

CREDIT RATING AGENCIES

*Indispensable Arbiters of Risk
or Glorified Financial Journalists
Peddling Regulatory Licenses?*

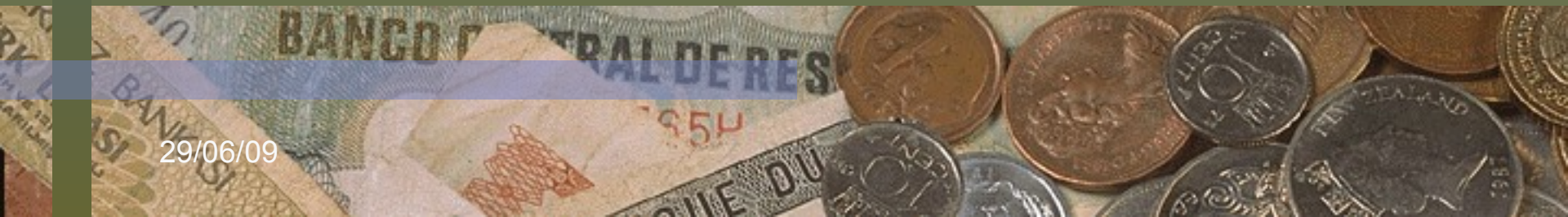
29/06/09

A collage of financial imagery including banknotes and coins. The banknotes are from various countries, with visible text like 'BANCO CENTRAL DE RESERVA' and 'BANK OF SIERRA LEONE'. The coins include a New Zealand dollar and a British pound.

Credit Rating Agencies

- On May 21 2009 S&P downgraded its outlook for the UK to negative, and suggested that there was a one in three chance that the UK might lose its AAA credit rating.

29/06/09



Credit Rating Agencies

- The U.S. dollar fell by .5% against a basket of currencies.
- The FTSE fell by 2.5%
- The ASX fell by 1.4%.
- DOW fell by 1.54%
- NASDAQ fell by 1.89%



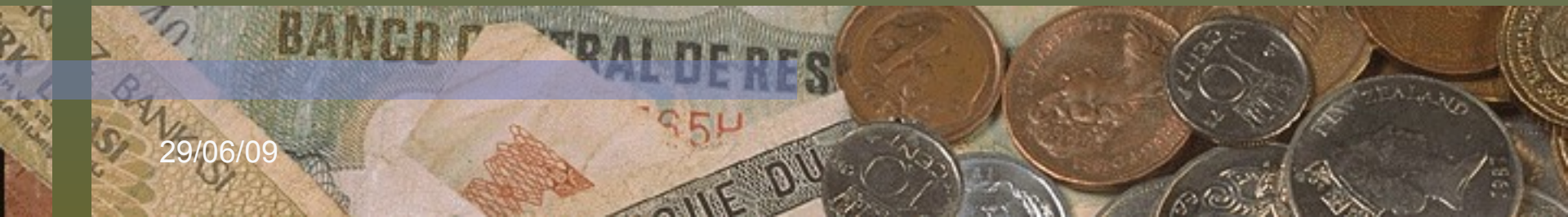
Credit Rating Agencies

- Credit Rating Agencies (CRAs) are private profit oriented entities that earn revenues for issuing opinions on the creditworthiness of sovereign governments, corporations, and a variety of specific debt issues and issuers.



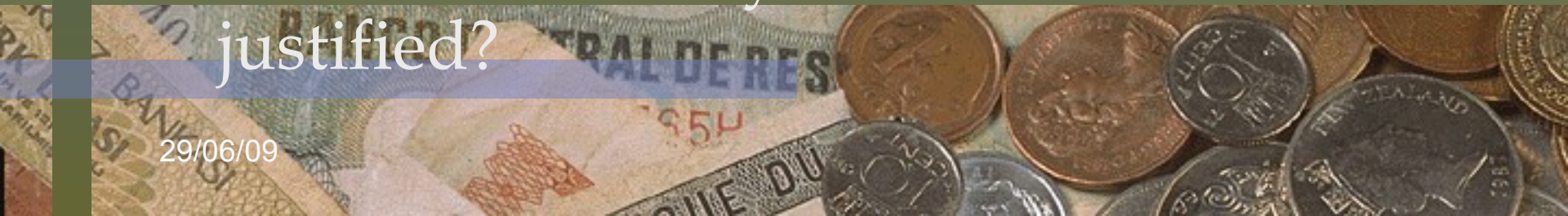
Credit Rating Agencies

- Credit Rating Agencies clearly enjoy a high level of credibility in the investment community and their opinions are extremely influential.



Credit Rating Agencies

- On November 29, 2001, the major credit rating agencies confirmed Enron Corporation's investment grade status.
- On December 2, 2001, Enron Corporation filed for bankruptcy.
- Are the credibility and the influence justified?

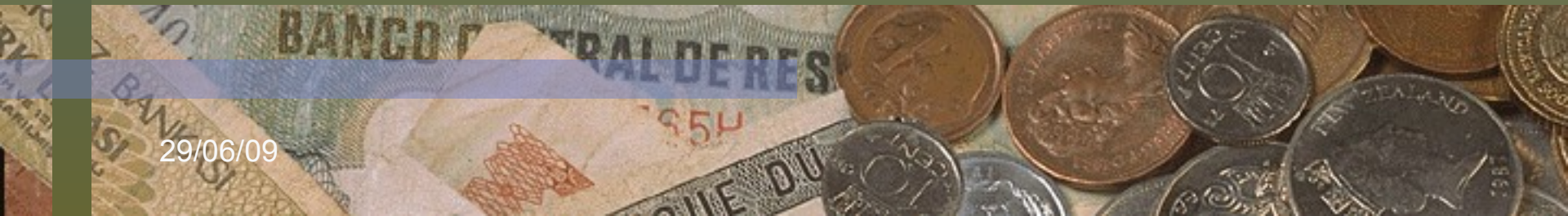


Historical Origins

- The precursors of today's Moody's and Standard and Poor's entered the business in 1909 and 1916 respectively.
- Initially, they issued ratings solely for the debt obligations of the railroads, which had catalyzed the development of a global bond market to finance their expansion.

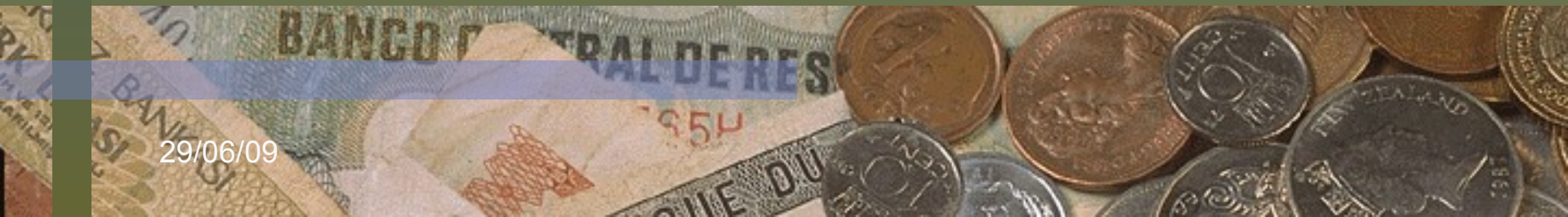
Historical Origins

- The advent of CRAs in the early twentieth century reflected the emergence of highly capital intensive industries in the U.S.A. and the corresponding expansion of capital markets to finance them.



Historical Origins

- Over recent decades, global capital flows have accelerated as sovereign borrowers, notably in the developing world, turn to private capital markets for financing needs previously met by commercial and development banks, as well as multilateral lending agencies.



Historical Origins of CRAs

- Standard and Poor's is now a wholly owned subsidiary of the McGraw Hill group of companies.
- Moody's Corporation is the parent company of Moody's Investors Services



What do CRAs Do?

- In essence CRAs issue an opinion on the likelihood of default.
- The opinion or rating is typically presented in the form of a letter grading system and an outlook. The outlook is the potential direction of a long term credit rating.

What do CRAs Do?

