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The role of the rating agencies: A round-table discussion on prospects for the ratings business. With Joseph Biernat (European Credit Management) Richard Hunter (Fitch Ratings), Sean Egan (Egan-Jones), held Wednesday, April 16, 2008 at the City Club, 19 Old Broad Street, London, from 12:30-2:15pm.

Put a Big Three ratings agency, a new entrant into the market and an investor with its own research department on a panel to discuss the role of ratings agencies, and temperatures are bound to rise. The debate went into a range of issues such as the role of investor and regulators and agencies' business models. The first speaker set the scene, describing his firm as investing solely in European credit and employing 37 researchers and managers. It meets every company it may invest in, since corporate analysis gets only half the way; the other half comes from "listening and seeing the shades of grey". The lack of the second half leads to problems, he said.

What happened in the market last year? Between 2003 and 2007 credit spreads narrowed sharply as investors sought higher yields, and in the process bought credit indiscriminate of whether it rated AAA or BBB. The problem was exacerbated by the arrival of credit default swaps and obligations (CDS, CDO), which were only traded over the counter, meaning no one knew the price, volume and location of all products. When Bear Stearns liquidated two of its hedge funds in summer 2007, credit spreads blew out as investors ran from risk and sold all structured products as indiscriminately as they had bought them. Spreads over Treasuries of plain vanilla RMBS bonds rose from 95 basis points to 600bp between June and January.

Yet ratings agencies issued six upgrades for every downgrade during that period. Why? Agencies certainly did an excellent job of covering corporate bonds with great consistency. The problem was they were giving AAA ratings to structured products that defaulted or were revised to D - things that had never happened before. The second speaker interjected to say that when his company saw new forms of companies that were hard to rate it turned down the work. One member said the real issue was the fact that agencies were not objective because they were paid by the issuers.

The third speaker agreed, saying the current system was broken and that it was unsustainable for an agency to take a £1m fee, downgrade a company from AAA to D and say it was investors' fault for not doing due diligence. Competition was another problem. It took 11 years for his firm to get SEC approval as a rating agency and only after going direct to Congress. He likened the current market to the oil industry of Rockefeller's days, describing it as an oligopoly. He highlighted a Wall Street Journal story that exposed agencies cooperating with the underwriters to ensure any new security they designed would get high enough ratings to be marketable.

The second speaker said conflicts of interest abounded: whether it was an issuer-pays, or investor-pays model; or with the regulators who had been known to ask agencies not to take action against certain vulnerable banks. But what is the alternative model that covered the entire global financial markets? The third speaker said he had rated Bear Stearns at BB- two days before its bailout while issuer-funded agencies gave it A and A2. The first speaker said new terminology was needed for structured products versus corporate and sovereigns. The second and third speakers disagreed and said a rating should reflect the probability of default and the size of the loss. Investors should be able to go to ratings agency as a car owner would go to a mechanic. The third speaker did not want to new ratings symbology adding friction. There was no intellectual problem with CDSs, simply a lack of information. The second speaker agreed he did not want a “balkanisation” of the ratings world and that investors had to be clear about what ratings were – one agency’s opinion.

The second speaker said there were proposed solutions that were misguided. Banning CDO ratings was foolish as the industry would simply invent new products. Changing people and models and inserting Chinese walls was simply window-dressing. Blaming investors for not carrying out due diligence was wrong – they have to be able to rely on third parties. The first speaker disagreed, saying ratings were just opinions yet investors had staked billions without doing their own research. The second speaker also rejected a pure free market solution; it was too late for that. Rating agencies should be able to claim they were lied to as they did after Enron/WorldCom.

What will the ratings world look like in three years’ time? The second speaker said it would be a process of continued improvement and hoped for an increase in the number of independent buy-side research outfits and acknowledged a systemic risk from only having three players. The third speaker said sophisticated investors would look to alternatives so they didn’t get blind-sided. The first speaker feared there would be no growth in competition and that if anything new entrants were pulling out of the market. On that depressing note, the roundtable wrapped up.