor securitized loan product that utilizes a letter grade system for fear of potential future downgrades which taint the entire security rather than the problematic portion. The trillions of assets already or feared downgraded is currently clogging the securitized credit markets. Until we recognize and address the Rubik’s cube of how our ratings, accounting and regulatory systems intersect, our attempts to correct our financial system will fall short.

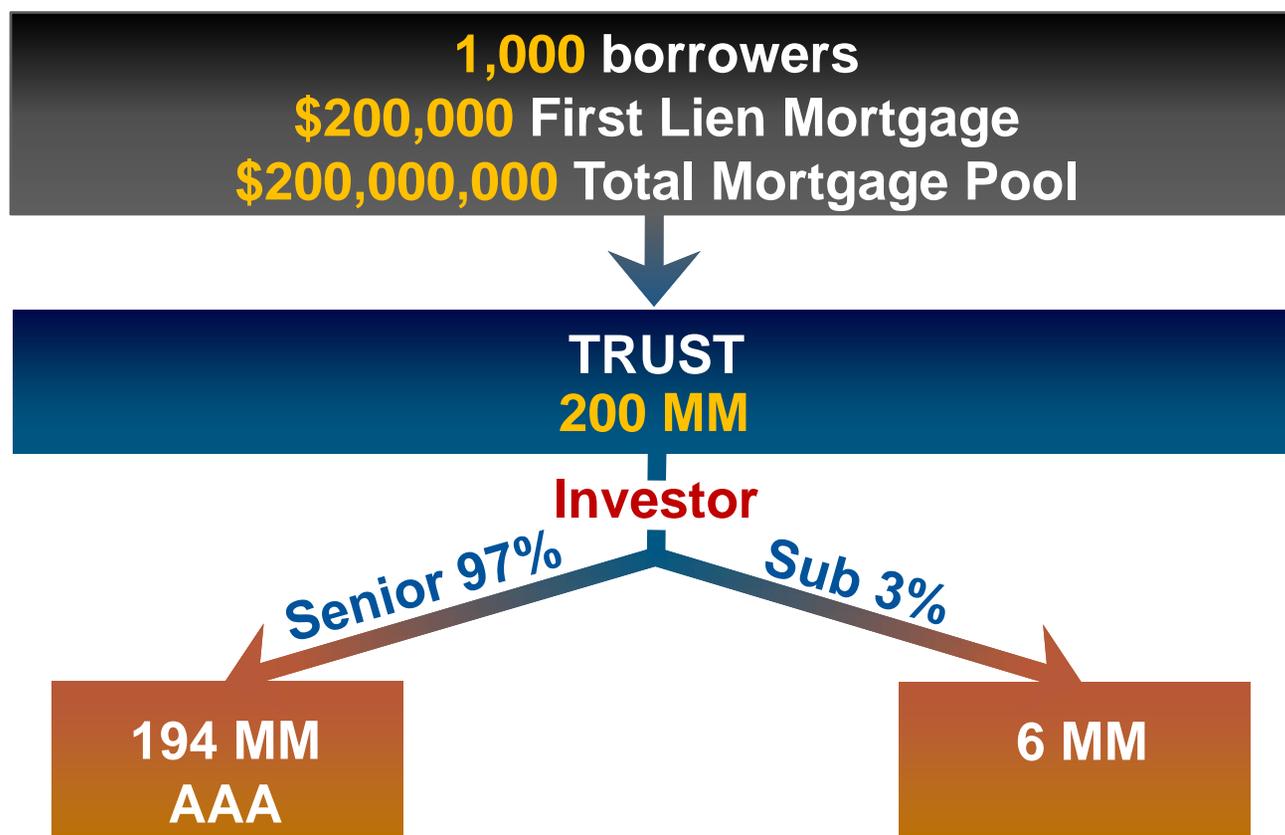
Thank you for allowing me to present our views and ideas to you.



