Rating Agencies

Why Did Rating Agencies Miss the Big One.

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INTRODUCTION

The following discussion stems from my 35 years of experience in founding and managing the Canadian Bond Rating Service (CBRS) and my two years as Managing Director for Standard & Poor's (S&P) in Canada, after they purchased CBRS in October 2000. The opinions are mine alone and are reflective of the current challenges facing the Rating Industry. I would also like to thank Ron Neysmith for his contribution to this article stemming from his years with CBRS, S&P (NewYork) and later as Director of Rating Advisory Services with Citi Bank.

"In all of my years of rating, my biggest challenge was always how to reflect a change in ratings in a situation, where my experience told me something was wrong or going wrong but where I didn't have sufficient data to prove it." This dilemma, I believe, is at the heart of the agencies' problem.

The pertinent question is, how did they lose investors' confidence and why did they miss the big one. Rhetorically, "Why shouldn't they have missed the big one?" The smartest people on Wall Street and Bay Street did. Regulators did, all forms of large and small Institutional Investors did. What makes Rating Agencies better at analysis than the best and brightest on Wall Street? The fact is, when it comes to analysis, Rating Agencies turned out to be no better or no worse than their peers. If Investors thought differently, it is a misconception that has gone unchallenged for a long time. Investors perceived rating agencies as a canary in the financial mine, perched there to warn them when trouble was brewing, but what happens when the canary comes down with laryngitis?

Is there really a problem with Rating Agencies, or are investors just upset with losing so much money, and looking for someone to blame? Are the agencies sufficiently regulated or will stronger regulation make them better? Will the new laws enacted by the SEC in 2006, the "Credit Rating Agency Reform Act" make the rating agencies better at performing their tasks? Would it have made a difference in the latest financial turmoil? So far no, but the future may tell a different story. I believe that part of the answer is investors' unrealistic expectation, that somehow Rating Agencies can always predict financial trouble. This burden of forecasting correctly is not placed on any other player in the financial industry. Who expects economists, securities analysts and the hoards of other market prognosticators, to be able to predict where economies or companies are going. Even Nobel Laureates get it wrong. Analysts are generally happy if they get it right 60 percent of the time, but Raters are expected to always get it right. Raters, for their part, have not gone out of their way to temper this impression by telling the market that they do get things wrong. Unfortunately, the situations that do go wrong are quite spectacular and get much press, such as Enron, Worldcom and AIG and their likes. But on a statistical basis, these account for a small percentage of all companies rated. Although the agencies say they can't be right all the time, they could have done a much better job of calling attention to deteriorating situations, by being more proactive and remembering that they are there to serve investors.

A Little History.

The answer to what went wrong is not very simple and is entangled in their long history. To begin to understand the problem, it is necessary to remember how Rating Agencies started and how they evolved into the significant financial players that they are today. When John Moody started in the early years of the last century, the financial markets were akin to the "Wild West", with no regulation, no oversight, and no independent research. Moreover, reported financial information, where it existed, was of dubious quality. An annual report was not required and some companies produced one only every three years. John Moody started out trading railway bonds, whose prices moved like common shares. To try to pick profitable trades, he studied the price movements of the bonds and began gathering financial information, where it was available, to supplement his analysis. In Time, this compiling of information later developed into the famous Moody's Manuals, which became the bible for the financial industry for close to seven decades. The rating system, started out as a simple means to identify companies that he thought were financially stronger and whose bonds would trade higher than weaker ones.

As rating agencies grew in stature and prominence they finessed their role by stating that they just rate the credit worthiness of the borrower and that they do not make or give any investment advice. This is technically true, in that they don't call up an investor and say, buy this bond. However, their fundamental activity is to distinguish between Investment grade and non Investment grade securities as most institutions are only allowed to purchase Investment grade debt. For decades, they have encouraged pension funds and others who invest in bonds, to use their ratings as an investment guide. Their success in getting ratings embedded in various regulations and investment guidelines has led to their great financial success, by getting the market to require ratings on almost every type of debt security. All agencies are registered as Investment Advisors with the SEC. In fact, for several years, S&P's motto was 'Setting the Standard" however, this was dropped several years ago. But the facts are undeniable millions of investors have invested trillions of dollars based on their ratings, thus, they do provide investment opinions, albeit, implicitly.