	Local Currency	Foreign Currency
Barbados	A-/Stable/A-2 A3/ RUR-	BBB+/Stable/A-2 Baa2 / RUR-
U.S.A	AAA/Stable/A-1+ Aaa / STA	AAA/Stable/A-1+ Aaa / STA

Investment Grades

Grade	Moody's	S&P
Highest Quality	Aaa(Den)	AAA(U.S.A)
High Quality	Aa1 (Belgium)	AA+
	Aa2 (Hkong)	
	Aa3 (Cyprus)	



Investment Grades

Grade	Moody's	S&P
Strong Payment Capacity	A1(Chile)	A+ (Chile)
	A2 (Bahrain)	A (T&T)
	A3(Bah)	A- (Aruba)

29/06/09



Investment Grades

	Moody's	S&P
Adequate Payment Capacity	Baa1 (Mex, T&T) Baa2 (BDS) Baa3 (India)	BBB+ (Mexico) BBB (BDS) BBB- (Brazil, Mt, Peru)

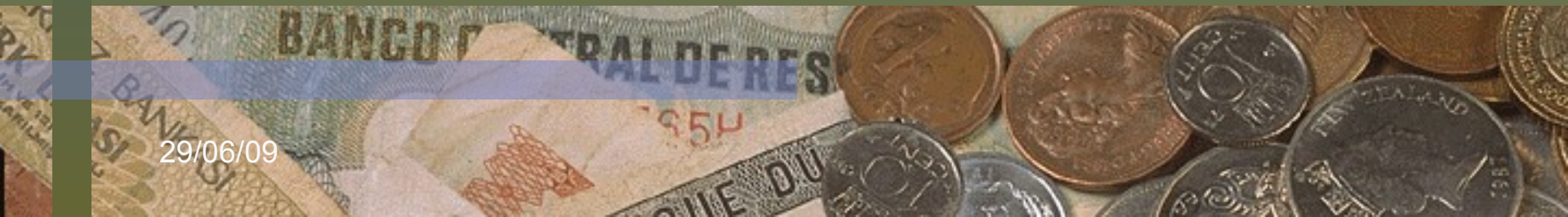


Non-Investment Grades Speculative (Junk)

	Moody's	S&P
Speculative	Ba1 (Brazil)	BB+ (Colombia)
Likely to fulfill	Ba2 (Guatemala)	BB (Costa Rica)
	Ba3 (Indonesia)	BB- (Ven, Uru)

Non-Investment Grades Speculative (Junk)

	Moody's	S&P
High Risk Obligations	B1(SVG) B2(DR/Jam) B3(Belize)	B+ (Suriname) B (Belize/DR) B- (Jam/ Arg,Gre)



Non-Investment Grades Speculative (Junk)

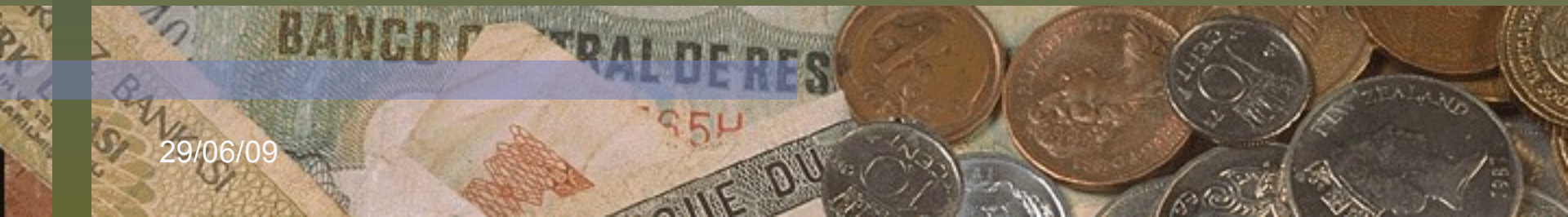
	Moody's	S&P
High Risk Obligations	Caa1(Cuba) Caa2(DR/Ja mCaa3 Ca (Ecuador) C	CCC (Cameroon) CC C SD (Ecuador) D



Caricom and the CRAs

There are currently three investment grade credits in Caricom:

- Bahamas (A3, A-);
- Trinidad & Tobago (Baa1,A) ;
- Barbados (Baa2,BBB).



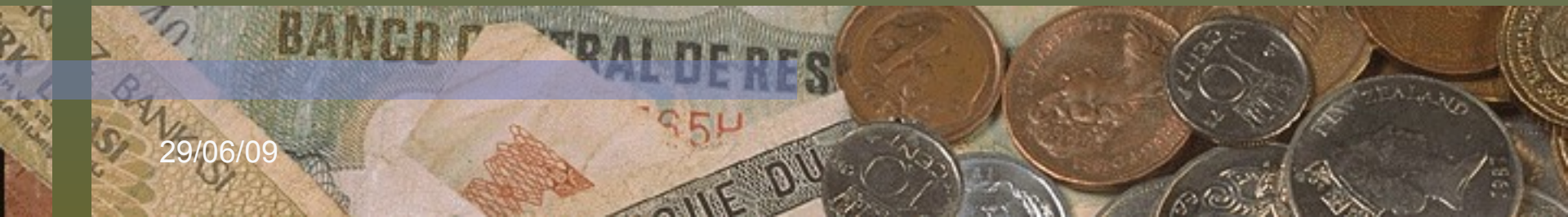
Caricom and the CRAs

- With the latest downgrade, Barbados' S&P rating has moved from A- to BBB. The rating has thus come down two places since the first rating in 1997.
- Trinidad & Tobago has moved from BBB+ to A.