Richard S. Berg
Chief Executive Officer
Performance Trust Capital Partners, LLC

Exhibit 1:
PMBS Example

Simple Example - 2006



Simple Example – 2009

Assumptions:

- Over the next 27 years, total of 8% will default
- Each liquidated loan will lose 50% (severity)

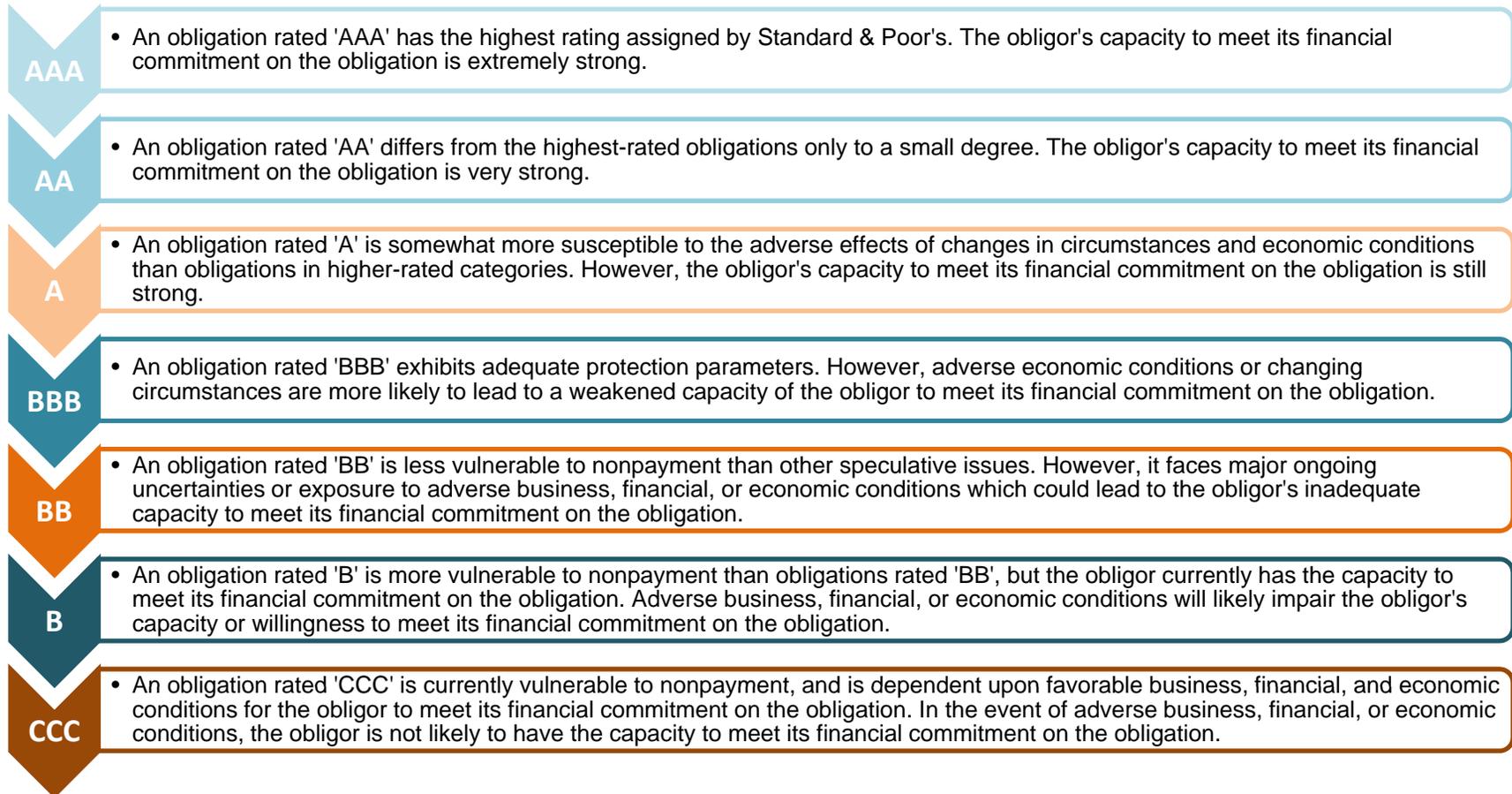
$$\begin{aligned}\text{Total Pool Loss} &= \text{defaults} \times \text{severity} \\ &= 8\% \times 50\% \\ &= 4\% \\ &= \$8,000,000 \text{ Pool Loss}\end{aligned}$$

Simple Example – 2009



Scheduled Principal	194 MM	6 MM
Actual Principal	192 MM	0 MM
Percent "loss"	1%	100%
Quality	0-10 ?	0-10 ?
RATING?		