The rating scales also contribute to a sense of great precision. From AAA down to D there are 20 rating levels and to most scales you can add on a positive or negative outlook. Add to these country ratings and domestic scales within a country, and scales for different types of securities, and you get the very distinct impression that ratings are highly precise. All this promotes the agencies aura of great credit prowess.

Financial analysis in the earlier years (1930 to 1960) was very rudimentary. It comprised of calculating basic financial ratios from published reports, and then ranking them from top to bottom, dividing them into groups and calculating trends. This process continued very much unchanged until the sixties, when everything began to change with the expansion of the debt capital markets . At this time, Rating Agencies were relatively small organizations, with their primary source of revenue coming from selling of their research reports to investors. The ratings were very much predicated on the recorded financial history of the company, as measured using various statistical ratios. There was little in the way of management interviews, and the use of projections was also limited. To obtain high ratings, companies had to show many years of consistently strong performance. The agency's position was to stand back and say to the borrowers, "Show me". Rating Agencies were not considered "insiders" and did not participate in the financing process. They were viewed as outside independent observers.

The agencies' favorite saying regarding the issuer is that the rating speaks to "the ability and willingness of companies to pay". The ability aspect is very much predicated on the ability of corporations to generate revenue, cash flow and earnings, and the willingness aspect, is captured by the various positive and negative covenants and financial policies written into the Trust Indenture. Moreover, as part of the willingness to pay, management had to show years of good stewardship of the business long before a high rating was ever given. As such, ratings were very much based on historical evidence and forward looking only as it assumed, a continuation of the past. In later years, the concept of the recovery of funds from the sale of assets was added.

All of this started to change in the late sixties and early seventies. Debt issuance began to explode with many new borrowers entering the market. The old style of investment banking began to give way to the new fast paced corporate underwriting departments within large investment banks raising money on behalf of multiple issuers. There was a profound change in the role of the underwriter in this period. Historically, the underwriter saw in its role, a responsibility to bring both the borrower and lender together and to construct a deal that met the requirements of both parties. This gave way to a purely transactional model, where the dealer just did the deal and drove on to the next one, with no real extended responsibility once the deal was done.

In this period the economy was rapidly expanding, and the need for debt financing was greater than ever. Institutional investors began to multiply and expand their investment horizons by investing heavily in equities. Equities became the name of the game. The more mundane, and less exciting credit analysis, was in a sense outsourced to the rating agencies and thus, the need for ratings exploded.

The rating agencies couldn't keep up. Their main source of revenue, which came from selling their rating manuals, was insufficient to fund their growing need to hire additional analysts. They had to find new and greater revenue sources if they wished to stay in business. As a result, in the beginning of the seventies, the agencies began to charge borrowers to be rated. There was little push back from borrowers as they saw the value in ratings and the fees charged, were quite modest. However, it ushered in the beginning of a closer working relationship between the borrowers and the agencies. Face to face meetings increased and corporations upgraded their working relationships and presentations to the agencies. Borrowers went out of their way to keep the agencies informed of developments and naturally, put the best possible spin on anything negative. This early development was very healthy. Rating agencies, in a sense, came in from the cold and became an integral part of the capital markets. My observation of this period is that the analytics were carried out in a very professional manner, and that the agencies were very much mindful of the buyers' requirements for tightly structured issues around types of security, covenants and priority in ranking. By the mid eighties, investors had given up most protective covenant structures and just accepted the borrowers unsecured IOUs', believing that the rating was all they needed.

Investors, particularly small institutional and retail ones, developed a near blinding faith in the pronouncements of the raters, as if they had superior knowledge of financial matters. Many didn't even read the rating reports, they just asked "What's the rating?" and that was the sum total of their analysis. Many gave up performing any meaningful credit analysis, although for optics, they stated publicly, that they did their own independent analysis.

The power and prestige the agencies reached was aptly captured in a quote by the Pulitzer Prize winning journalist, Thomas Friedman when he said " there are two superpowers in the world today in my opinion, there's the United States and there's Moody's. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful"

This use and importance of ratings had its beginning in the financial devastation of the thirties, when in subsequent years, the regulatory authorities began to enshrine ratings in the investment guidelines of many State and local pension funds. Rating agencies were thought to possess an analytical "Black box", which somehow guided them on who was going to prosper and who was going to fail. The agencies, for their part were secretive and published little of their methodologies. This is in sharp contrast to today, where they publish volumes of information. However, ratings are educated opinions, and opinions are just that, an estimation, an informed judgment. In hindsight, however, it will be right or wrong.

