

Rating Agencies – Things are coming to a head

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Enron – A Portent of Things to Come

1. On 2 December 2001 Enron Corporation declared bankruptcy. At the time of its declaration it was the seventh largest corporation in the United States of America. In the year before its bankruptcy it had posted income of more than one hundred billion US dollars.
2. The bankruptcy declaration sent ripples throughout the US business community and impacted that community in many ways, not the least of which was the utter destruction of its auditor, Arthur Anderson.
3. As the auditor began to list and then sink, the BBC reported its managing partner as saying – “Lots of people were there at the time beyond auditors. There were rating agencies reporting up to a very short time before the collapse.”
4. This was a reference to the fact that, until 28 November 2001, the three major rating agencies were declaring the obligations of Enron to be “investment grade”. On that day they all reduced their ratings on those obligations directly to junk status.
5. This rating action demonstrated that the original ratings were not worth the paper they were printed on and, at the same time, begged a further question - what did the action say about the balance of the ratings issued by those three companies?
6. In theory, at least, if all three rating agencies could make the same basic error in relation to this huge corporation, then it was possible that one or more of them could make the same error in any other rating assessment.
7. A pall had fallen over the agencies and their ratings.

The Rating Agencies

8. At the time of the Enron debacle there were only three rating agencies of any import;
 - i. Standard and Poor’s;
 - ii. Moody’s Investor Service; and
 - iii. Fitch Ratings.
9. At the time, all three were NRSRO’s – Nationally Recognized Statistical Rating Organizations.
10. This status had been endowed upon them by the Securities and Exchange Commission. It enabled and motivated banks, insurance companies, brokerage houses, major investors and regulators to rely upon ratings promulgated by the three agencies.
11. For years before the Enron collapse a system had been in place in the US whereby the SEC determined which rating agencies were universally accepted to be accurate and reliable.
12. In fact the SEC certified in advance (by issuing “no action” letters) that any regulated entity relying upon the views of one or other of these three agencies would not be the subject of enquiry by the regulator if the views turned out to be incorrect. These certificates were

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published far and wide and could be relied upon not just by the entity to which they were addressed but by all and sundry.

13. The effect was to imbue the three agencies with the full faith and credit of the US government.
14. The SEC actually began the NRSRO system in 1975 and in the following quarter century through to Enron the system became institutionalized. NRSRO's were referred to in state and federal legislation. They were included in regulations promulgated by the various US regulators. Banks were permitted to hold less capital if it was in the form of instruments rated highly by one or more of these NRSRO's. Towards the end of this period foreign jurisdictions began referring to the opinion of NRSRO's in their own financial dealings.
15. By the turn of the millennium these three rating agencies were all pervasive. Their AAA concept was ubiquitous.

The Business of Rating Agencies

16. The standard business of the agency was to assess the creditworthiness of a company and its obligations and to provide that assessment in the form of a "rating". Expert analysts gathered together all available public and, in most cases, private information regarding the company and its obligations and then assessed its creditworthiness based upon innumerable factors which included the history of its business, the future prospects for the business, the overall economy, the impact on them of interest and exchange rates and so on.
17. When the AAA label was attached by the rating agency, all investors understood what had occurred. The agency had done its homework and had come to the view, at that point in time, that the prospect of the company honoring its obligations was "extremely strong".
18. By 2000 the rating agencies had been at this game for more a century and they had accumulated knowledge, information and systems which enabled them to make a really good fist of their assessments. Even so, terrible mistakes such as Enron could, and did, occur from time to time.
19. The rating agencies were front and centre in the Asian crisis, the Russian crisis, Orange County and the problems with the power supply system in Washington. On each of those occasions serious rating problems were revealed.
20. In each of these events the agencies were shown to have clay feet in relation to their stock standard rating work.
21. As investors railed against the rating agencies in relation to these defective ratings they were unaware of a much more serious problem, as yet dormant, but which would erupt within the decade.
22. From about the middle 90's the rating agencies ceased sticking to their last. Seduced by superior fees, the agencies began to rate structured credit products and, eventually, synthetic structured products.

Synthetic CDO's

23. A synthetic collateralized debt obligation is a bet that a nominated number of companies (say 8 out of 150) will not default over a given period of time (say 7 years). The party buying the protection (the issuer) pays a premium to the party providing the protection (the CDO investor).
24. These CDO's are issued by "bankruptcy remote vehicles" which are deliberately not capitalized and often reside in hide-away jurisdictions.
25. There is no suggestion whatsoever that these entities have any capacity to pay anything. The question of their creditworthiness does not arise. In fact the CDO issuer does not even promise to repay the monies advanced by investors, rather it promises to return what part of the collateral may still be in existence when the term of the CDO comes to an end.