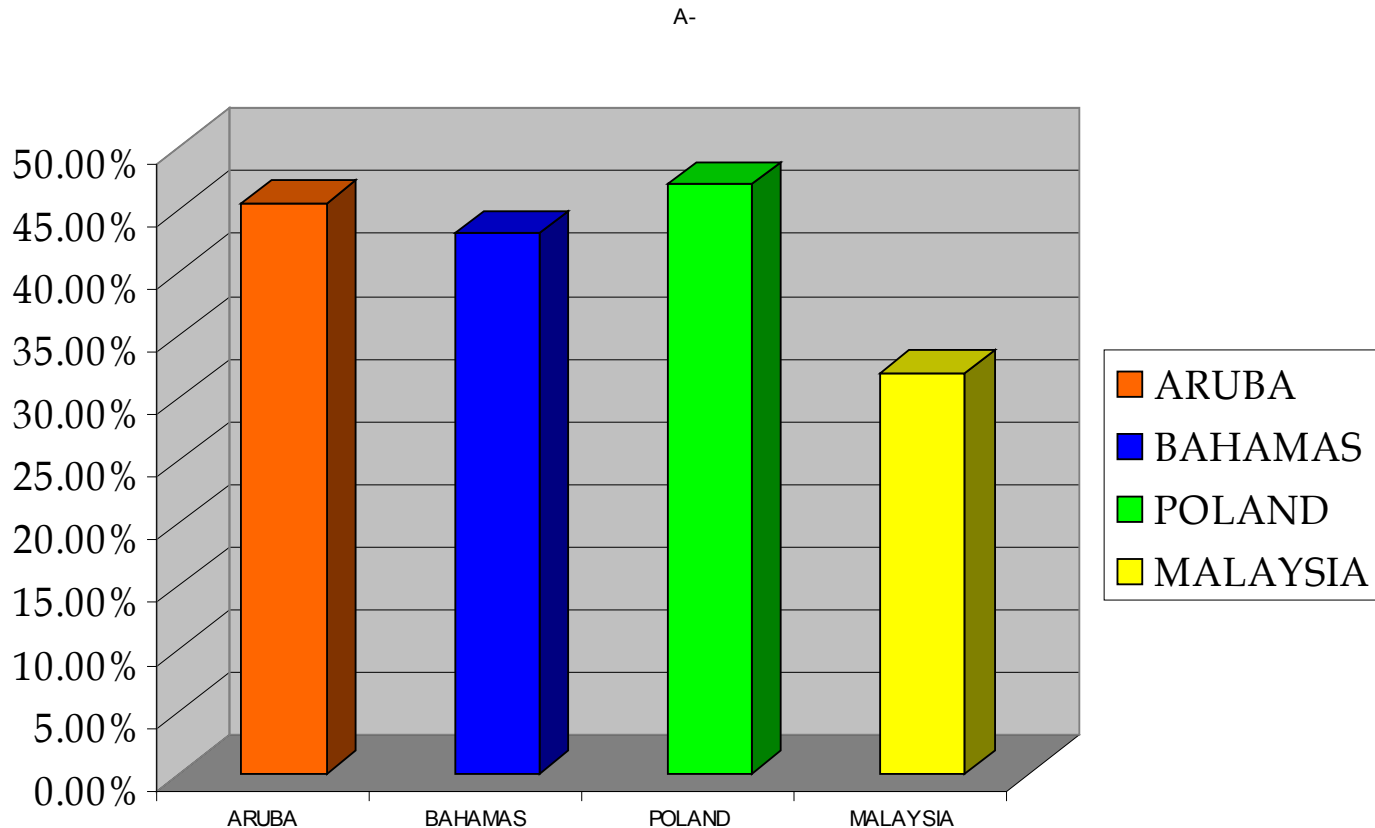


Caricom and the CRAs

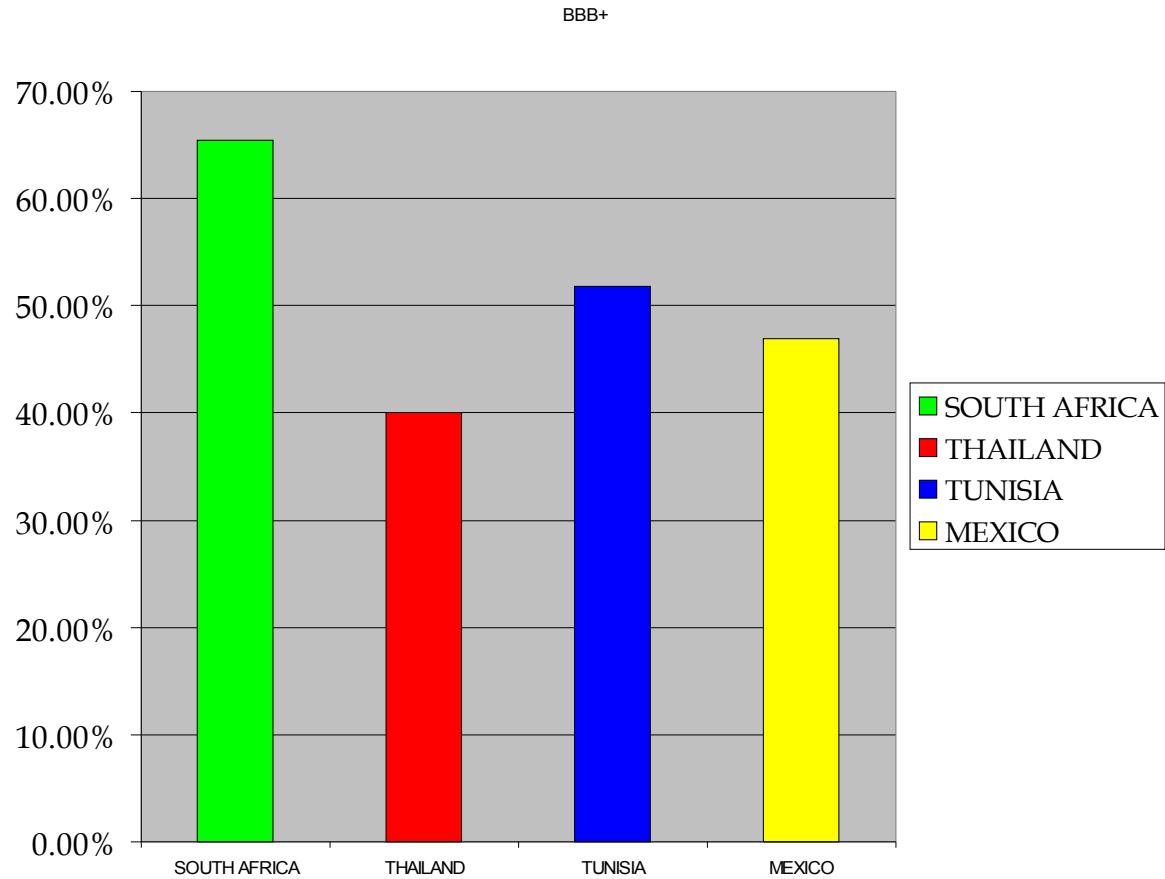
- Barbados' downgrades have largely been attributed to an increasing Debt to GDP ratio.
- In essence the agencies argue that the debt ratio for Barbados is out of sync with the debt ratios for A- and BBB+ rated countries.



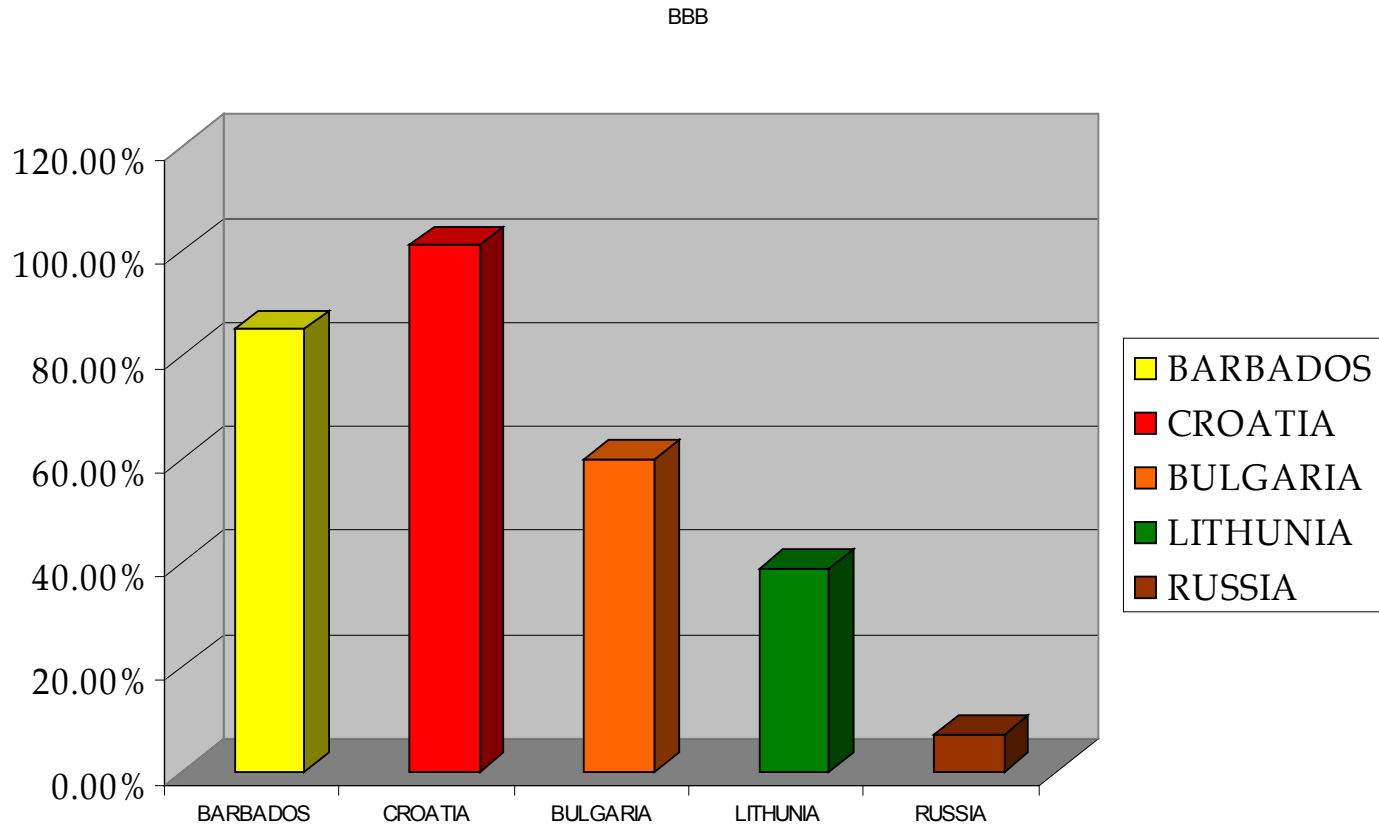
Debt to GDP Ratios of A- Rated SOVEREIGNS



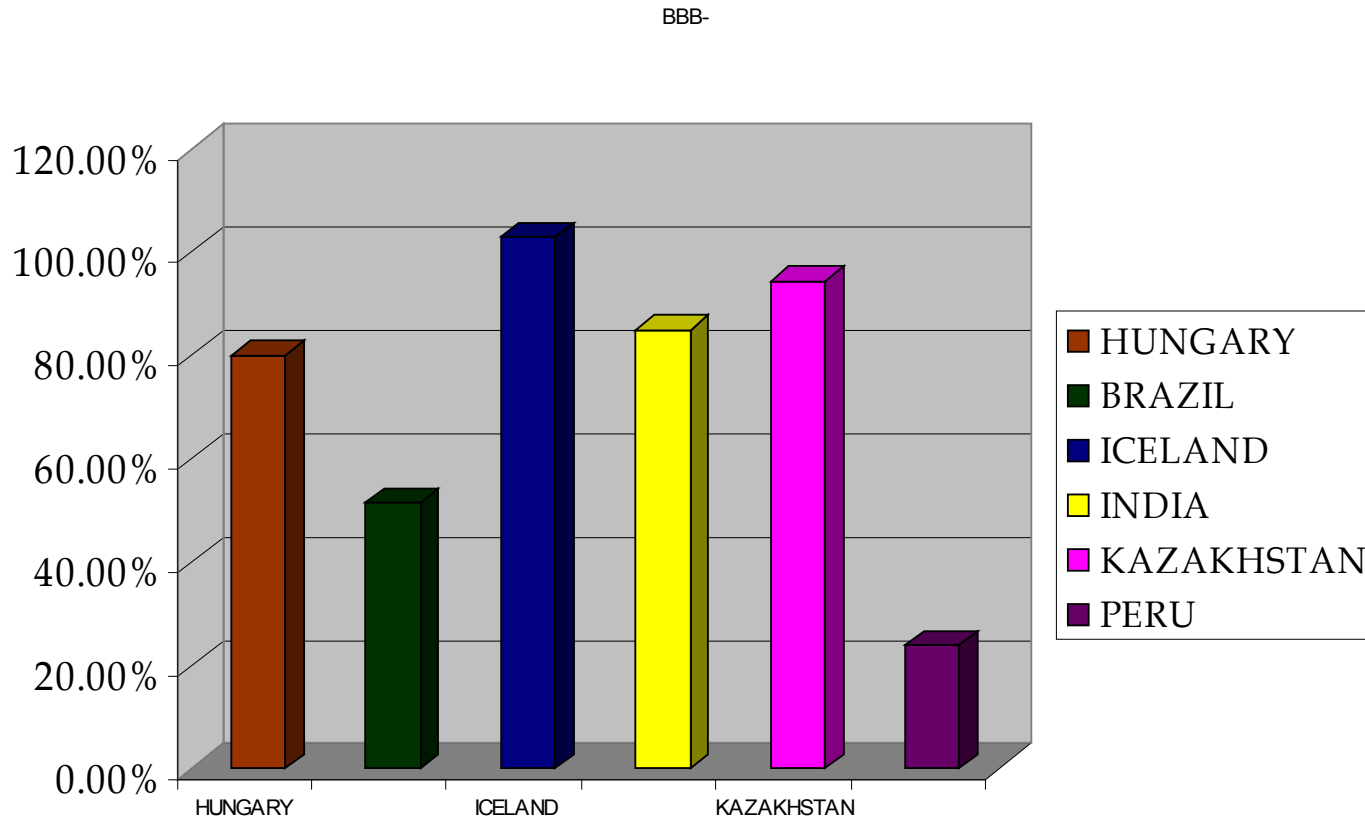
Debt to GDP Ratios of BBB+ Rated SOVEREIGNS