In the opinion business, one is just acceptable, two is better and three is the best. As an example, Canadian investors in the non-bank sponsored ABCP learned the hard way when that market froze and collapsed. Even after 16 months, it is still in restructuring, the funds are still frozen and it appears that only a Government bailout will be able to save the restructuring. All of the non-bank issuers carried only a DBRS rating and none were rated by either Moody's or S&P. But from my perspective, there were actually three opinions, one rated and two not rated. This fact in itself, should have said volumes to investors had they cared to listen. In addition to not being rated, both Moody's and S&P published articles speaking to the inadequate liquidity arrangements backing these ABCP programs.

The financial markets naturally focus on the big misses, like the Enron's, but there are other misses that are not as evident. These occur when a company is rated higher than it should be, or conversely, rated lower than it should be. In the first case the investor loses, and in the second, the company loses as it pays a premium for the funding. These little misses are far more frequent than any single big miss, and are often corrected as time passes and the agencies get more comfortable with the borrower. These situations occur when an agency is not as comfortable with the borrower and the rating is notched down a little to reflect their concern. The opposite occurs when the agency has a more positive view than is warranted.

The success and market dominance that both Moody's and S&P have achieved in the US is complete, with about a 90 percent market share. The fact that all investment guidelines required a rating for debt, enshrined their success. They soon reached maturity in the US and expansion could only come from abroad. This led both organizations to significantly expand internationally, as they wanted to be raters to the world.

Regulators and Politicians Come Calling

There has been much criticism of rating agencies both on the domestic and international fronts, specifically pointing to their poor calls on the big misses. This has triggered calls from regulators and politicians for new legislation and/or greater regulation of the agencies' activities. Investors and others have tried to sue the agencies. The agencies' main defense has been that ratings are opinions, and as such, are protected by the First Amendment under freedom of speech. They have also defended themselves by saying that they were given bad or fraudulent information and/or lied to by management which, no doubt was true. However, when post mortems were done on these failed companies, it revealed that there were telltale signs showing up many months prior to the default, and that the deterioration had in some cases set in several years earlier. A peculiar aspect of this is, what the credit raters didn't pick up, or failed to mention in their reports, the market price movement in the company's common shares was clearly registering that something was going on. This has led to the situation where the ratings were only changed long after the market registered that something was terribly wrong. In some cases, just months before bankruptcy, was declared. When this occurs, investors are rightly upset and can legitimately ask, if the raters were asleep. If they were not asleep, why didn't they sound the alarm? The answer is not simple, particularly for financial companies where a downgrade can trigger a loss of confidence in the company and cause a "run on the bank". Imagine the predicament that a rating agency is put into, if in its opinion, a particular bank is going to fail but the general market had not come to that opinion yet. But then again, what is their role? The rating action would accelerate the very thing that it was warning against. It is far easier to downgrade non financial companies where the debt can not be accelerated. There is an additional side problem in situations where, in a loan agreement, there is a clause that requires a borrower to repay or post additional collateral if the borrower's rating is downgraded.

This leads to the question, should investors view ratings as lagging indicators, in that they reflect the borrowers past history. Are they coincidental, in that the rating reflects what is occurring today? Or are they leading, in that they reflect what the agencies believe will occur to the borrower. Investors assume that there is a strong element of future analysis in ratings, as the agencies indicate that their ratings should be good for a three year period.

How They See Their Role

Regulators and politicians now have a new regulatory system in place in the USA, and Europe is working to have new guidelines in place sometime in 2009. This has been their attempt to have Rating Agencies do a better job by minimizing abuses and holding them accountable. This assumes that had such a system been in place, the agencies would have sounded the alarm bell and somehow "saved" investors. This view does not coincide with the way the rating agencies see their role.

Investors think that the agencies are there to work for them, to take their side and interests into account when rating a security. They are under the assumption that rating agencies are there to warn them if trouble is coming. However the agencies are very careful to point out that, they do not work for investors, nor do they work for the borrowers, and certainly not the underwriters, and they don't have any type of market policing roll. So who do they work for? "THEMSELVES"!

Let me explain. The agencies express their mandate as identifying "the fundamental credit worthiness" of the borrower. To achieve this, they have developed a vast body of knowledge and methodologies covering the financial analysis of borrowers across all industries and in many countries. Their allegiance is to their "Body of Knowledge", it is like a temple, where the body of knowledge is the holy book and the raters are the priests that interpret the book for the faithful. Now Church and State are separate and this is why the agencies have been so tenacious in their opposition to regulation.

