

The debt rating agency business after 2006: who wins?

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THE CREDIT RATING AGENCY DUOPOLY RELIEF ACT OF 2006 (THE 'ACT') OPENS THE DEBT RATING AGENCY BUSINESS TO COMPETITION. REGULATORY LICENCE LIMITED COMPETITION AND PROTECTED MOODY'S AND S&P'S MARKET POSITION, DESPITE SUSPECT DEBT RATINGS PERFORMANCE. AROUND 30 NEW RATING AGENCIES COULD SOON BE ON THE CARDS TO THREATEN MOODY'S 25%+ RETURN ON EQUITY, GARNERED ON THE BACK OF THE STRUCTURED CREDIT BOOM, SINCE THE LATE NINETIES. THE QUERY: 'WHO PAYS FOR RATINGS? INVESTORS? ISSUERS?' IS A RED HERRING. YOU GET WHAT YOU PAY FOR. INSTITUTIONS - AND THEIR FIDUCIARIES - STAND TO BENEFIT FROM NEW COMPETITORS AND THE DUOPOLY'S DEMISE.

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The 2006 Act

The Act lifts barriers to entry and opens up the closed debt rating agency business to competition. Currently, the US Securities & Exchange Commission ('SEC') recognises only five 'nationally recognised statistical rating organisations' ('NRSROs'): Moody's, Standard and Poor's ('S&P'), Fitch, Dominion and Best's. NRSRO designation is 'the franchise' for debt rating agencies. Many other regulators (NAIC, ERISA, State Banking and Insurance Departments, etc.) and institutional investors base investment policies, such as portfolio management and underwriting, on a securities' initial, and ongoing, NRSRO rating.

NRSRO = regulatory licence

Up until now, Moody's and S&P, with 80% of the market, dominated the debt ratings business, on the back of what Frank Partnoy of the University of San Diego Law School calls the NRSRO 'regulatory licence'. Regulatory licence

limited competition, promoted questionable 'buy-side' investment management policies (in the extreme, 'buying on agency ratings') and fostered conflicts of interest among bank originators and rating agencies to the detriment of institutional investors and their fiduciaries. Moreover, NRSRO designation - effectively, subcontracting debt market regulation to selected rating agencies - remained stuck in the 1970s, while the credit and fixed income markets and rating agency roles in them changed radically in recent decades.

25%+ ROEs and conflicts

Moody's and S&P often work in concert with investment banks modelling CDO transactions and are more like 'gate openers' than 'gatekeepers', according to Partnoy. Over 40% of firm revenues come from structured credit ratings, which often exceed 12-15 basis points, in contrast to three-four basis points on traditional debt ratings. Moody's generated a 50% operating margin and 25%+ ROE for its shareholders in recent years. (Check Moody's

on Yahoo!, symbol: MCO, for any five-year period since the late nineties). S&P is part of McGraw-Hill (symbol: MHP) and does not disclose results, but they are believed to be similar.

30 new agencies?

Although final regulations await SEC promulgation, the Act directs the SEC to make NRSRO designation largely a matter of form. Hereafter, wannabe rating agencies need only demonstrate a three-year track record and 'some acceptance' by institutional investors to join the NRSRO club. Some observers estimate that around 30 new rating agencies, attracted by Moody's hedge fund-type investor returns, could be on the horizon because of the Act.

Gradual change?

Moving forward, new NRSROs will impact institutional credit and fixed income investment strategies and business practices. Their entry can alleviate conflicts of interest and agency costs, borne by investors, that permeate the originator-rating agency structured credit distribution channels. They can validate or improve regulatory and institutional investor metrics, for too long dependent upon the five SEC-designated NRSROs.

You get what you pay for

Vested interests, silos, and legacy systems built up over three decades may delay moves to new 'best practices', notwithstanding perceived conflicts of interest. Already, some question the need for several additional rating agencies, especially given that many of the new agencies indicate that they will charge investors for their ratings. In contrast, debt issuers pay for today's debt ratings. However, this ignores hidden costs borne by investors, such as when originators tweak rating agency models to package US\$1bn of debt assets into CDOs that, somehow, are worth US\$1.02bn (see 'Why Should Institutions Invest in CDOs, At All?', *The Euromoney Structured Credit Products Handbook 2006/07*). There is no free lunch in the debt markets. However, when law ends oligopoly, many benefit and few lose.

