

COMMENTARY

RATINGS AGENCIES ROB FERGUSON

How bad credit got dressed up as good

"If the sub-prime bust is the catalyst, the real story remains the exposure of the whole structured finance industry as a collective endeavour to disguise risky credits as 'safe' credits."

Marshall Auerback,
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This is a powerful accusation, but I believe it is true. The business of credit rating agencies – Moody's, Standard & Poor's and Fitch – began about 1860 in an environment of poor transparency. But as insiders selling valuable proprietary information from private briefings, they served a useful purpose. And they held an information advantage that, for a fee, they shared with the market.

Ratings were for many years given only to government bonds, municipal bonds and corporate bonds. Structured finance ratings are a relatively recent innovation.

In the theory of corporate finance, a corporation is supposed to be seen as perpetual. In the past there was a tendency for ratings to remain static and for bonds to be held to maturity. Corporations were stable, and a ratings change would often be seen as a shock.

So along comes structured finance products to this sleepy world of ratings. By the time this happened, tough disclosure rules had eliminated ratings agencies' informational advantages and therefore reduced the value of the agency's franchise.

Compared with the relative simplicity and transparency of government and corporate ratings, what could be better for a diminishing franchise than highly complex opaque products that require massive computer modelling to get some indication of risk? So structured finance products were a godsend to the ratings industry.

Complexity and opaqueness are



Risky business behind the mask . . . a 'collective endeavour' to hide the problems underlying structured finance.

usually hard to express in a simple AAA description, but the rating agencies continued to use this simple approach as it best optimised their franchise.

The simplicity-seeking reached as far as suggesting that government, municipals, companies and structured finance products could be compared across the board in their ratings. In other words, an AAA government was the same as an AAA structured finance product. This was the charade.

But thankfully we don't just have ratings, we also have markets. What did the markets show us in regard to ratings? Well, as the ratings agencies acknowledge, two AAA securities can have a market value range as wide as 10 points over LIBOR (the London interbank offered rate) versus 200 points over LIBOR. How can that be? The air of precision in 20 different rating categories implies that AAA

means equivalent risk, and so equivalent pricing for risk. We are told ratings are a range, not a set point. Ratings also only reflect the possibility of default, not the likely recovery from default. Clearly, different defaulting securities will have different recovery sums, which will be vital information for investors. But the rating agencies do not assess this. Neither liquidity nor volatility is reflected in a security's ratings.

Being designed in an era believing in perpetuity, ratings don't need to go down too quickly. Agencies prefer to "look through the cycle". In other words, they hope to get through the valley to the next bull market, which hopefully alleviates the need to mark down ratings in the short term. Ratings are generally only changed when permanent impairment happens. So we see the market pricing some structured finance products for near total loss

of principal whereas the rating agencies still have their stock at A or above. Connected with this is the absurdity of rating when finally marked down with a view to permanent impairment coming down nine notches in one move.

Now the rating agencies argue that these non-rated aspects of structured finance securities are well known to professional investors. This is where we connect back to "a collective endeavour to disguise risky credits as safe".

Complexity requires scarce special skills to analyse. So just as rating agencies saw structured finance products as a way to revive a tattered franchise, so did banks and investment banks.

It used to be that the bond department of banks and investment banks was the sleepy hollow of the business.

Spreads were low because transparency was high, a commodity business. But

complexity reversed that trend and created extraordinary new revenues that had more of the characteristics you normally associate with equity distribution revenues than bond department revenues.

In fact, the structured finance industry and regulators have created a situation where rating agencies and associated industry players are more important for debt analysis than equity analysts are for equity analysis. Regulators, trustees, governments and boards now require banks and pension funds and government instrumentalities to buy only high quality rated debt.

The story gets worse. Investment banks naturally assume the role of finding the holes that come from trying to simplify the complex.

The ratings scales allow investment banks to create a structured financial product by picking a parcel of the worst priced securities, as reflected by spread over LIBOR, that will fit into a AAA product. The rating agencies aid and abet this arbitrage. So the worst possible product to achieve a AAA rating is created. Huge spreads – 3 to 5 per cent – are then pocketed by the investment banks by picking up the difference the low equity package cost to put together versus what it is sold to the unsuspecting rating-based buyer. Bunching lesser credits gives concentration of risk rather than diversification. So there's the "collective endeavour" to disguise risky credits as safe!

Now sure, like cigarette packs, there are plenty of fine-print warnings. But let's face it, structured finance ratings are junk. Rating agencies have shown they are not up to the task. If investors haven't got the skills to analyse complex products, they shouldn't be playing the game.

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