26. These CDO's could not have been sold without a high rating. They were so hellishly complicated that no one in their right mind would have undertaken to read all the relevant documents from cover to cover. Warren Buffett recently suggested that a standard CDO of residential mortgage backed securities consists of more than 750,000 pages.
27. Investors don't read that material – they rely upon the credit rating.
28. In rating these instruments the agencies spent no time at all re-assessing each of the companies in the list. Rather, they constructed models which told them what sort of defaults had occurred in the past. The models were based upon numerous assumptions. At the end of the procedure, however, each rating agency came up with a view as to the actual level of past defaults over various periods of time.
29. This information, though interesting, wasn't worth very much. It looked backwards while investors were only interested in looking forward.
30. Strangely, the agencies used the same well known badging process with CDO's as they had used with single company assessments. They awarded the AAA rating to the "best" of the CDO's. They didn't just state what the past default rate had been – they rated the CDO as AAA.
31. In doing so they were not giving an opinion as to the creditworthiness of the issuer of the CDO. As set out above the issuer had no creditworthiness. It generally had issued capital of around \$1.
32. So what did the AAA rating on a CDO mean? What was it that was "extremely strong"?
33. It is clear that the AAA rating is saying something about the CDO which is being rated and nothing about the company which issued it. It is equally clear that the rating does not refer to the creditworthiness of the issuer of the CDO. What is being rated is the likelihood of the investor receiving his interest payments during the term of the CDO and then receiving back his funds at the end of that term.
34. Put another way, the rating is an assessment of the likelihood of there not being the required number of defaults in the list of companies referred to in the CDO, or there being a material diminution in the value of the collateral.
35. In the vernacular the rating agency is saying – "we have checked all this out and it is our expert opinion that it is extremely unlikely there will be 8 defaults amongst the list of 150 companies over the next 7 years or a material diminution in the value of the collateral so there is an extremely strong likelihood that you will receive the interest payments and you will get your money back at the end of the term".
36. By way of example in the Mahogany CDO, widely distributed in Australia, the transaction documents make the following point- "Standard and Poor's credit ratings address the likelihood of a debtor making full payment of interest and ultimately repaying the principle."

The Past as a Portent of the Future

37. If the rating agencies did not re-examine each of the 150 companies in the list and if they ascribe their rating by reference to what has happened in the past then the \$64 question is whether what has happened in the past in this area is any portent of what is likely to happen in the future?
38. If there is no necessary connection between corporate defaults in the past and corporate defaults in the future then it would seem that the whole rating operation falls to the ground.
39. Strangely, the transaction documents often contain an attempted "get out" clause by the issuer and by the rating agency. In the case of Mahogany the following statement occurs – "past default rates may not be indicative of future rates and there is no expectation that past rates will apply to the entities in the portfolio."
40. This statement has to be right because from time to time seriously adverse financial periods occur called recessions and every now and then depressions.

41. A AAA rating which suggests that there is an extremely strong likelihood that investor funds will be recovered within the 7 year period of a CDO is akin to saying that there will be no such recession during that 7 year period.
42. If this is right then what on earth does the AAA rating mean for a synthetic CDO?

The Proliferation of Structured Transactions

43. As the financial wizards churned out more and more structured products (credit default swaps, collateralized debt obligations, asset backed securities, residential mortgaged backed securities and constant proportion debt obligations just to mention a few) the rating agencies were in the very nice position of being the gate keeper.
44. None of this paper could have been moved without the stamp of approval from the rating agency and there were only three of them. (In fact, truth be told, there were really only two – S&P and Moody's controlled the bulk of global rating work).
45. That was an oligopoly (or duopoly) which was certain to eventually cause disaster.
46. Initially the transactions involved "real" assets and serious work had to be done on assessing the ratings for those assets.
47. Before long the wizards did away with the real assets and started creating synthetic transactions.
48. For the rating agencies this was a terrific development. It enabled them to commoditize their ratings. They could churn out the ratings much more quickly and at a lesser cost to them.