In talking with investors, it is evident that they did not pick up the subtlety in how rating agencies see themselves; they thought that rating agencies worked for them alone. In away, it is akin to a company's shareholders believing that the auditors are there to protect them. For their part, the agencies should have done a better job of dispelling this myth and spent more time educating investors on how they see their role.

The Current Mess

The current sub prime collapse and the default of many structured products illustrate a basic flaw in trying to rate all types of securities. Historically, ratings were always based on two dynamics, first the "ability to pay", and second, the "willingness to pay". The first was based on a historical analysis of the financial history of the borrower, as it went through various cycles in its business. A pattern for each borrower's business and industry was developed, that could be analyzed and dissected to see how the borrower would fare under various conditions. Rating agencies have been using analytical models, both simple and complex, for many years, as an important tool in developing ratings. However, we all know that a model's ability to predict an outcome is only as good as the reliability of the input data: the old, "garbage in, garbage out", theory. Models can not predict an unknown prior event. As an example, the historical default pattern of residential mortgages did not hold up, as fraudulently underwritten mortgages entered the system. This is essentially what started the whole sub prime collapse. The games played by the various participants are now well known and have been exposed throughout the press. However, during years in which these sub prime mortgages were building up, there were stories in the financial papers calling attention to the rapid growth in this class of "liar" mortgages. Many noted people, including the Nobel Laureate, Paul Klugemam, wrote about the housing bubble and its consequences. In my opinion, there were enough signs around for the rating agencies to go back and seriously question the underlining data. Although some comments were made, no rating action was taken until it was too late.

The real tragedy was, that bad mortgages were wrapped up with other good mortgages and securitized to form the base of RMBS's (Residential Mortgage Backed Securities) and were then put into highly leveraged CDO (Collateralized Debt Obligations) products. These were structures that bought the bonds that were backed by mortgages. The leverage was so high, that even a small increase in mortgage defaults, triggered a collapse in the structures, leading to the current collapse in the financial system. Had the rating agencies spotted this one, they would have been heroes for eternity, or at least until the next calamity.

One note about the use and transparency of models. S&P developed a model for CDOs called the CDO Evaluator that was freely available to users on its web site. There was also a model for RMBSs called "Levels" that could be licensed for a fee. Investment dealers actually used these models to structure products around certain rating parameters. A question to ask is, how well did the users of these models understand them and how did they use them in the analysis of these very complex securities? Recently, Moody's admitted that there were coding errors in one of their models that lead to incorrect results. In structured products the AAA stress test was based on historical default and transition experience which in this case turned out to be erroneous. There is now a widespread move by the agencies to review all their models.

When an AAA rating is placed on a security, the agency essentially says, that in its opinion, you can expect full repayment of principal and interest on time under all known and reasonably expected events. The rating agency can make this forward looking statement because, one of the strongest weapons in the rating process is management's ability and willingness to do everything it can to correct problems and avoid a default. This "human element", the ability to react and effect change, is what was missing in most structured products.

Once they were structured by the dealers, rated by the agencies and sold to investors, they became somewhat orphaned and were expected to run as if on automatic pilot. Most of the money made from these products was made through upfront fees, and as soon as they were sold, the creators were off to some other scheme.

The pressure to put AAA ratings on these structures was no doubt great, for without a AAA tranche, these structured vehicles would not be profitable for the Dealers. The agencies would have insisted on as much credit enhancement as they thought necessary (or as the various models indicated), but it was no doubt a process involving negotiation with a maximum effort by the dealers to minimize enhancement (due to cost) and maximize profits.

Although I have no first hand knowledge, there were people within the agencies who had grave doubts about the viability of these structures,(recently some emails have come to light that confirm this) for AAA means little or no perceived risk and as time showed, these structures were fraught with risk. The agencies could have worked their way through these structures and spotted the errors, but it would have taken a level of due diligence and drilling down that was not done based on historical assumptions and stresses.   In addition, they probably would not have been given the level of disclosure that they would have needed. The question to be asked is whether ratings as we known them, be applied to every type of debt instrument.

