From: Kim Shafer
Sent: Wednesday, December 08, 2010 6:00 PM
To:
Cc:
Subject: email rather than MFR is source

Read below

Kim Leslie Shafer | Senior Research Consultant | Financial Crisis Inquiry Commission | |

From: Ann Rutledge
Sent: Tuesday, November 16, 2010 12:06 PM
To: Kim Shafer
Subject: Re: comment on CDOs sought - would any or all of these work- feel free to call if easier

Hi Kim, #2 (with the addition) and #3 are both great! I'd say, whichever you like better—I like #3. Thanks! Ann

On 11/16/10 11:40 AM, "Kim Shafer" wrote:
The accepted wisdom was that the search for diversity had taken a wrong turn because the asset managers who selected the portfolios for the troubled CDOs were not experts in sectors as diverse as airplane leases and equity mutual funds. But, in fact, that wasn't the problem at all: The real problem was that [CDOs based on structured product ratings][re-securitizations] are especially dangerous. Ann Rutledge, a structured finance expert, explained to the FCIC:

OR

The danger with CDOs is when they are based on structured finance ratings. Ratings are not predictive of future defaults; they only describe a ratings management process…. and a mean and static expectation of security loss. However, the security loss expectation necessarily changes over the life of the structured product. (Those changes can be more sudden and dramatic than is typical with corporate credit.) Thus, it is easy to mask large losses building up in the original portfolio.

OR – with perhaps too much rewriting at the end

ABS CDOs are especially dangerous because they are based on ratings—the estimated ("expected") default or loss. When a portfolio of RMBS securities is put into a new capital structure that has more leverage, it becomes acutely sensitive to unexpected changes in portfolio risk. Those unexpected changes may have been part of the original loss distribution; they just were not the mean, which is what the rating presented. The leverage adds danger.

Footnote: Ann Rutledge is a principal in R&R Consulting, co-author of Oxford University Press' Elements of Structured Finance (2010) and a former employee of Moody's Investor Service. She and co-principal Sylvain Raines first spoke to the FCIC on April 12, 2010.

Kim Leslie Shafer | Senior Research Consultant | Financial Crisis Inquiry Commission |

From: Ann Rutledge
Sent: Tuesday, November 16, 2010 9:50 AM
To: Kim Shafer
Subject: Re: comment on CDOs sought
Importance: High

The danger with CDOs is when they are based on structured finance ratings. Corporate ratings are typically stable and valid through the cycle because the underlying operations do not change much in the short- to medium-term, but ratings of structured products are intrinsically dynamic, and this dynamism is not reflected in the static rating. Because the ratings on ABS and RMBS are not updated to reflect these dynamics, it is easy to mask the build up of large losses building up in the original portfolio.

On 11/15/10 10:15 PM, "Kim Shafer" < wrote:
Thanks. Am trying to get closer to the language you originally said. And to capture in simple language what you meant by linear and non-linear.

The danger with CDOs is when they are based on structured finance ratings. Ratings on corporate (companies) typically ……. , but ratings of structured products mask the risk of large losses [or some better but simple explanation of cliff risk *if* that is what you meant].

CDOs were bogus because they were based on ratings and not on real collateral. My notes also say: "repackaging" and "corporate is linear; structured finance is non-linear."

Kim Leslie Shafer | Senior Research Consultant | Financial Crisis Inquiry Commission |

From: Ann Rutledge
Sent: Monday, November 15, 2010 8:50 PM
To: Kim Shafer
Subject: FW: comment on CDOs sought

Or, to simplify it a bit,

Moreover, RMBS CDOs are especially dangerous because they based on ratings—the estimated ("expected") default or loss. When a portfolio of RMBS securities is put into a new capital structure that has more leverage, it becomes acutely sensitive to unexpected changes in portfolio risk. This is the concept of convexity applied to credit risk—the incremental change in value for an arbitrarily small change in portfolio defaults or losses.

------ Forwarded Message
From: Ann
Date: Mon, 15 Nov 2010 19:01:11 -0500
To: Kim Shafer
Conversation: comment on CDOs sought
Subject: Re: comment on CDOs sought

Thank you for the opportunity to comment! This is the whole explanation. Pls feel free to use part of it, if you like, or none if it doesn't work!

CDOs differ from ABS and RMBS in important respects. With a CDO, there is no information arbitrage—no discovery of value—because the original motivation was to hide risk under Basel. No default risk analysis is conducted at the point of sale, and collateral risk measure is based on the rating, not empirical performance data. While hiding risk in a CDO may defeat the purpose of Basel, it does not necessarily cause a buildup of unforeseen risk if the ratings are more or less predictive of future defaults. Unfortunately, this is not the case. Ratings are not predictive of future defaults. Moreover, RMBS CDOs are especially dangerous because when an RMBS security is placed in a new capital structure with more leverage, its expected behavior will correspond to a point further out in the risk distribution—not the original mean loss expectation.

On 11/15/10 6:42 PM, "Kim Shafer" wrote:
Was just looking for 2-3 sentences.
Timing is important.

Kim Leslie Shafer | Senior Research Consultant | Financial Crisis Inquiry Commission |