Debt to GDP Ratios of BBB Rated SOVEREIGNS

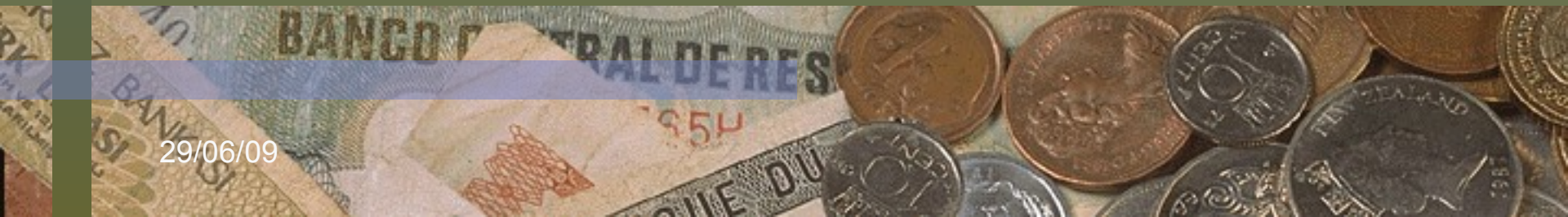


Debt to GDP Ratios of BBB- Rated SOVEREIGNS



Why do Credit Ratings Matter?

- In theory, the credit ratings fill the informational needs of the institutional investors constituting the target market for sovereign bonds.



Credit Risk Assessment and Reputational Capital

- The CRAs can be seen as one response to the asymmetric information problem, inherent in capital markets.
- Confronted with information asymmetry, investors may look to ratings from major credit rating agencies as high-quality assessments of credit risk.



Reputational Capital and Credit Risk Assessment

- From this perspective, the power or influence of the CRAs would stem from the information content of their ratings over and above other means of credit risk assessment.



Reputational Capital and Credit Risk Assessment

- Through the information content of their ratings, CRAs can build up significant reputational capital.
- As such, their opinions on creditworthiness can exercise enormous influence over investors' decisions, and thus over and how and when governments can borrow.



Reputational Capital and Credit Risk Assessment

- A large volume of academic research suggests that, to a large extent, Moody's and S&P's rating assignments can be explained by a small number of well defined criteria, which the two agencies appear to weigh similarly.



Reputational Capital and Credit Risk Assessment

- Per Capita Income (+);
- Inflation (-);
- External debt (-);
- Economic development (industrialized)
- Default History

29/06/09

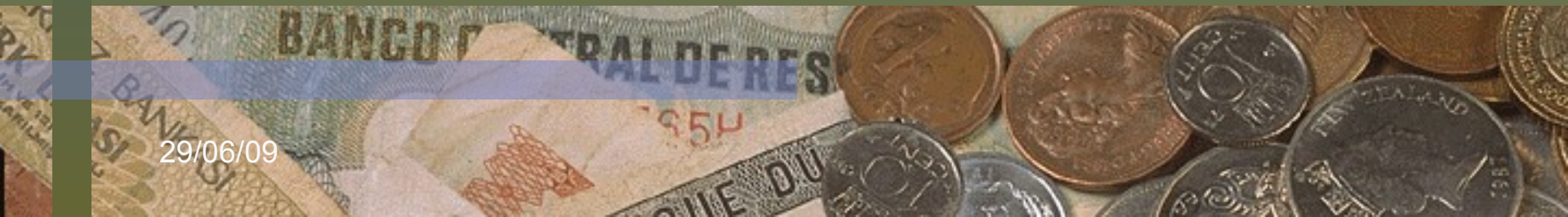


Reputational Capital and Credit Risk Assessment

- Despite this, an equally large volume of research suggests that credit ratings appear to have some independent influence on yields over and above their correlation with other publicly available information.
- In general yields, and by extension borrowing costs, rise as ratings decline.

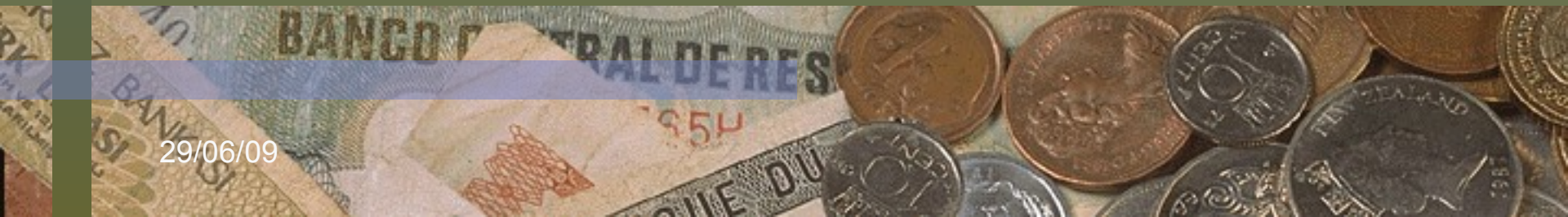
Reputational Capital and Credit Risk Assessment

- The relationship is rather more pronounced as an entity moves into and out of the investment grade category.
- In particular, ratings announcements have immediate effects on the yields for non-investment grade issues.



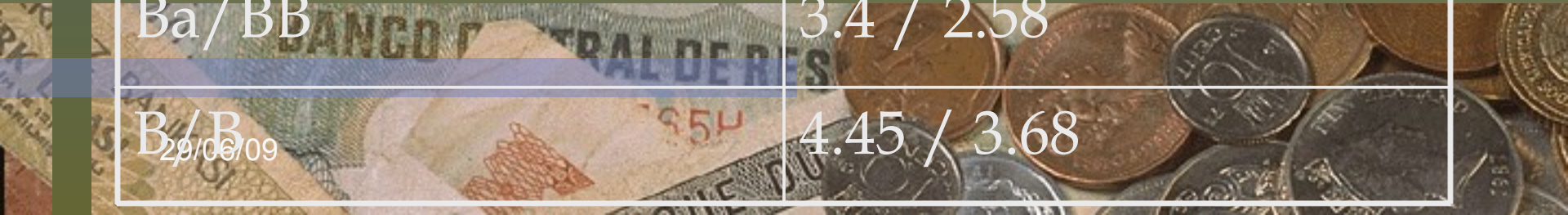
Reputational Capital and Credit Risk Assessment

- In sum, although the agencies' ratings have a largely predictable component, they also appear to provide the market with information, especially about non-investment grade sovereigns, that goes beyond that available in public data.