Winners and losers

The Act directly benefits new agencies and their private equity backers, who target Moody's and S&P's super profits. Hedge funds, given that much of their business is driven by debt rating arbitrage, will continue to benefit from new players' ratings. Software vendors always benefit during fundamental changes to business models. Perhaps the biggest benefits will accrue to institutional investors and their clients, provided they review portfolio management policies, almost exclusively influenced by Moody's and S&P debt ratings, especially in structured credit. Hence, going forward, Moody's and S&P will be hard pressed to maintain 25%+ ROEs in the face of new competition.

How did this start? Limited regulatory licence, circa 1975 - Credit, fixed income and rating agencies, 'buy and hold'

Credit and fixed income were largely 'buy and hold' markets until around 1980. The 1933 Glass-Steagall Act split the commercial and investment banking businesses. In general, in the debt markets, US commercial banks directly financed borrowers' short term transactions (working capital, international trade, etc.) and medium term credit facilities (three - five year revolvers, term loans etc.) from deposits raised on the strength of their own balance sheets. US investment banks placed long-term debt (10+ years), as private placements or public debt issues, with institutional fixed income investors (insurance companies, pension funds, etc.), who bought and held them to fund future liabilities. There was an active syndication market for credit facilities, loans and bonds on origination, but very little ability to transfer debt instruments and their credit risk once it was on the books.

Relationship management lending

However, once banks and investors advanced borrowings, they were committed to borrowers for the term. Commercial banks stressed 'relationship management' as much to protect their credit exposures as to cross-sell services and

grow revenues. Credit facilities were often priced on overall account profitability (“let’s cut pricing on the revolver; they give us lots of FX business...”). Loan work-out groups (LWGs) were the iron-fist-in-velvet-glove that faced troubled borrowers (though LWGs enabled negotiations with lenders who had an interest in their borrowers’ and, if borrowers owed enough, their own, survival). Throughout, large lenders and institutional investors did their own credit underwriting and ongoing due diligence, accessing privileged financial information directly from borrowers. New York money center commercial banks developed their own internal risk ratings for borrowers (‘ratings go from one through 10...translation: AAA through D’) that overrode agency ratings.

Rating agencies rate ‘real’ borrowers

Passive asset managers, who did not originate their own credit exposures, paid over 90% of debt rating agency revenues. Rating agencies, acting for their institutional customers, rated ‘debt’ (claims senior to equity in a borrowers’ capital structure) of ‘real’ borrowers (corporations, financial institutions and municipalities with financial statements supporting long operating histories and ability to successfully repay such debt), domiciled overwhelmingly in the US. Rating agency debt ratings added little value to large lenders and institutional investors. At best, debt ratings confirmed that a relatively few high-grade borrowers could access public debt markets in addition to private commercial bank and institutional funding sources. Rating agencies were thought to be financial publishers of investment opinions and a backwater of the financial services industry.

The SEC and the NRSRO designation

The SEC originated the ‘Nationally Recognised Statistical Rating Organisation’ designation in the early 1970s. Wall Street ended fixed commissions in 1975, prompting investment bank and stock broker consolidation. The SEC, concerned about ‘capital adequacy’ of the remaining players in a then shrinking industry, sought to uniformly value firms’ bond inventory holdings. The lower the rating, the riskier the bond and the more capital required to hold the portfolio. Thus, the SEC used bond ratings as a ‘smoke alarm’ to identify under-capitalised firms.

Regulatory licence expands

Over the years, other regulatory regimes (NAIC, ERISA, etc.) followed suit and an SEC practice evolved into an industry-wide ‘regulatory licence’, according to Partnoy. Only bond ratings provided by large nationally recognised statistical rating organisations, like Moody’s and S&P, were used. Smaller rating agencies, providing similar services, were excluded as ‘NRSROs’.

1980 - Volatility and financial crises force change; rating agencies structure, in addition to rating, debt issues

Persistent 1970s stagflation (remember Reagan’s ‘misery index’? Prime 20+%, unemployment 10%), rising energy and commodity prices, volatile interest rates and foreign exchange markets came to a head around 1980, resulting in corporate, sovereign (Latin America, Warsaw Pact) and



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individual bankruptcies (S&L crisis). Two developments enabled the NRSROs to use their regulatory licence to structure, in addition to rating, debt issues.

