

August 20, 2010

To: FDIC- Bobby Bean or Ryan Billingsley

For: Alternative to current Credit Ratings

From : Jim Meyer, MAI

Have recently seen information concerning Alternatives to Credit ratings being requested by the FDIC. I am sure that you will receive numerous articles and information from concerned parties. I am glad that you are researching alternatives to credit rating since previous credit rating were proven to be a weak overall measure of security albeit they were easier to apply.

I will show my thinking quickly since you may be seeing the same thing numerous times from other parties.

Ratings = Risk X Return X Liquidity

Risk

Risk is measured by the ratio of value/loan or an example from real estate as follows:

Risk = Value/loan example : $\$100,000/\$50,000 = .50$

$$\$100,000/\$60,000 = .60$$

Risk for other types of assets could be measured differently. Risk for a stock could be measured by its ability to return dividends (PE ratio) or other methods. A companies risk could be measured by analyzing the totality of its assets to liabilities.

Return

Return is measured by the ratio of income/loan or an example from real estate as follows:

Return= Income /Loan example: $\$60,000/\$40,000 = 1.50$

$$\$50,000/\$40,000 = 1.25$$

In order to better work in the equation the ratio would be converted to grade and then to a percentage or as follows: $1.50 = A = 100\%$ or 1.0 $1.25 = B = 90\%$ or $.9$. The ratio conversion could be set by a created asset board.

Liquidity

Liquidity is determined by the market factors in asset classes

First, the asset classes will have an overall rating. (Example-Real estate, stocks, cash)

Second, the specific asset class will have a general or regional rating (if applicable)

Third, the specific asset class will have a specific rating.

For example, cash will have a very good Liquidity rating since it is easily transferable. The overall liquidity could be compared to other currencies i.e. the Greek currency would be 50% or .50, German at .95 and American at .90. Some measurement could be the analysis between sovereign bond spreads for same time periods.

For real estate, a well located retail property with 100% occupancy in a good area (such as Washington, DC) could show liquidity, with equal weight to each variable , as follows:

$$.90 \text{ (American)} \times .90 \text{ (DC)} \times .60 \text{ (Real Estate)} = .80 \text{ (rounded)}$$

Another retail property in Reno, NV with 80% occupancy could be:

$$.90 \text{ (American)} \times .65 \text{ (Reno)} \times .60 \text{ (Real Estate-Retail)} = .72 \text{ (rounded)} \quad \text{Note: occupancy will be considered in return.}$$

As such, a retail center in Reno could have a rating, with equal weight to each variable, as follows:

$$.60 \text{ (Risk)} \times .80 \text{ (Return)} \times .72 \text{ (Liquidity -see above)} = .71$$

Note: Risk and return would be estimated separately-calculations not shown

A property together with other properties could be rated together. For example, a securitized asset of 30 properties with individually rated properties could be at .88, which may be in a "B" credit classification. The A, B, C, D, etc. could indicate a broad rating scale. A national board would set the letter scale in relation to the grading points. In no case should a rating company be allowed to set up its own rating lettering. The varied rating systems from Moody's, Standards & Poor's and others are confusing. A national standard should be maintained.

For stocks the national and industry group would be considered. Investor's Business Daily has a good stock group asset classification system. For example, a vibrant stock in a good location

with a good book value (which considers assets/liabilities similar to return and risk) could be, based on equal weight to the variables, rated as follows:

.95 (German) X .80 (Stocks asset group) X .90 (Industrial machinery- specific) = .88 (rounded)

All of the components will need to be calculated in order to find an overall rate. Some components such as sovereign quality will need to be calculated by a national board. Some components will need to be estimated by regional groups (possible Fed. regions) and items such as stocks and real estate will need their cash flows/ liabilities estimated. Well respected investors such as Warren Buffet could provide a method of rating stocks based on assets/liabilities .The same guide would be used by everyone and could consider international guidelines.

Companies will arrive at their Rating by applying the Risk, Return and Liquidity formula. The rating and all information will be reviewed by a rating company delegated by the federal company. I think it is important to get away from accounting firms, who rubber stamp company or asset information. The new delegations will apply to individuals not companies. If in the inspections of ratings by the federal government the rating is found to be erroneous, then the company will have stiff penalties including fines and a lowering of their credit rating. The delegated inspector would have stiffer penalties .The penalty should be severe enough that companies will not risk a drop in credit rating just because they thought it was worth the chance to fudge a little.

Finally, an important portion of the equation could be that each component (Risk, Reward and Liquidity) could be weighted or be flexible considering market conditions. However, it is estimated that a model top and bottom should be set, which could not be moved beyond.

Obviously this document is a very broad stroke. If any of the ideas help, please use them.

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