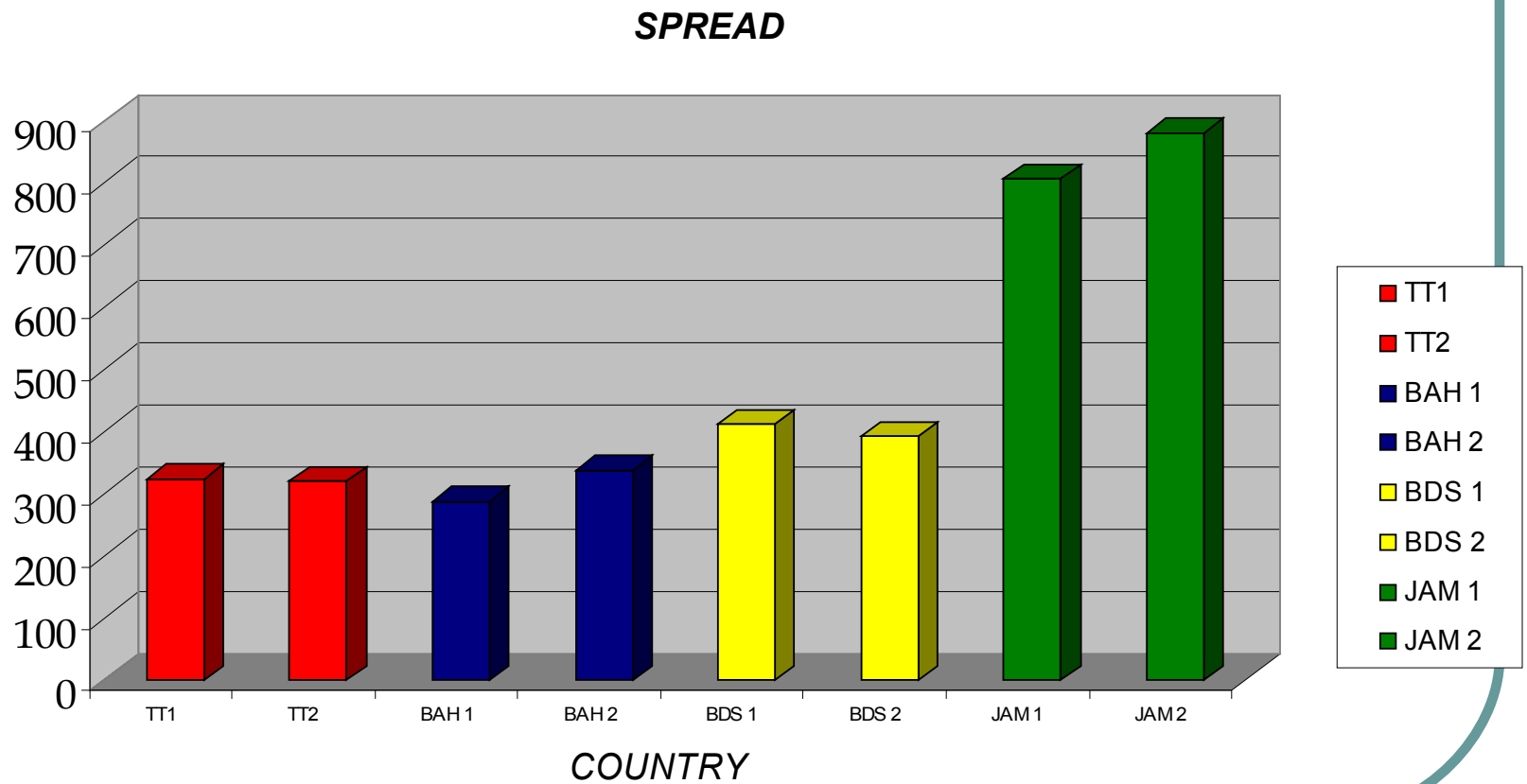
Ratings and Borrowing Costs

Rating (Moody's / S&P)	Spread over U.S Treasuries (Moody's / S&P)
Aaa/AAA	0.32 / 0.29
Aa/AA	0.34 / 0.40
A/A	0.61 / 0.59
Baa/BBB	1.58 / 1.14
Ba/BB	3.4 / 2.58
B/B	4.45 / 3.68



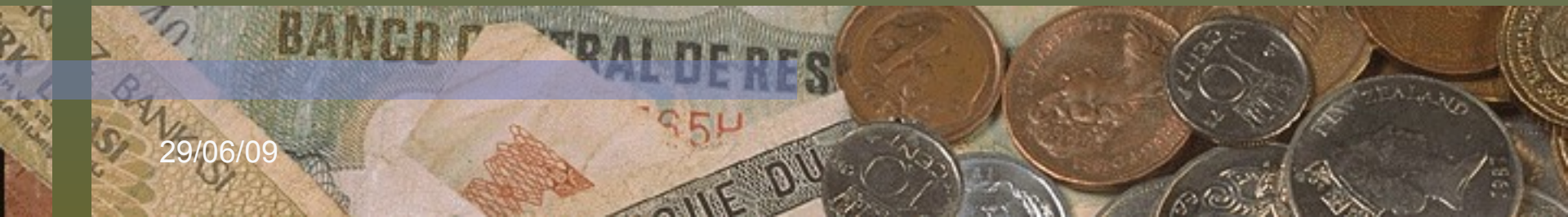
29/06/09

Spread relative to U.S. 10 yr note



A Common Language of Risk

- In addition, the CRAs are viewed as having created a common language of risk, which has greatly facilitated the development of global capital markets to the benefit of investors and issuers alike.



Indispensable Arbiters of Risk?

- Proponents have argued that the information content of credit ratings and the common language of risk they provide make them largely indispensable in global capital markets.



Reputational Capital or Regulatory Licensing

- The US's financial regulatory system incorporates ratings issued by agencies that enjoy the government recognized status of a “nationally recognized statistical rating organization” (NRSRO).
- While the SEC recognizes at least 10 NRSRO, Moody's, S&P and Fitch enjoy over 95% market share.

Regulatory Licensing

- At least 44 SEC rules and forms rely on ratings, including:
- Rules that require money-market funds to invest in investment grade instruments
- Rules that exempt investment grade structured products from the (fatal) designation as investment companies.



Regulatory Licensing

- State laws require state funds and employee pension funds to meet credit-rating requirements.
- Banking regulations determine regulatory capital requirements based on the credit ratings of the securities the bank owns.
- Judicial decisions protect fiduciaries that rely on credit ratings.



Regulatory Licensing

- Agency ratings (with the agencies identified by name) are hardwired into the financial infrastructure through private arrangements:
- Investment guidelines and covenants for all manner of fixed income instruments are keyed to agency ratings.



Regulatory Licensing (Frank Partnoy)

- “Credit ratings are valuable not because they contain valuable information, but because they grant regulatory licenses vouchsafing compliance.”
- Markets react to credit ratings, not because of their information content, but the regulatory implications.



Regulatory Licensing

- The major players therefore flourish not because they enjoy strong reputations in the market place, but because ratings-dependent regulation creates artificial demand for their products.



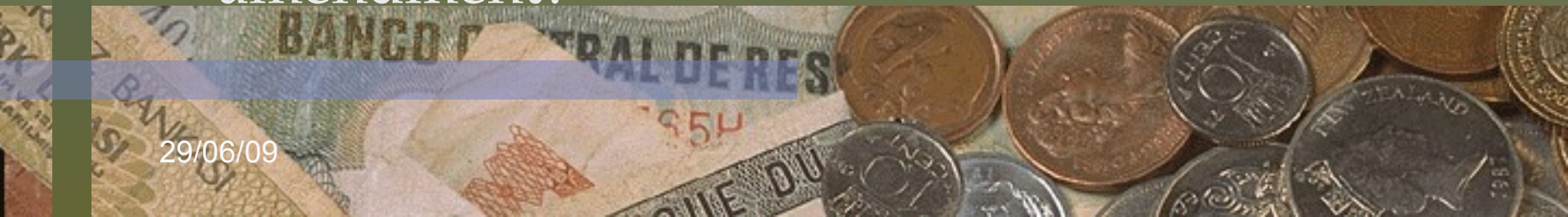
Regulatory Licensing

- Many “skilled” analysts from “respectable” organizations venture opinions as to creditworthiness, what is so special about the NRSROs?
- How are credit ratings from the major agencies fundamentally different from financial journalism, and why have they been granted legal and regulatory authority?



Legal Liability for Ratings

- Credit ratings are currently protected as free speech. As such the CRAs face no legal liability for their ratings as say an auditor might for an audit opinion.
- Can one justify granting the ratings regulatory license and still characterize them as journalistic speech protected by the first amendment?



Issuer Pays Business Model and Potential Conflicts of Interest

- Whereas ratings initially were purchased by subscribers (that is, investors themselves), forcing the agencies to compete vigorously for customers free to walk away if they took a dim view of the analysis on offer, today ratings are paid for by the issuers themselves.



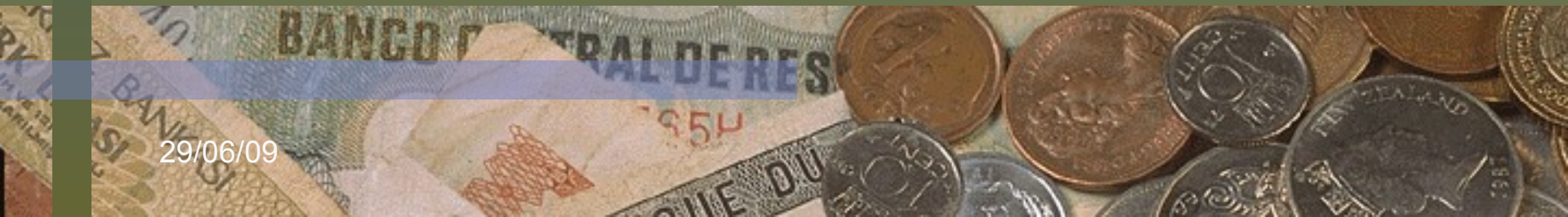
Issuer Pays Business Model and Potential Conflicts of Interest

- In fact advertisements for the newly emerging ratings agencies in the 1940s spoke of:
- “The agencies endeavoring to acquire their respective reputations for independence, integrity and reliability through ratings financed solely by investors’ subscription fees.”