Direct Involvement by the Agencies

49. The rating agencies discussed with the wizards;
 - a. the geographic spread of the 150 companies within each portfolio;
 - b. the industry spread of those companies; and
 - c. the rating levels of the companies within the portfolio.
50. In some cases the agencies were involved in drawing up the documents for the transaction. Certainly all transaction documents were vetted by the agency.
51. Some went as far as visiting the wizard's office in order to discuss their requirements as to the content of the transaction documents.

The Money Side of Things

52. Evidence has begun to emerge that the agencies received up to three times the normal fees when they provided ratings for structured products.
53. Once triple rates were being paid the wizard could, and did, demand that such fees would only be payable if, in fact, the transaction went ahead i.e. if the transaction got the rating required.
54. In these circumstances, the rating agency could do all the work only to find that it got no fee because it was not prepared to give a AAA rating to the particular transaction in question.
55. That would be really galling if a fee three times the norm was expected. On occasion it might even lead a rating analyst to agree to a rating which should not have been given. This is the nature of conflict of interest.

Summary

56. In summary therefore the rating agencies;
 - a. provided ratings for trillions of dollars of structured products;

- b. understood that they had been given a privileged position by having been declared to be Nationally Recognized Statistical Rating Organizations;
 - c. knew that the investment community relied heavily upon those ratings;
 - d. in providing their ratings intended that the investment community would rely upon them;
 - e. knew that if the ratings were wrong then great damage would ensue;
 - f. took a direct hand in the construction of the structured products; and
 - g. Demanded and accepted fees many times the norm for these ratings.
57. In these circumstances what happened if the rating agencies were hopelessly negligent in providing the ratings? What happened to investors if the rating models and the assumptions on which they were based were hopeless? What happened if, in the extreme case, the agencies gave in to the temptation to bolster a rating in order to ensure they got the business?

The First Amendment

58. The first amendment to the United States constitution reads as follows – “Congress shall make no law respecting establishment of religion, or prohibiting the free exercise thereof, or abridging the freedom of speech, or of the press, or the right of the people peaceably to assemble, and to petition the government for a redress of grievances.”
59. When investors complained that they had been damaged by a rating agency the agency turned to this part of the constitution for their defence.
60. The defence goes along the lines that the rating agency is similar to a financial journal. It objectively publishes its opinions on financial matters. As a result, it is protected from any liability in making those public statements.
61. If this defence is truly available to the rating agencies then they have a license to print money. They can charge billions of dollars to issuers so that those issuers can use their ratings to sell their financial instruments but they can avoid all liability for any damage they cause by negligent ratings.

Back to Enron

62. Shortly after, and because of, the Enron failure the US Congress passed the Sarbanes-Oxley Act of 2002.
63. Section 702 (B) of the act required that – “the commission (i.e. the Securities and Exchange Commission) shall conduct a study of the role and the function of the credit rating agencies in the operation of the securities market.”
64. In particular, Congress required the commission to examine the role of credit rating agencies and to report on any conflicts of interest and “measures to prevent such conflicts and amelioration of such conflicts.”
65. On the face of it the rating agencies were under the hammer.
66. They had of course been in that position before.
67. In SEC release 33-7085 the Commission called, in August 1994, for comments in relation to “the process employed by the commission to designate rating agencies as NRSRO’s and the nature of the commission’s oversight role with respect to NRSRO’s.”
68. The commission set out that “with the proliferation of structured securities subject to substantial non credit payment risk, it is appropriate to review the regulatory use of ratings and to specify, if necessary, what types of ratings fall within each of the regulatory provisions that refer to specific ratings.”
69. This “concept release” in 1994 led to a rule proposal in 1997 which never came into effect and the system rolled on towards Enron.
70. Pursuant to the requirement on the Sarbanes-Oxley Act the SEC produced a report on the role and function of credit rating agencies in January 2003. The report concluded by setting

out that “the Commission has identified a wide range of issues that deserve further examination” before suggesting that amongst others the following matters required attention;