The agencies clearly realize that they have fallen down, and acutely feel the criticism thrown their way. Their response has been to announce a major review of their procedures, enunciating new oversight committees and a new rating system for structured products. These initiatives will no doubt help; however, I feel that they will make the agencies more reluctant and certainly very cautious in rating new products, particularly those that focus on market value assumptions. They certainly have been wounded by the level of criticism sent their way. Their old defense against criticism, that ratings are opinions, and protected by Free Speech, did not protect them this time around. The agencies have lost the confidence of investors and it will be a long time before they earn it back.

Because ratings are arrived at through a committee process, I am not sure the solution is for more committees. However, it might be worth considering forming an ad hock super or oversight committee to review rating decisions, where there was a divergence of opinion in coming to the rating.

Their Structure

The first point to throw out, is that it is sheer nonsense to believe that the agencies can be right 100% of the time. My experience is that they employ some of the best and most conscientious analyst around, who can hold their ground with any Wall Street analyst. They review more companies per analyst than a typical equity analyst; however the nature of the analysis and structure of the analytical teams allows them to do so. The agencies' main disadvantage in attracting and holding onto their staff is that they can not match the pay scales and bonuses of the Investment Banker and other major financial companies. Their best analysts are easily poached by other firms, particularly if the analyst has the ability to "sell a story". A second consideration here is that rating agencies do not seek "star analysts" as the investments banks do. Firstly, for the real fear that they will be hired away and secondly, it is preferable and by design, that the ratings be seen to come from a faceless committee than an individual. There are practical benefits to this in managing the business, as it is easier to replace no-name people than explain why a high profile analyst left and more importantly, one analyst is not seen to be the reason for the downgrade.

The second point is in the structure of the Rating companies. The explosive growth in the number of new borrowers and different types of issuing structures over the past 20 years has forced the agencies to run fast. The development of the structured finance market has been the most challenging component of this growth. The structured market changed the way the agencies looked at credit and increased the level of risk assessment.

In the structured world, instead of just looking at business and financial risks, they were looking at a combination of the legal structure, the cash flow and the credit patterns of various types of financial assets. Moreover, in the structured world, history is scarce and in many cases, there is only an indirect history. There is a difference between the traditional pure vanilla assets that are securitized such as credit cards, receivables, auto loans and leases, where the data has seasoning and a history. Versus the more esoteric assets, resecuritized products or the multi variations in mortgage loans that we saw in this cycle.

In most cases, debt is repaid over time, from cash flow or earnings. In the structured world, debt is repaid from maturing assets and more commonly, by refinancing outstanding short term debt. In many cases the structures were not homogenous and you had to model how you thought the different assets will behave over time. The assumptions you put in and relationships (correlation) between differing asset classes became critical .The Achilles heel for these structures is the "all other things being equal" assumption. It is the exogenous events that generally sink the structure, the one you couldn't model. Another dynamic was that, with the first structures, because they were the first, the agencies build in a scenario which produced a high level of collateralization. As the structures mature, the originators, for profitability reasons (and perhaps for good performance during strong economic times) requested lower levels of collateralization for subsequent structures, sighting the good performance of the earlier ones. The risk here was that time periods generally do not cover a full business cycle. On top of this, you had to create multi tranches rated from AAA down, a mistake in any one level created multiple problems for the lower rated tranches. There is also the issue of Fair Market Value accounting and the Mark-to-Market issue which has increased the volatility of these structures, due to the inability to accurately price these structures.

Nationally Recognized Statistical Rating Organization

This awkward sounding designation (NRSRO) was brought in by the SEC around 1977 and had a profound effect on the industry. Until this time, when debt was required to be rated for legal or regulatory investment purposes, it was always assumed that Moody's, S&P or Fitch were the accepted ratings. In the seventies new rating agencies began to come on the scene with Canada's CBRS being the first. The US market was the largest in the world so expansion into this market was a natural goal. However, for the ratings of a new agency to be accepted by US instructional investors, they had to be "recognized" by the SEC. For its part, the SEC stated that to be given an NRSRO designation you had to prove that your ratings were used by US investors. This was a great circular argument and barrier to keep out other rating agencies. Although you could apply, there were few guidelines and it was only in 2000 that finally, rules and a procedure was established.

This had two important effects. First, it kept out competition from other agencies. But second, it gave the ratings by Moody's and S&P the official stamp of approval of the SEC, the regulatory body set up to protect investors. So whether it was intended or not, this move by the SEC made ratings by Moody's and S&P seem infallible and the go-to ones in the eyes of investors worldwide. This ushered in the most successful financial years for the agencies. As a result today, Moody's and S&P have about a 90% market share.