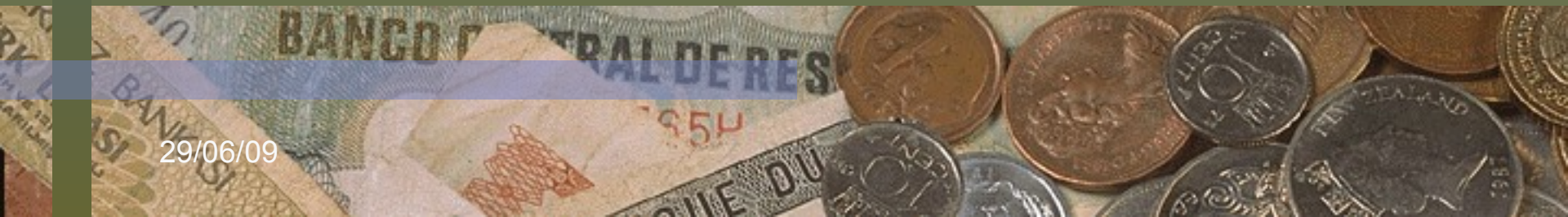
Issuer Pays Business Model and Potential Conflicts of Interest

- The investor is the user of the credit rating, but the issuer (borrower) pays the fees. The current business model violates the typical “user pays” model.



Issuer Pays Business Model and Potential Conflicts of Interest

- Critics have pointed to the potential conflict of interest arising from the fact that the agencies are paid by the very entities they are supposed to be evaluating and have tended to doubt the capacity of agency codes and procedures to address the problem.



Issuer Pays Business Model and Potential Conflicts of Interest

- In 2006 structured finance products made of 44 percent of Moody's revenues.
- According to the NY Times, Moody's profits tripled between 2002 and 2006 to \$750 ml, mostly because of the fees from structured finance products.



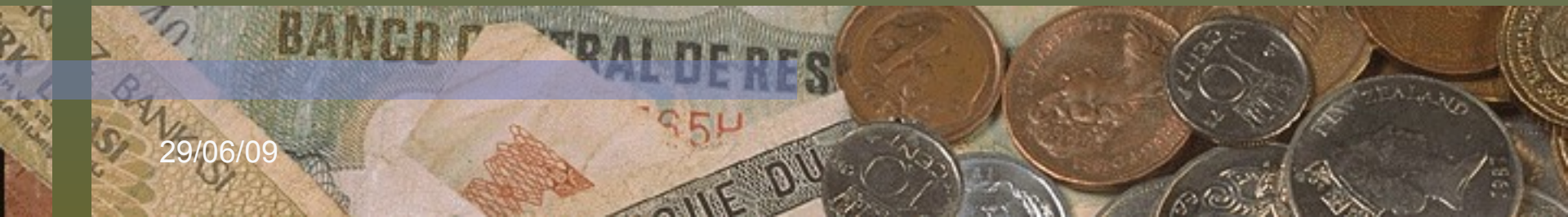
Issuer Pays Business Model and Potential Conflicts of Interest

- Issuer based fee structures are a response to the cost of maintaining a deep, global bench of trained credit analysts and appropriate research and editing support.



Issuer Pays Business Model and Potential Conflicts of Interest

- A credit rating has “public good” characteristics in that once a rating is publicized, it is impossible and unfair to exclude nonpaying users from this information and insight.
- Having issuers pay the fees, solves the free rider problem.



Issuer Pays Business Model and Potential Conflicts of Interest

- The need to preserve reputational capital.
- Ratings that consistently favoured issuers would quickly lose their credibility.



Normative Principles Underpinning Sovereign Rating Analysis

- Ratings agencies use two broad categories of variables in their sovereign ratings analysis:
 - Economic Risk;
 - Political Risk.



Normative Principles Underpinning Sovereign Rating Analysis

Economic Risk

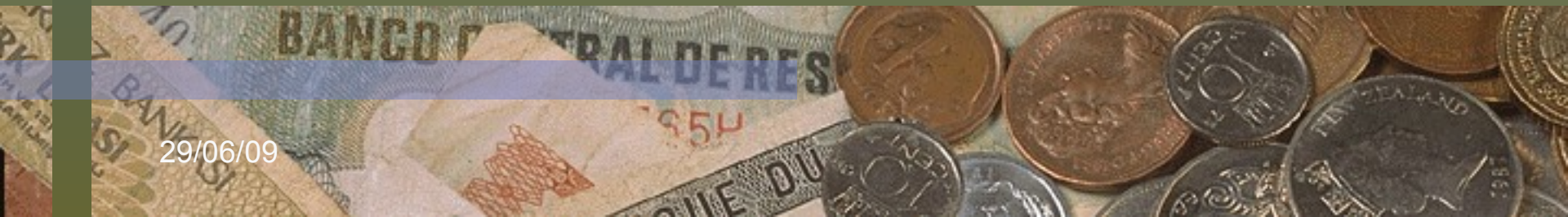
- Primarily a “quantitative” concept drawing on various macroeconomic indicators considered pertinent to evaluation of the sovereign’s ability to pay.



Normative Principles Underpinning Sovereign Rating Analysis

Political Risk

- Primarily a “qualitative” and subjective concept thought illuminative of the sovereign’s “willingness to repay.”



Normative Principles Underpinning Sovereign Rating Analysis

- Governmental separation of powers;
- A free press;
- Market structures;
- Enforceable property rights;
- Openness to trade and capital movements;
- Orthodox market oriented programs.



Normative Principles Underpinning Sovereign Rating Analysis

- Malaysia's downgrades during the Asian financial crisis were explicitly attributed to the "policy error" of imposing capital controls.
- A borrower was punished by the agencies for an unorthodox economic policy, even though there was no consensus among economists as to whether their policy could be labeled a "policy error."



Normative Principles Underpinning Sovereign Rating Analysis

- The US government thus has put these unregulated firms in the position to express their interpretation of good economic policy to sovereign governments through the process of rating them, and the sovereigns are obliged to listen.



Performance of the Rating Agencies

- Largely useful in predicting defaults.

Notable Failures

- The Asian Financial Crisis
- The US Corporate Crisis of 2000
- The current global financial crisis



Asian Financial Crisis

	Jan 1996	Dec 1996	June 1997	Dec 1997
Indonesia	Baa3/BBB	Baa3/BBB	Baa3/BB B	Baa3/BBB
Malaysia	A1/A+	A1/A+	A1/A+	A1/A-
Mexico	Ba2/BB	Ba2/BB	Ba2/BB	Ba2/BB
Philippine s	Ba2/BB	Ba2/BB	Ba2/BB+	Ba2/BB+
South Korea	A1/AA-	A1/AA-	A1/AA-	Baa2/AA-
Thailand	A2/A	A2/A	A2/A	Baa1/BBB

29/06/09

Asian Financial Crisis

- Credit ratings failed as a leading indicator of a currency crisis.



29/06/09

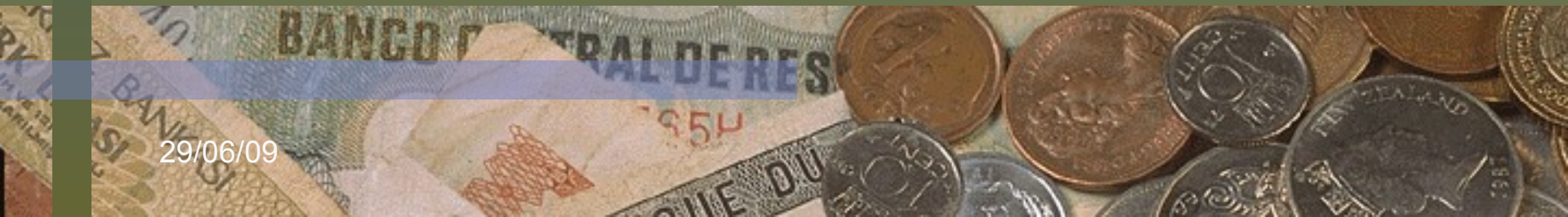
US Corporate Crisis of 2000/2001

- Enron was rated investment grade four days before it filed for bankruptcy on Dec 2 2001.
- WorldCom was rated investment grade three months before filing for bankruptcy.
- Global Crossing was rated investment grade in march 2002 and defaulted on loans in July 2002.



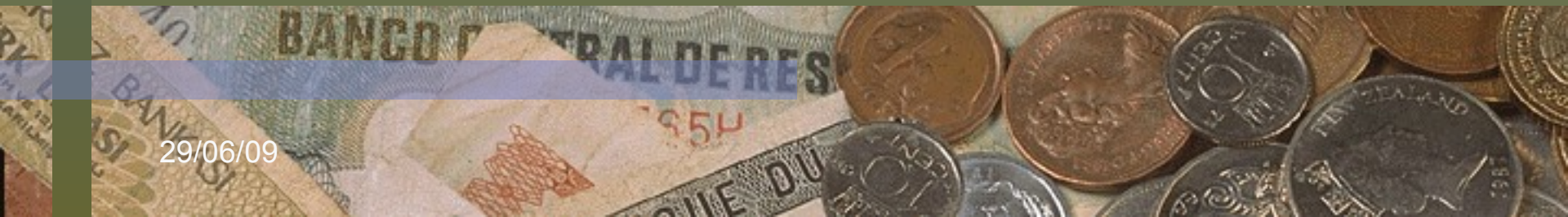
US Corporate Crisis of 2000/2001

- California utilities were rated “A-” two weeks before defaulting.
- AT&T Canada was rated investment grade in March 2002 and defaulted on loans in July 2002.



US Corporate Crisis of 2000/2001

- Credit Rating Agencies were perceived to have failed so badly that United States congress held hearings on the industry in November 2002.