- i. whether rating agencies should disclose more information about the key basis of , and assumptions underlying, their rating decisions;
 - ii. whether rating agencies should implement procedures to manage potential conflicts of interest that arise from the fact that issuers pay for ratings;
 - iii. whether the Commission should prohibit direct contact between rating analysts and issuers; and
 - iv. whether there should be more direct, ongoing oversight of rating agencies by the Commission.
71. On 19 April 2005 the SEC promulgated a proposed rule change whereby the term NRSRO would be better defined. It did not propose any rule changes in relation to any of the other matters referred to in the 2003 report.
 72. In September 2006 congress passed the Credit Rating Agency Reform Act described in its title as “an act to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating agency industry.”
 73. Congress set out in the introduction to the Act that it was reacting to a statement by the Commission that it required statutory authority to oversee the credit rating industry.
 74. Interestingly, the Congress found it necessary to include a provision which prevented NRSRO’s from suggesting that they had the full faith and credit of the United States-“it shall be unlawful for any nationally recognized statistical rating organization to represent or imply in any manner whatsoever that it has been designated, sponsored, recommended or approved, or that the abilities or qualifications thereof have in any respect been passed upon, by the United States or any agency, officer, or employee thereof.”
 75. This is no doubt a recognition by Congress realized that, prior to this provision, this is exactly how NRSRO’s were thought of around the globe i.e. essentially having the tacit support of the US government.
 76. The Act also dealt with conflicts of interest primarily those arising from the fact that rating agencies were paid by the issuers.
 77. The Act made the SEC accountable for all rating procedures.
 78. In due course (June 2007-just as the global financial crisis got into full swing) the SEC published its final rules in relation to credit rating agencies.
 79. There are not many synthetic CDO’s issued after the rules were promulgated so this was a classic case of too little too late.
 80. What the legislation and the rules do show, however, is the need that existed for such rules as at the end of 2007. What was legislated against was that which in fact existed prior to the legislation.

Investor Complaints

81. Around the globe investors who purchased CDO’s have come to realize that the ratings ascribed to their investments were wrong and badly wrong. In many cases there has been a total loss of their investment.
82. Rating agencies have reacted by changing their models and they have done that by changing the assumptions which underlie the models and by building in further protection against erroneous assumptions.
83. As a result many CDO issues which were originally highly rated became rated as junk overnight.
84. On its face this seems to be an admission by the rating agencies that their original methodology was flawed and mislead investors into thinking that they were purchasing

investments with an extremely strong likelihood that they would suffer no loss when such was not the case.

85. In March 2009 Abu Dahbi Commercial Bank and others issued a class action against Morgan Stanley, Moody's and Standard and Poor's claiming amongst other things that they had been damaged by the ratings ascribed to their CDO investments by the two rating agencies.
86. The rating agencies raised the first amendment as a complete answer to the complaints.
87. On 2 September Judge Shira Scheindlin in the District Court for the Southern District of New York held that the first amendment defence did not apply and sent the matter on for trial.
88. His Honor made this finding upon the basis that the ratings in that case (as for all CDO's) were made available to only a small group of investors (i.e. those who purchased the CDO's).
89. If this judgment stands up on appeal and if the rating agencies are held liable in that case then we may be watching the beginning of the end for the two major rating agencies. There is no balance sheet which could sustain the actions which will commence around the globe if the Abu Dahbi litigation is successful.

The Australian Position

90. On 10 September 2009 ASIC put out a release which disclosed that it;
 - a. had given class action relief to the three NRSRO's shielding them from liability for errors made in their ratings and referred to in Australian prospectuses and product disclosure statements;
 - b. had done away with the requirement for the three NRSRO's to be licensed as Australian Financial Service providers;
 - c. intended to require that they be licensed by 1 January 2010; and
 - d. were considering whether they would again prohibit reference to ratings in prospectuses and product disclosure statements unless and until the rating agencies had consented to their inclusion and thereby became liable for any inaccuracy.
91. ASIC said in the release that the license would require that rating agencies disclose their methodologies, assumptions and procedures resulting in each credit rating.
92. ASIC suggests that these moves are required to protect retail investors. Under the Australian corporate system an investor who has \$500,000 to invest is, by virtue of that fact alone, a sophisticated investor. Investors who earn \$250,000 per year or who have assets of \$2.5M are also deemed to be sophisticated. With the advent of higher prices for the family home and self managed super funds many investors are now deemed to be sophisticated when clearly they are not.
93. ASIC poses the question as to whether credit ratings are important to unsophisticated retail investors. Apart from the answer to this question being blindingly obvious it misses the point ratings are also desperately important to many, if not most sophisticated investors.
94. But why does ASIC need to seek advice on this question? Why does ASIC think the agencies have been paid billions of dollars by issuers to rate their products? Surely the answer is obvious- because all concerned (including the issuer and the rating agency) know that, without the rating the investing public will not touch the product. The question is not whether ASIC should now lift the protection from liability it gave to the rating agencies but rather why it gave that protection in the first place.