

It is again open season for rating agency bashing and the agencies are being blamed for at least three sins:

- Ratings are a lagging indicator of credit quality as the agencies are slow to take action
- ***The fact that rating agencies are paid by investment bankers and issuers leads to conflicts of interest.***
- Rating agencies have thus failed to serve investors as they are too close to issuers and investment bankers

In the current credit crunch, the agencies have appeared incompetent, failing to reflect in time in their ratings the deteriorating credit quality of sub-prime mortgage loans, pressures on home price appreciation and the ripple effect of sub prime loans on RMBS, CDOs backed by such RMBS, financial guarantors and others exposed to the sub-prime mortgage sector.

Rating agencies have been criticized before: in the bankruptcy of Penn Central (1970), the New York City financial crisis of the mid 1970s, the defaults of the Washington Public Power Supply System in 1983 (where the underlying contractual security arrangements were declared invalid), the Asian financial crisis (1997-1998), and the failures of Enron and WorldCom in 2001. Criticism of the rating agencies in failing to react to changes in Enron's credit quality led to SEC investigations, culminating in the Rating Agency Reform Act of 2006, But rating agency bashing has reached a new high in the current sub prime crisis: the US Congress and the European Union have promised hearings on the "culpability" of the agencies with respect to their "tardy" downgrades of subprime securities; the US SEC and IOSCO have promised to review rating agency transparency and due diligence particularly with respect to their assessments of complex financial products and lawsuits against the rating agencies are being mounted in several U.S. states.

But unfortunately for the rating agencies, the current criticisms are a serious threat to their franchise.

First, the current credit crisis is deeper than the prior crises that led to the earlier bouts of rating agency bashing. The closest parallel is to the Penn Central crisis when the commercial paper market shrank by about 10% whereas during the present crisis, there has been a contraction in commercial paper market of 17% in the month of September 2007 alone, not to mention the broader freezing up of market liquidity. .

Second, the current spate of rating agency bashing comes not from the failure of one or a few entities and of the agencies to call that failure but from a meltdown in a large class of complex capital market securities totaling over \$2 trillion, investors in which may lose as much as \$400 billion or more. It is not surprising that as of mid-December 2007, asset backed commercial paper outstandings have contracted by more than one third from a peak of \$1.2 billion in early August. Moreover, the resecuritizations of RMBS via ABS CDOs and the ABS markets in general have ground to a virtual halt.

Third, the current wave of rating agency bashing comes not long after criticisms of accounting firms, investment bankers, and rating agencies for aiding and abetting corporate fraud in the context of Enron, WorldCom and others which set a precedent of holding those responsible to

account – in some cases with dire consequences, such as the demise of Arthur Anderson. With higher standards for holding those deemed responsible to account, the rating agencies are thus less likely to escape unscathed, notwithstanding the protection of the First Amendment on which they have relied on successfully to date...

Let us take the substance of the current criticisms.

The rating agencies were indeed too slow to act. In all fairness, the rating agencies did warn about problems in the sub prime market as early as 2005 but were largely ignored as sub prime loan origination continued apace during 2006 and early 2007. It took events like the collapse of the two Bear Stearns hedge funds and huge mark downs at Merrill Lynch and other firms invested in the sub-prime mortgage sector for the rating agencies to take significant rating actions. Old rating agency stress tests for high ratings have now been abandoned for more draconian standards – too late for those who invested in the securities that turned out to be too highly rated. While the markets believe that the agencies were too slow to review their rating models and take timely action on downward revisions of existing ratings, the agencies counter with the rationale that ratings cannot just gyrate with the markets but should rather adjust to fundamental changes in the market place.

Being paid by investment bankers and issuers leads to conflicts of interest. It is hard to deny that the agencies are paid by issuers. They are. But this criticism is the least likely to stick as there is no better economic model for the rating agencies and as investors are not about to ante up the high fees needed for formal credit ratings. It just is not going to happen. At the same time, the rating agencies know that in the long run their reputation is more important than winning one or a few assignments from one investment bank or issuer. So their objectivity is not in my view clouded by this potential conflict of interest. This is borne out by some academic studies on the issue.

Inner Circle /Outer Circle: The current attacks on the rating agencies are focused on structured financings, where the rating agencies are integral members of the “working group” that create the transaction structures. So the criticism that the agencies are too close to issuers and investment bankers at the possible expense of rating agency independence and objectivity is probably justified. In my days in the rating business, a clear distinction was made between “insiders” such as investment bankers, accountants, board members and management who were party to inside information on the issuer’s business and financial position and “outsiders” such as analysts, investors and rating agencies who made judgments about the issuer’s credit strength on the basis of generally public information provided under generally accepted accountings standards for their use. The advent of structured finance put the rating agencies somewhere in between being insiders and outsiders. This is because structured finance ratings required intense interaction among rating agencies, investment banks and issuers to ensure, for example, that the rating agency stress tests were met by the transaction. The rating agencies increasingly became critical in the structuring process for the rated transactions, defining and adjusting the standards (or the rating criteria) to be met to achieve the high target ratings. In this interactive and intense rating process in structured finance ratings, the agencies went well beyond the simple assessment of corporate or municipal credit quality based on meetings that might have lasted one day (plus or minus) with the issuer’s management and analysis of the issuer’s past financial performance.

Many rating agency analysts parlayed their increasing clout in this rating process by walking across the street into lucrative investment banking careers.

So, will the rating agencies be held to account and if so what will this do to the franchise of the rating agencies? Given the sharp decline of rating agency stocks since last summer and their reduced earnings, the markets have already given their answer although the markets have not alternatives but to use the existing rating agencies. But can the rating agencies redeem themselves? That they must this time make a serious effort to do so is in my view a foregone conclusion because their franchise has suffered a serious blow. They must find a way to extricate themselves from the no man's land between being insiders and outsiders and move back closer to the outside. In fact the SEC has begun a review of policies and procedures regarding ratings of RMBS and CDOS, the advisory services that the rating agencies may have provided to investment banks and mortgage originators, the conflicts of interest arising from working perhaps too closely with investment banks and issuers and disclosure of rating processes for new and existing ratings.

What should the rating agencies do?

1 It seems to me that the rating agencies should perhaps step back a little from ratings based largely on what they put forward as immutable quantitative stress tests that were not supposed to change with the credit cycle and turn a bit more to judgment and subjectivity because credit is not just a numbers game. This may mean that some issues may not be ratable because the numbers just are not reliable and the historical asset performance track record is just too short.

2. And the rating agencies may have to jettison – or to carefully separate -- the role of determining ratings standards and that of applying those standards on a transactional basis because using the same teams to do both exposes the rating agency analysts to pressures from issuers and investment bankers for easy ratings, leading rating agencies to lower standards in good times and tighten them in bad rather than having standards that can stand the test of time.

3. The rating agencies should also consider barring for a period of time – perhaps a year or longer – former rating analysts from lobbying their colleagues after they leave the rating agency for lucrative positions on wall street so as to require a cooling off period before they use their inside information to beat down on the rating standards they helped create and/or enforce.

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