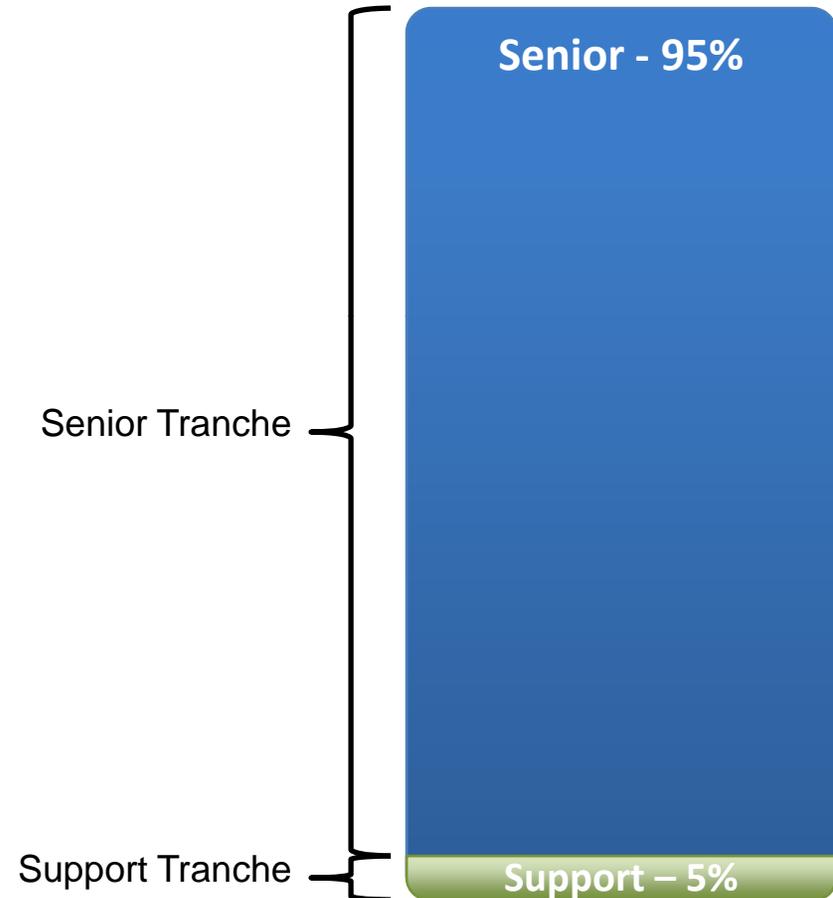
Ratings



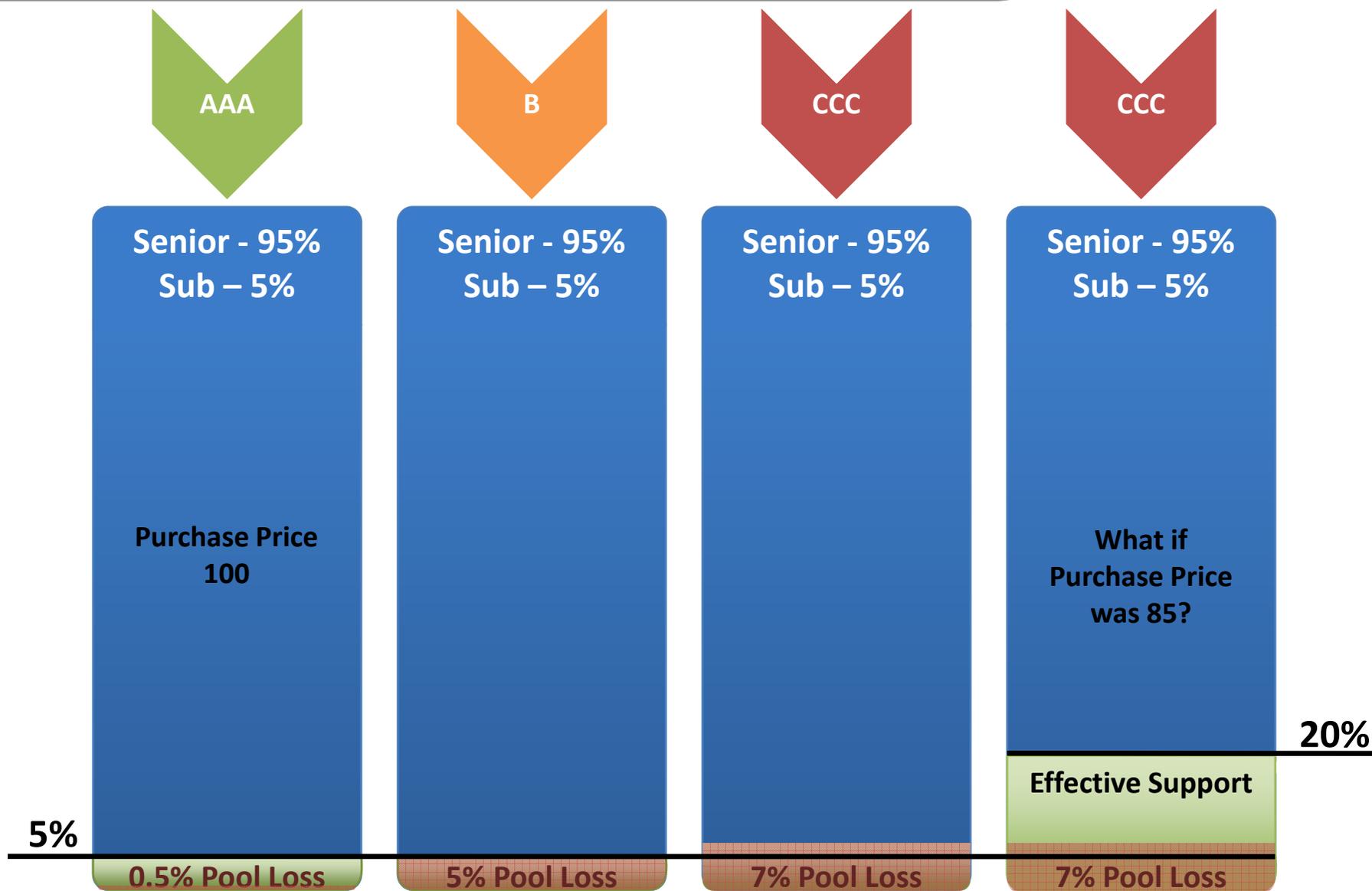
Standard & Poor's Rating Definitions

Ratings Methodology

- Senior tranches have credit protection via the support tranches. Supports sit in the first loss position. Senior tranches incur no losses until the supports are gone.
- In this case, a 5% loss in principal would be required to exhaust the support tranche and incur the first \$1 of loss to the senior tranche.
- $\text{Default} * \text{Severity} = \text{Loss}$



Ratings Methodology



Single Obligor

Single Obligor

- Rating is probability of default
- Rating is silent on magnitude of loss
- Default 0% or 100%
- Severities typically large

Multiple Obligor

Multiple Obligor Security

- Rating is probability of default
- Rating is silent on magnitude of loss
- Can have “partial” defaults unlike single obligor credits
- Severities are much smaller than single obligor credits (home is collateral)

Exhibit 2:
Fitch and S&P Ratings



Inside the Ratings: What Credit Ratings Mean

August 2007



Defining Creditworthiness

Credit ratings can apply both to entities and to individual obligations, and can be broadly separated into two types.

1. Ratings Which Address Relative Likelihood of Default (“First Dollar of Loss”)

Corporate, bank, insurance and sovereign issuers are typically assigned Issuer Default Ratings (IDRs), which express creditworthiness in terms of relative measures of default likelihood.

Structured finance ratings are typically assigned to an individual security or tranche in a transaction, and not to an issuer. Ratings in structured finance primarily reflect the relative probability of default of the rated liability², and not its loss severity given a default, although loss severity on underlying *assets* is incorporated in the analysis.