I do not believe that there should be officially sanctioned ratings or agencies. Back in the forties and fifties when the level of financial analysis was merger and investment analysis was just beginning, the agencies were the only ones to go to. Today, all that has changed and the rating agencies should earn their place with investors by the timeliness and astuteness of their analysis, not because their ratings are official.

Revenue Sources:

As I pointed out, for a good part of their life, rating agencies' only source of revenue came from selling their rating manuals and other statistical information products. It was only with the explosion of debt insurers in the beginnings of the seventies, that agencies started charging Issuers. Without this new revenue they could never have expanded their staff to keep up with the demand for ratings. This new source of revenue proved very lucrative. In the beginning, rating fees charged to borrowers were a small percentage of the total cost of issuing new debt. Since you couldn't issue without a rating, the rating fee was seen as a cost of doing business. This was combined with an analysis of how much time was spent covering a company for a full year. As time passed and the market got used to paying fees, the agencies realized that they had real market pricing power. Not only did the rating determine the relative cost of the issue, but without a rating, there was no bond issue. Even when companies felt that the level of fees was unjustified by the amount of work that they saw, they were reluctant too complain to hard, for they saw no upside in ticking off their rater.

Getting a company to pay at the time of the new issue was generally very easy. The bigger challenge was getting them to pay on an annual bases when they did not issue frequently. Some augured that the ratings were for investors and that they should pay a significant portion of the fee. Investors however, viewed ratings as public information, and as such, should be free. It didn't take too many years for the fee convention to become established, as ratings equaled market access. Moreover, with the sophistication in technology and information bring disseminated instantaneously, the agencies argued that in order to provide simultaneous dissemination of information to all, the investor pay model would not work.

The underlying issue of how do you figure out how much to charge, proved very difficult. Some suggested that it should be calculated as a professional fee for time spent, much like accountants or other such professional services. In the end, because the vast majority of companies didn't complain and didn't ask for time sheets, fees were set based on the revenue required by the rating companies to perform the work. By itself, this was not an unreasonable proposition. Two developments contributed to the growth in rating fees and are discussed below.

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The first is the general compensation regime on Wall Street which contributed to what I call fee disparity or fee envy. This all gets caught up in the perceptions of what the investment bankers make on a deal, and what the rating agencies make, considering that without a rating the deal could not be done. Although the agencies' fees were always much smaller the investment dealers' there was a view to charge what the market will bear.

This led to the practice of the agencies charging a certain amount of Basis Points, based on the dollar amount of the issue. This practice, I believe, is very wrong, as it gives the agency a financial incentive for larger issues. There is a general relationship between the size of company, size of issue and the amount of work, but it is not a direct liner one. Furthermore, the perception is bad and without a rigid costing system in place, fees expanded. Companies for their part, were reluctant to complain, and just paid the fee. Rating agencies would argue that the fee is not known to the analyst and that, charging a certain amount of basis points, is to share in the upside of a successful placing as a result of the rating and the value added that the ratings research report has.

The second issue is that Moody's, S&P (McGraw Hill) and Fitch before it was bought by Finlac, are all public companies with public shareholders. They need to show continued growth in revenue and earnings, just like every other public company. Even the most cursory analysis of their financial history reveals that they are very profitable companies and have been so for a long time. Warren Buffet, who has a history of picking truly great companies, has now bought a 20% stake in Moody's. The importance that investors in both Moody's and S&P place on the new issue business, can be seen by the fifty plus percent drop in their share price over the last year, in tandem with the collapse of the structured market. From one perspective, I question if rating agencies should be public companies. They don't have any requirement to raise funds as their free cash flow is very strong. If they were private, they would be free from market pressure to show earnings growth and could just focus on their core business of providing independent third party research. It could be analogous to the differentiation between public television and private commercial television.

Many have made the inference that the agencies missed this crisis and were slow to change ratings because, by being paid by the insurer, they compromised their objectivity. From my perspective, this was not the case. It would be wrong to infer that Moody's, S&P or Fitch has ever compromised their rating standards for financial considerations. I have never seen this or heard any anecdotal comments. They just didn't recognize the early warning signs nor saw the depth of rot in the underlying mortgage structures.