Enron's Ratings

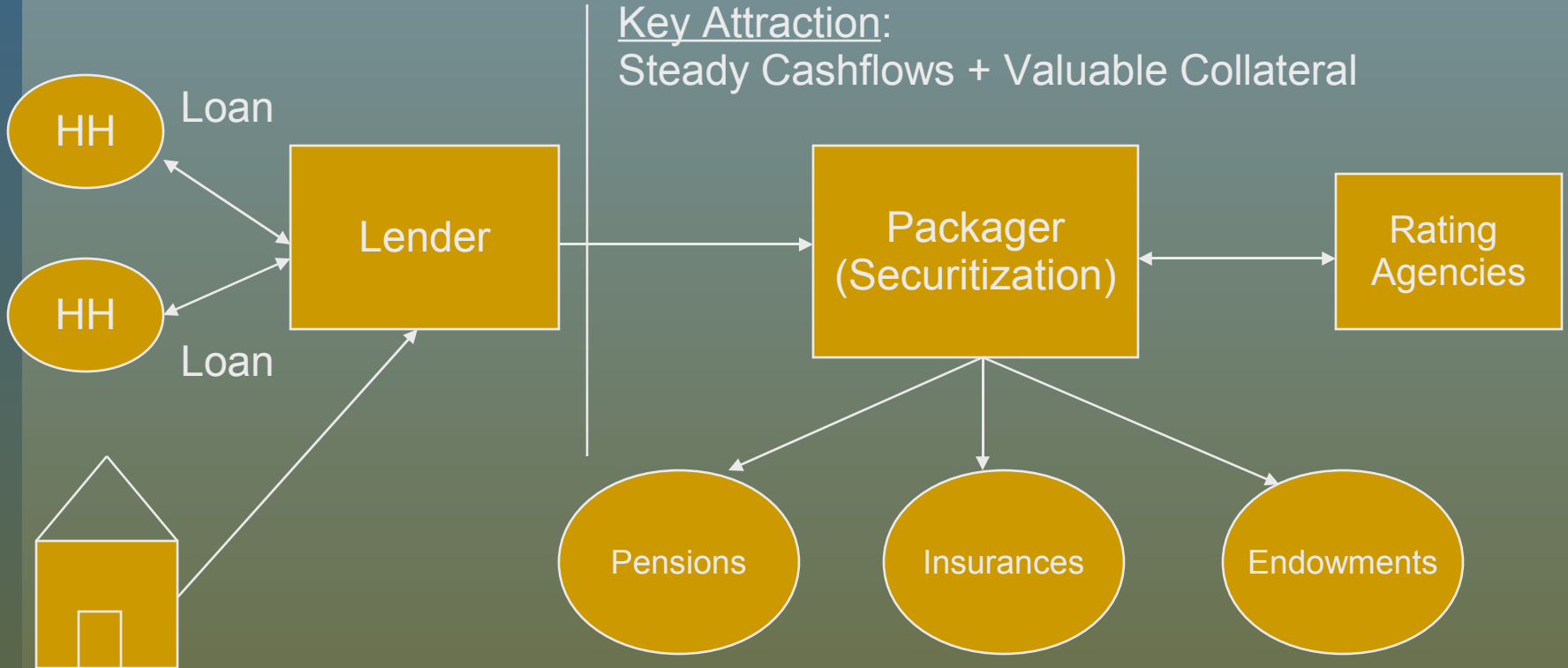
Date	Egan-Jones	S&P	Moody's
4/19/01	BBB+	BBB+	Baa1
6/27/01	BBB	BBB+	Baa1
10/23/01	BBB-	BBB+	Baa1
10/29/01	BB+	BBB+	Baa2
11/26/01	B+	BBB-	Baa3