2. Ratings Combining Relative Default Likelihood and Loss Severity

Individual securities or obligations of a corporate or sovereign issuer, in contrast, are rated on the long-term scale taking into consideration *both* the relative likelihood of default and the recovery given default of that liability. As a result, individual securities of entities, such as corporations, are assigned ratings higher, lower, or the same as that entity’s issuer rating or IDR. The difference between issuer and security rating reflects expectations of the relative recovery prospects for each class of obligation. At the lower end of the ratings scale, Fitch now additionally publishes explicit Recovery Ratings in many cases to complement issuer and issue ratings.

	Corporate & Sovereign Finance	Structured Finance
Issuer	Rating covers Default	-
Issue	Rating covers Default/Loss Severity	Rating covers Default ²

Foreign and Local Currency Ratings

International credit ratings relate to either foreign currency or local currency commitments and, in both cases, assess the capacity to meet these commitments using a globally applicable scale. As such, both foreign currency and local currency international ratings are internationally comparable assessments.

The local currency international rating measures the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled and hence does not take account of the possibility that it will not be possible to convert local currency into foreign currency, or make transfers between sovereign jurisdictions (transfer and convertibility risk).

Foreign currency ratings additionally consider the profile of the issuer or note *after* taking into account transfer and convertibility risk. This risk is usually communicated for different countries by the Country Ceiling, which ‘caps’ the ratings of most, though not all, issuers within a given country.