However, it is fair to say that, as public companies they felt real pressure to show continued growth in revenue and earnings. This revenue stream is very dependent on the new issue market and the activities of the investment dealers. The dealers bring the new issues to the agencies and the agencies closely track what percentage of the deals they get and what their market share is. In my opinion, it would be preferable if rating agencies didn't have to negotiate fees directly with the borrowers. Some form of a "stamp tax" set by the SEC where every borrower is charged a fee, which is then remitted to the agencies might be an alternative route. However, there should mandatory disclosure in the documents of all fees paid to each of the agencies and to any other market participant.

The working relationship between the issuer, investment banker and rating agency has dramatically evolved over the years. In days gone by, when there was no exchange of money between raters and issuers, raters did their thing, wrote their reports and went on. The level of contact between both parties was much reduced compared to today and the agencies were viewed as truly, independent and very much at arms length. Today, the majority of companies actively engage in dialogue with the rating agencies; there are frequent meetings and issuers answer the telephone any time a rater calls. The raters have access to senior management that equity analyst can only dream of having. Companies go out of their way to develop a good working relationship with their raters. Raters for their part, value a good working relationship but guard against becoming to close with management, for the obvious reasons. Although Raters are classified as "Insiders" there are a small but growing number of companies that treat the agencies the same as any outside analyst, and the agencies are not given any additional information that is not already in the public domain. There has always been a philosophical argument amount analysts as to whether you better read on a company by talking or not talking to management. It's an interesting question.

While most corporations try to develop a very collegial relationship with the raters, the investment bankers take a very aggressive stance. They actively poach the agencies to pick up their very best talent to be part of their teams which bring new borrowers to the market. These ex-raters help and/or write many rating presentations, coach the companies on the issues to focus on and the right buttons to present. This environment is challenging, but healthy in my opinion, as it keeps everybody on their toes.

One of the frequent complaints that borrowers have about the agencies is the turnover in analytical coverage and in some cases the new analyst has only a superficial knowledge of the business. Some of the most awkward moments I have seen, is a twenty something year old trying to have a conversations with a fifty year old CFO about the future of the business. A complicating thing is that many good analysts, have poor communication skills.

The drive for new issue fees is great, as theses fees represent a significant part of profit growth. This led to the controversial practice of “unsolicited ratings”, where the agency would put a rating on a security where the borrower had not requested the rating, or refused to pay a fee. This practice has by and large wound down, as it was very contentious for obvious reasons. But it does underline the importance of getting new issue fees.

The analysts within each agency do not have any responsibility for setting fees as there are other business development individuals that contact the company regarding products and services and any fee discussions.   However, every analyst, particular those at the Managing Director level are aware that higher revenues to the agency is a positive as remuneration is generally composed of a base salary and bonus tied to performance and objectives.

Other Revenue Sources

Over the years the agencies have tried to expand their business beyond “pure” ratings. They have tried various consulting roles, with the idea of leveraging off their general analytical knowledge. By and large, most of these ventures have not been that successful, as it was difficult to turn raters into consultants and salesmen. In situations where they purchased a new business, there were significant cultural differences and integration problems. The financial bottom line was that few of these new ventures had the wide profit margins that the rating business enjoyed. In S&P’s case the one business that has turned out to be very successful is their Indexing business.

Another area of additional revenue comes under the broad banner of “Rating Evaluation Services” or Rating Assessments. This service is where the agencies use their knowledge to assist the borrower to structure a financing which will yield a certain desired rating. This service is used to opine on the rating outcome of a particular event such as a merger or amalgamation. In this case, management picks one two or three scenarios, presents all the information they have regarding the financial and operational implications. The rating agency then provides an opinion on the outcome of the existing rating should each of these scenarios play out. The difficulty here is by assisting in the development of models or structures, the agencies take a certain ownership in their success. The Investment Banks are happy with this situation, for the agencies create and rate their own structures. If anything goes wrong, they can point the finger at the agencies and claim that it met their standards.

Another example where the agencies have assisted in the development of parameters includes new loan risk models for Banks, used for codifying loans under the new Basel II Accord. There are other examples where the agencies give “shadow ratings”, preliminary per ratings or conditional ratings, based on “what if “ scenarios which are very helpful to the company and its’ underwriters. In most cases there are fees charged directly for these services, or may be included in the final rating fee. The thing to guard against here is the slippery slope that gets you closer and closer to rating your own creation.

Conclusion

In this current crisis, there have been many who have called for greater regulation of the rating agencies. On the assumption that, if there had been greater oversight, the agencies would not have missed the increasing levels of risk in many of the financial institution what were heavily involved in the sub-prime and securitization markets. I believe this is a false hope, it was not the lack of regulation, but a lack of insight and analysis of the situation that lead to the crisis brought on by the liquidity crunch. The best that can be said by the agencies is that they were not alone, and were among very good company.