I. Mid 1980s – ‘fallen angels’ become ‘junk’

The few ‘fallen angels’ of the 1970s (credits with operational problems that had trouble servicing debt) became many ‘junk bond issuers’ in the 1980s. Borrowers sought to maximise debt for a target debt rating to maximise the tax shield of debt and reduce their cost of capital. This also encouraged the use of bankruptcy as a corporate finance tool.

II. Mid 1980s - asset securitisation and origination based lending

By the mid 1980s, investment banks originated pools of assets and financed them separately from the companies that sourced them in their course of business. Residential mortgage-backed securities were the first such asset-backed securities, a result of the S&L crisis of that time. Shortly thereafter, credit cards, auto loans and other assets followed. Ultimately, this would militate against ‘relationship management’ banking. However, its immediate impact was to increase loans and loosen consumer credit underwriting standards. Until then, each loan was underwritten (had to repay) on a zero loss basis. Thereafter, ‘grids’ determined the likelihood that a borrower would repay on time and the pool’s probable cumulative losses of those who failed.

Securitisation of asset pools employs actuarially based pricing

The capital markets borrowed actuarial technology from the property and casualty [‘P&C’] insurance industry to package many securitisations. Complex analysis of asset pools enabled many institutions to support the use of ratings in their ABS portfolio management and enhance the regulatory licence of Moody’s and S&P.

- P&C insurers use the ‘law of large numbers’ to pool risks that are random (e.g. factory burning down, hurricane, plane crash) and independent (it’s unlikely that the above random events happen at same time and place). P&C

insurers can thus protect their customers against these risks which are catastrophic to them individually, for a lower cost (‘premium’) than if each set aside reserves (‘capital’) for the potential catastrophic event individually. In theory, constructing diversified portfolios of truly random and independent risks produces the lower cost benefit for the insurers and their customers.

- P&C insurers then tranche such pools of risk, for transfer to their reinsurers, according to their likelihood of loss: the ‘working layer’ bears all losses up to a pre-determined ‘attachment’ point and is often retained by the insured; equivalent to a deductible (comparable to an ABS equity tranche). Thereafter, one or more excess of loss (‘XOL’) layers govern payment for losses beyond that attachment point; equivalent to mezzanine and senior ABS tranches. In this way, reinsurers assist in P&C portfolio diversification, creating value for their customers and themselves.
- The problem with applying actuarial methods to the credit markets is that credit risk in general is neither random nor independent. Increasingly, individual, corporate and sovereign borrowers use bankruptcy as a sophisticated financial planning tool. According to Robert Arvanitis of Westport, CT-based Risk Finance Advisors, the resulting moral hazard militates against actuarial method. In addition, when ‘credit events’ happen, they tend to be highly correlated and spill over into other, seemingly unrelated, markets.
- Perhaps the real danger of uncritically applying actuarial methods to credit risk is its poor record in its home territory. McKinsey’s work, ‘The Journey’, documents an average historical 6% ROE for the P&C industry - far below other financial services.

2007 - Credit derivatives; debt issues and rating agency conflicts

The global credit and fixed income markets have grown astronomically since the mid nineties. Credit derivative volume exceeds US\$26 trillion today, compared to US\$2 trillion in 2000. Seemingly, everyTHING and everyONE trades.

In 2007, debt markets are driven by structured credit. The rating agency model has switched; now 90% of their revenues are paid by issuers of debt securities. Conflicts of interest and agency costs pervade investment bank originators, issuers and rating agency distribution channels.

Moody's and S&P's track record in rating transactions, and borrowers who use structured credit to improve financial statement presentation, has not been good over recent years. Consider the high investment grade ratings,

immediately prior to default or downgrade of the following borrowers during this period: Asia (1997), Russia and Long Term Capital (1998), Enron and 'energy traders' (2001), Telecom (2001), wholesale CDO downgrades (2002), P&C insurers and finite insurance (2004). Still unwinding are current rating issues of US subprime borrower mortgages (March 2007).

New rating agencies have lots of opportunity. Perhaps the Act came along just in time?

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