² At the distressed level, elements of loss severity may be incorporated in structured finance bond ratings in the ‘B’ and ‘C’ categories

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The Fundamentals Of Structured Finance Ratings

Structured finance has become an increasingly important tool in today's financial markets, with issuance levels growing at an extraordinary rate in the past few years both in the U.S. and Europe, as well as in most markets in Asia-Pacific. Its development has been accompanied by vocal debate from market participants and commentators alike on the manner in which credit rating agencies, including Standard & Poor's Ratings Services, evaluate the creditworthiness of such securities.

Our goal in this article is to demystify some of the complexity that surrounds the structured finance¹ discipline by addressing as directly as possible the primary concerns that have been raised. We think that doing so may also alleviate many of the concerns that have been expressed about the manner in which we arrive at our rating opinions and the process involved.

THE PROCESS OF ASSIGNING STRUCTURED FINANCE AND "TRADITIONAL" CORPORATE OR SOVEREIGN RATINGS

Understanding The Rating Process

The fact that the structured finance rating process involves a degree of interaction and that arrangers may change structures to meet rating agency criteria has led some commentators to muse whether the ratings analyst becomes an advisor. The answer is no. Moreover, any such inference is a fundamental misunderstanding of the role and actions of the rating agencies in structured finance.

When a non-structured finance debt issuer seeks a rating or approaches us to discuss an existing rating, it will engage in a dialogue with our rating analysts. It will seek to explain the way it sees its own strengths and its place in the economic and financial environment in which it operates. The analysts will then take this information away and an analytical committee will reach a conclusion and assign an initial rating, make a rating change, or issue a rating confirmation.

¹

Neither the terms "structured finance" nor "securitization" yet have clear definitions. For the purposes of this paper, both will be used interchangeably.

When we have rated new CDO structures some commentators have occasionally expressed the view that we were entering a totally new field of previously unrated, unexamined structures or credits. Others have expressed the view that a new CDO structure requires us to create an entirely new methodology. Both these views are erroneous, for the reasons given above.

A case in point is the rating of constant proportion debt obligation (CPDO) transactions, where part of our tranche default risk assessment is based on a market value analysis of certain credit derivative indices. Clearly, CPDOs were a new instrument. What was not a new development for us was analyzing market value risk as the basis for a structured finance rating. In fact, market value analysis is a key component of many different structured finance ratings and has been for many years. All RMBS ratings require an analysis of residential property values and their movement over time. Most auto loan ABS transactions require the same for cars, aircraft ABS transactions for aircraft. Over the years we have also rated equity basket CDOs that required analysis of equity market values. A number of transactions have required us to model foreign exchange risks and determine the market value of various currencies. As we have pointed out, even the most complex CDOs are usually variations of well-understood themes; variations on structures that we often have a long experience of rating. CPDOs and the analysis of market value risks is just a case in point.

RATINGS ADDRESS DEFAULT RISK

Meaning Of The Ratings

Another topic of criticism is our use of a single rating scale (see our ratings definitions for Standard & Poor's rating scale, detailed under "***Related Articles***" below) for different types of debt. Some argue that, although structured finance, corporate, and government ratings use the same symbology, a structured finance rating is somehow different from a corporate rating. Sometimes, critics even apply the argument to different asset classes within the structured finance universe: an RMBS rating is claimed to be different from that of a synthetic CDO. The claim is that investors are being misled, as they do not understand the crucial differences between the ratings.

First, it is important to understand the intended meaning of a credit rating. Our ratings are an opinion on the default risk associated with either an issuer or an issue, as of today, based on all the information we have in our possession. Our rating speaks to the likelihood of default, but not the amount that may be recovered in a post-default scenario.

The definitions of each rating category also make clear that we do not attach any quantified estimate of default probability to any rating category. In other words, even though our default and transition studies may indicate that the annual average default rate of 'BBB' structured finance securities between 1987 and 2007 was 0.18%, this does not mean that a 'BBB' rating is a mathematical prediction of a 0.18% default probability. It also follows that we have never claimed that, should a particular set of 'BBB' rated debt suffer a 0.37% default rate, for example, those ratings were somehow wrong or inaccurate. To attach precise expected default rates to any rating category is to imbue the rating process with a degree of scientific accuracy that it could not possibly bear, and which has never been claimed for it.

Let us remember that a rating is only an opinion about the relative likelihood of future events (i.e., default or non-default). Such an opinion may, in the case of Standard & Poor's, be based on an enormous amount of analysis and data, but in the end it remains no more than an opinion. Forward-looking predictions have never been an exact science and rating agencies have never made claims to the contrary.