However, the very reason for the existence of the agencies is to spot and call attention to changes in the financial conditions of borrowers. They are the canaries in the financial mines. More regulation would not have prevented this crisis. Regulation implies that there is a set of rules that are codified and are to be followed in various circumstances. It works well in the accounting profession and in civil and criminal law. But the investment world is very much about risk assessment and the future. Every time an investor buys or sells a stock or bond, it is based on an expectation of future gains or losses on the security. The agencies clearly state that the ratings take into account a forward opinion of the borrowers’ prospects and are not solely based on historical analysis. More regulation would imply that it would make them better at their job. The only way I see more regulation helping is, if the agencies had a “policing mandate”. This would give them the power to force CEOs and CFOs to fully disclose all. They would have the power to request any and all documents related to anything they are working on. This would be backed up some form of legally enforced penalty or sanction. In this circumstance, you would only need one agency and it would be an arm of the SEC.

Rating agencies over their history have done a good job at identifying and codifying risk and are very good at picking up gradual deterioration in financial quality. GM for example, has taken twenty years to stand on the edge of bankruptcy. Lehman Bros. and AIG, did it almost overnight. Yet as we are now seeing, the seeds of their destruction were sown many years earlier

The level of financial complexity and the globally interwoven nature of financial markets require extremely skilled and knowledgeable analysts to begin to understand what is going on. Within the agencies, there are many very bright but younger analysts who have not experienced the passage of time needed to develop a critical assessment of the borrowers. They report to people with more experience, who report to people with more experience, but somehow, it wasn't enough. There was a break down in the system designed to catch risk.

The rating agencies by accepting the role as the official arbiters of credit risk have the responsibility to point out financial trouble, when ever they see it. The difficult calls are not easy; they involve judgment and opinions generally in an environment where there are strong counter opinions. In 2005 Warren Buffet, told the financial community that these derivative instruments, were in his opinion "weapon of mass financial destruction", yet most people chose not to believe him.

The agencies are very process driven and have a collegial atmosphere. Methodologies are centrally controlled and applied throughout. This is necessary to keep control of the qualitative aspect of ratings but does make the system rigid and more difficult to quickly respond to changing circumstances.

The agencies must put in place a system where their best and most experienced analysts are in the front lines. A decision process where experience, judgment and institution can be capitalized on.

Their response to the criticisms and attacks to their competency had made them very defensive. They have responded by being very technical by trying to explain away the problem. Their portrayed as being unsympathetic by distancing themselves from the problems.

By missing the big one, the rating agencies have destroyed a substantial part of their franchise value in both dollar and reputation terms. They can get it back; it will take time and a major restructuring of how they conduct their business, by being more proactive, courageous in their calls and remembering who they are there to serve.

Recommendations and Changes to Consider.

MISSION: The rating agencies must reaffirm that their primary goal is to inform investors of the risk profile of the debt instruments they are buying and to monitor and report on changes to those investments.

1. Fees. Getting investors to pay is a non-starter, all fees will have to come from the issuer. I suggest that within the regulatory framework there be an independent body that would set the fees schedule for ratings after consultation with the industry. It would be a gross fee and the company being rated would direct to which agency or agencies it would be given to or shared between.
2. All rating fees and to whom they are paid would be listed in the company's annual report.

3. No fees would be based on a percentage of a new issue amount. The fees would be calculated on the bases of professional services rendered.

4. Ratings should not be legally mandated, they should be there by market convention. No regulatory body can figure out "who rates best".

5. The senior analyst on the account must have had experience working within the industry that is being rated and must be a seasoned rating analyst.

6. The rating committee structure should be modified so that the most experienced analysts are part of the decision and that their opinions be given a higher weighting. Or as another option, have a number of standing committees composed of senior managers and analyst and have the line analyst present to these pre-established committees.

7. The final decision does not have to be unanimous but in the case of disagreement, a minority report should to be written by the dissenting analyst and be place as a permanent record in the rating committee internal report.

8. As part of the audit process under the new Act, the auditors must review the rating committee decisions, particularly those with minority reports.

9. Rating agencies must be able to access all information that they require to complete a rating. If any information is not given, the agency in its report, must disclose this fact. This is not to suggest that the agencies be the main provider of information.

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