29/06/09



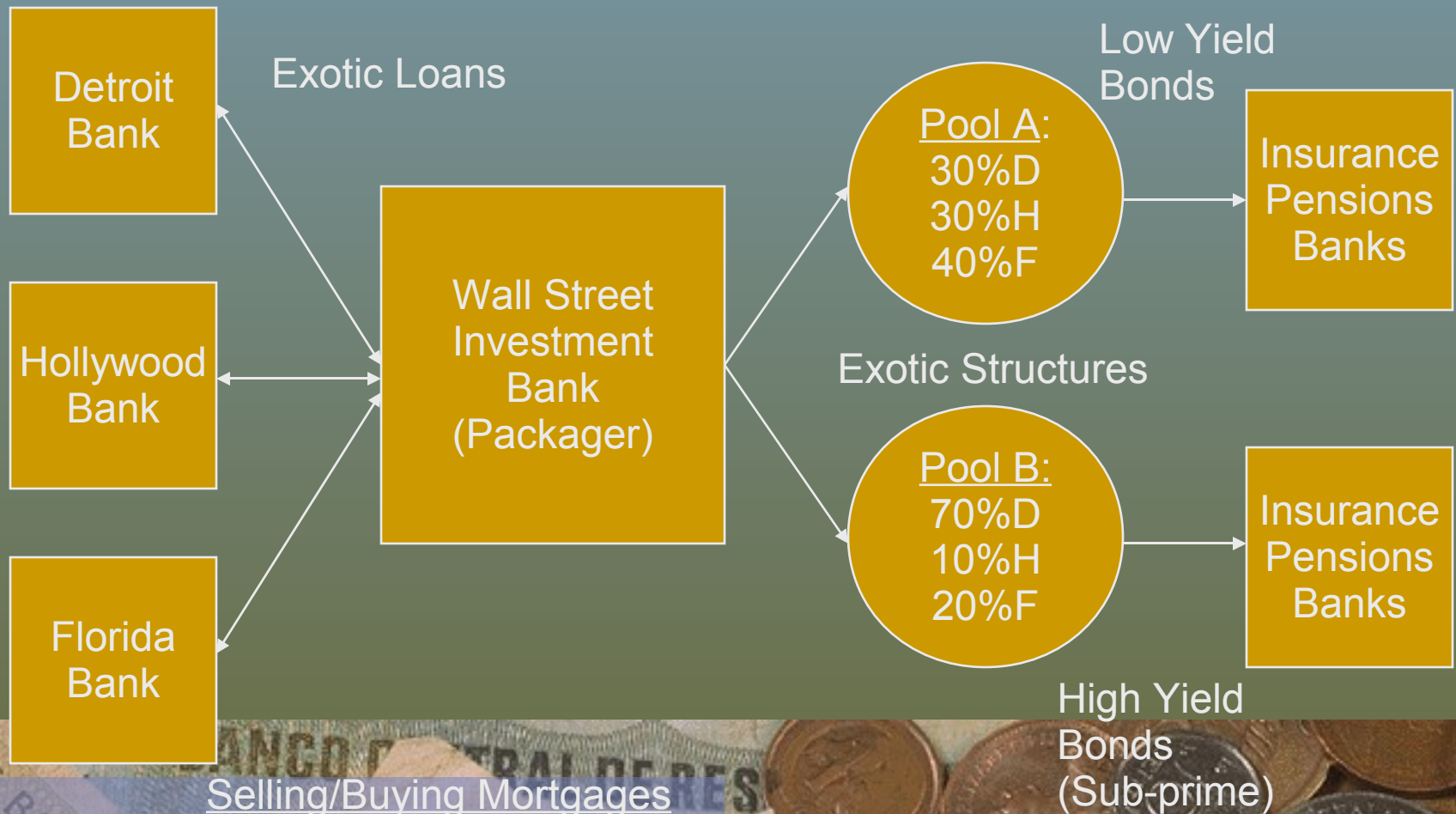
The Sub-Prime Mortgage Crisis

Key Attraction:
Steady Cashflows + Valuable Collateral

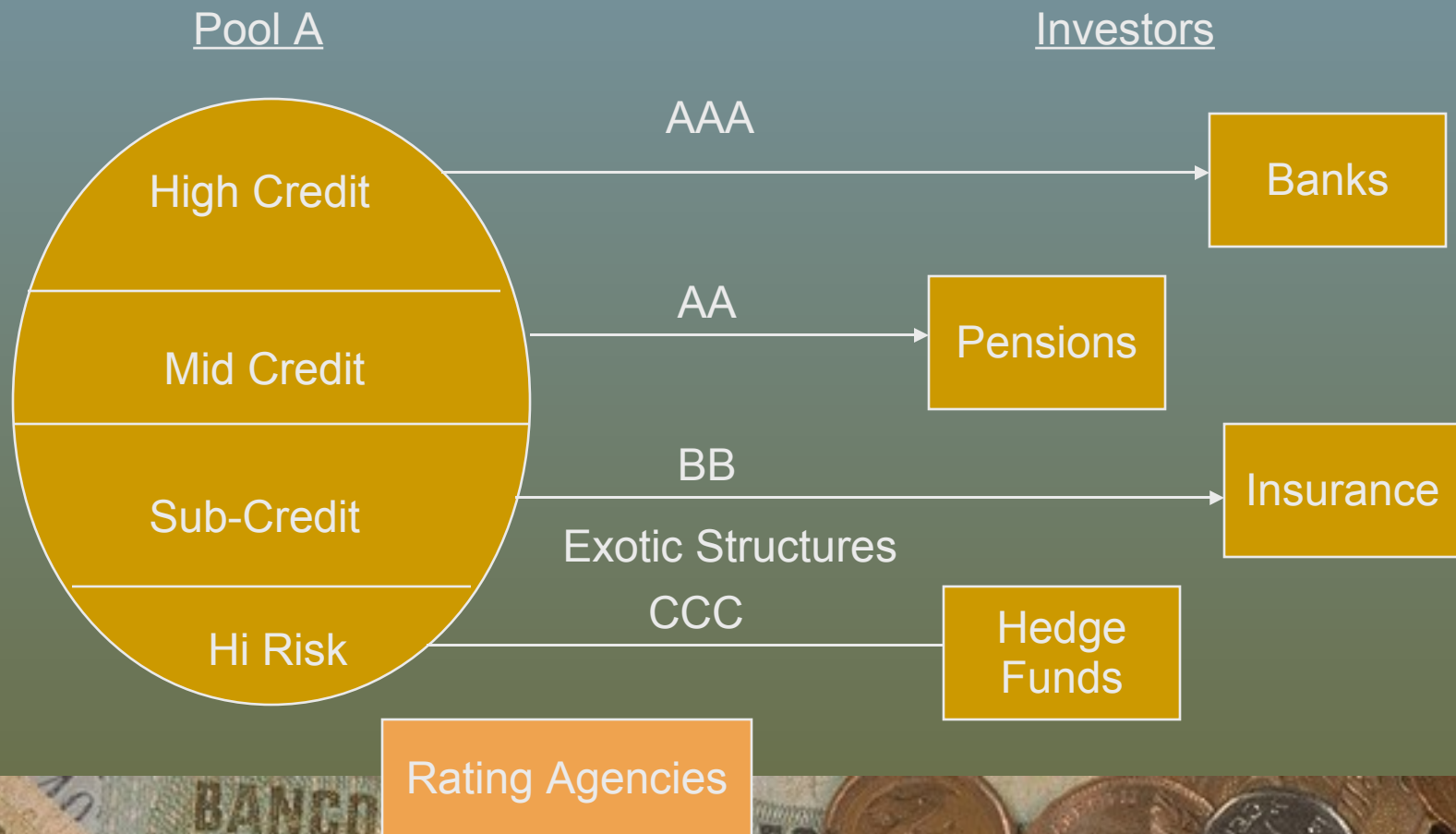


Investment Guidelines

Securitization Process (A)



Securitization Process (B)



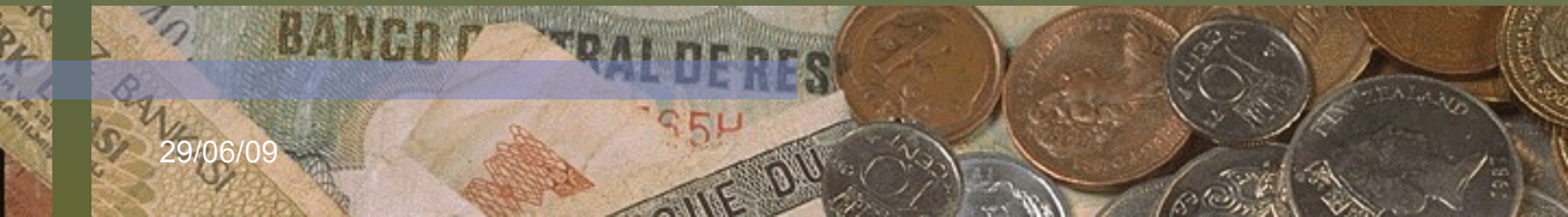
CRAs and the Sub-Prime Crisis

- The complexity of securitized products led to markets being reliant on the grades assigned by the ratings agencies.
- Regulators were not involved in these markets, so the ratings agencies essentially acted as proxies for regulators. With structured products ratings agencies “run the show.”



CRAs and the Sub-Prime Mortgage Crisis

- The recognized agencies became the effective “arbiters of risk” for the entire market in structured finance products, and they appear to have failed miserably.

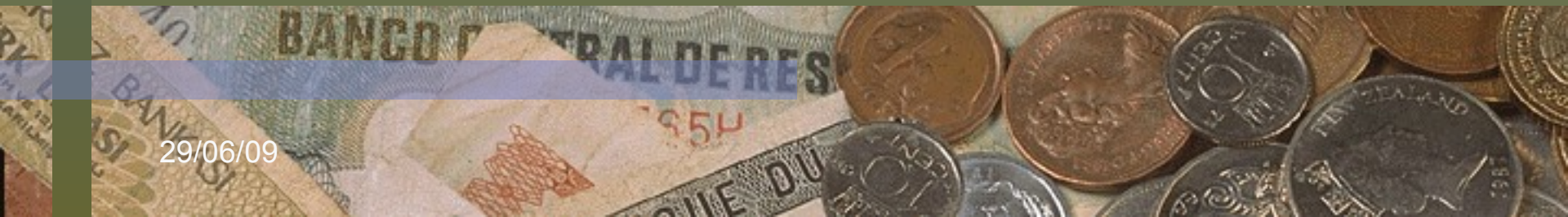


Conclusion

- Investors are confronted by a dizzying array of investment alternatives.
- The ratings provided by established CRAs seem to provide a convenient mechanism for muddling through this maze, and as such have assumed tremendous influence and importance in modern capital markets.

Conclusion

- Governments have valorized and codified the private authority of an elite few rating agencies.
- A small number of rating agencies are literally and legally the gatekeepers to the vast US, and increasingly global, capital market.



Conclusion

- The regulatory force accorded to the ratings from selected agencies may have freed these agencies from market discipline.
- The current situation makes it unclear whether or not the influence of ratings stems from their information content or the regulatory import.

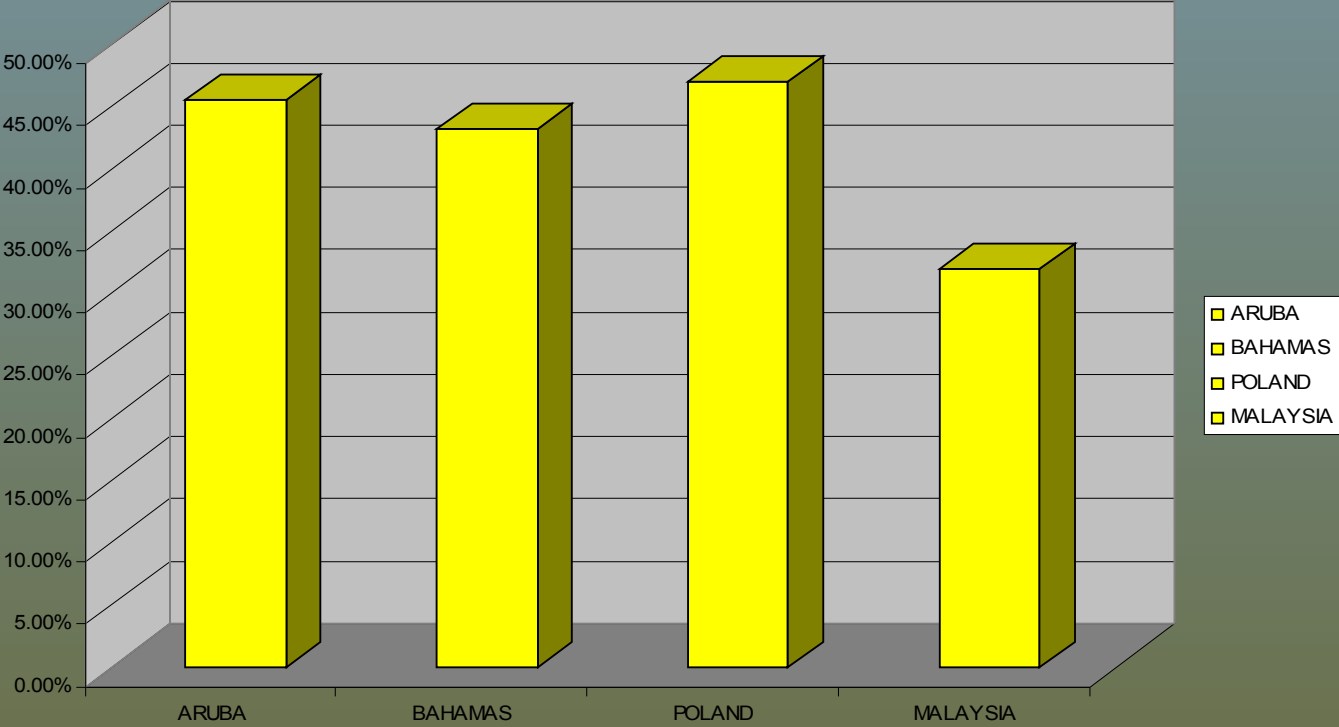


Conclusion

Credit ratings are clearly no substitute for strong and effective regulation, and informed judgments by investors.

A removal of the regulatory import of ratings would go a long way towards allowing investors to use their judgment and allow the markets to rate the rating agencies.

A-



29/06/09



29/06/09