

Rating agencies – the epicenter of the most recent financial disaster

A proposal for a new investor centric rating scheme

I agree with the SEC's assessment that credit rating agencies sit close to the epicenter of the financial earthquake that Wall Street and Main Street have been struggling with for over a year. In fact it is the rating agencies that sit squarely and almost alone in the center. It has also become quite clear that the changes in regulation of the rating agencies proposed to date are at best marginal. What is required is a clean slate approach to ratings, culminating in a completely new investor centric framework.

This article will first give a brief characterization of exactly how I believe the rating agencies were the spark and fuel that created today's financial markets problems and then outlines a proposal for a clean slate regulatory approach.

First a look inside the epicenter

In this last market cycle, many individual and institutional investors have abrogated their due diligence responsibilities to analyze a security's credit worthiness to the rating agencies. If the rating agencies did their job, employing them to rate an issuer's securities and sharing the diligence costs across all buyers results in a deeper, more efficient market that benefits issuers and investors. An easily communicated, credible risk rating system is a clear benefit to all capital market participants, unless the risk rating system breaks down.

In that case, the system runs amok. Institutions and individuals invest in securities that they unwittingly believe are of AAA quality. They do not spend much time analyzing what underlies that security, assuming that the credit rating agency has done that for them.

Meanwhile, Wall Street's profit machine kicks into high gear. The banks take low quality loans, slice and dice them to repackage them, earning significant fees, driving quarterly earnings and executive bonuses. The banks push harder and harder to find new loans, regardless of quality, that can be repackaged, sometimes providing temptation for originators to commit fraud or clearly unconscionable tricks to originate loans. Higher bounties and fees are paid for loans to feed the Wall Street fee machines.

Why did all this work? Because global investors thought they were getting high quality A to AAA assets as they were told by the rating agencies, when in reality they were getting a stir fry of table scraps. Table scraps are table scraps, even if you have first dibs like some of the senior structured debt tranches.

In the end global investors believed they invested in the gold standard of credit quality when in fact they were getting paper that was in some cases worth 20 cents on the dollar. It is the profit oriented, issuer centric rating agencies that fed and endorsed this scheme

with all of the credibility bestowed upon them by the SEC and the current regulatory regime.

The failure of the issuer centric ratings framework caused a systematic under pricing of risk and an artificially inflated appetite for higher risk loans. Had rating agencies properly rated these securities, investors would have had significantly less interest in owning them. Banks would have wanted to buy fewer loans from originators and less loans would have been originated. This does not mean there would have been no housing bubble, it only means that the supposed structural innovations in the capital markets would not have been turned into a magnifying weapon aimed right back at us, turning a housing oversupply into a financial earthquake.

The underlying risk in these structured securities would have been identified and communicated more accurately with a properly functioning rating agency structure, preventing the ripple effects that have shaken the financial markets to their core.

An investor centric rating agency model

To address the root cause of the rating agency failure, a new rating agency framework must clearly align the economic incentives and goals of the rating agencies, issuers and investing public around three key principals:

- 1) Accurate and timely risk assessment
- 2) Opinions free of conflicts
- 3) A clear line of responsibility to investors

From those three principals the following investor centric framework is derived.

Pay for performance. Ultimately the role of the rating agencies is to help investors assess risk. Investors and capital markets then price that risk and form their own opinion of the true investment risks. In a capitalist, performance oriented economy, good performance is rewarded and poor performance is punished. However, credit ratings have become a structural component of the U.S capital market and the SEC enforced monopoly has insulated the agencies from being compensated or punished for their performance.

Under the investor centric model, any issuer requesting a rating will pay an upfront and annual rating fee. The issuer selects a rating agency, then a second, and depending on the issue's size, a third rating agency will be selected by lot from a Qualified Pool. Each rating agency is paid the identical sum and given the same access to information.

The ratings must clearly express the probability of an interest payment default and the potential recovery in the case of liquidation. It is important to measure these probabilities over potential holding periods such as 1, 3, and 5 years and to maturity. One way to create a pay for performance scheme, and far from the only way, is to group the fee pool paid to each rating agency by vintage year of issuance and measure actual default and recovery rates against those predicted by the rating agencies.

So for example, say during the securitization boom a particular agency was due \$100 million of fees from securities issued in 2006. The agency would receive \$25 million up front for the year and another \$25 million would be set aside to be disbursed based on the accuracy of the initial rating through maturity and for 1,3, and 5 year periods from issuance. That disburses \$50 million of the original \$100 million in fees

The remaining \$50 million would be an annual credit monitoring fee, to be paid over the life of the bonds; say for simplicity's sake all the bonds in the vintage year matured in 5 years. Each year the agencies would have an opportunity to refresh their rating. A \$5 million annual monitoring fee would be paid with the remainder to be disbursed depending on the timeliness and accuracy of the revised ratings.

Penalties for underestimating defaults will be significantly more than the fees for a particular issue and will be in proportion to how inaccurate the rating was and the size of the issue. It is beyond the scope of this article to detail the mechanics of the payment scheme, but the salient point is that rating agencies get paid well for being right and punished severely for being wrong. Pay for performance.

Eliminate conflicts of interest. Under the investor centric model, issuers would continue to pay for ratings, but payment to all rating agencies for consulting and ratings work would be passed through a new regulatory board of representative fixed income investors organized and ultimately overseen by the SEC. Issuers are free to select a rating firm they consult with prior to issuance. The consulting firm must be paid for its services and can not provide a rating on any of the issuer's (or affiliate's) securities for a period of two years from the date its consulting relationship with the issuer is terminated.

Stop ratings shopping. Once the rating companies are selected by the issuer and by lottery, an issuer can not choose to reject or terminate any of them and must provide all of them with identical management access and non-public information. Mechanisms must be put in place to assure this. The issuer has an opportunity to rebut and comment on any rating in a rebuttal and clarification section to be included in each report. The rebuttal may include the opinion of the rating consulting firm as well.

Create an investor centric regulatory body. Rating agencies should clearly articulate that their mandate is to assess risk for investors. If that is their mandate, then they should report directly to investors. A ten person governing body can be organized under the auspices of the SEC with a mix of members including the largest pension funds, endowments and money management firms. It is the largest investors that have the greatest stake in making the system work best for them.

They would be responsible for creating, maintaining and administering all of the payments to rating agencies. Most critically this includes the performance payment system. They would assure equal access to information, run the lottery system by which certain rating agencies are assigned to rate securities and create the criteria to admit rating agencies to the Qualified Pool.

Create competition. To better assess risk and bring more expertise into the system, the entire group of rating firms must be expanded to include a more diverse background and skill set. Imagine a system of full line and boutique suppliers. Some boutiques choose to specialize in mortgage backed securities, others in industrial companies, financial institutions or retailers. The full line suppliers are known; S&P, Moody's and Fitch, and can grow over time. One of them is most likely to be selected as the issuer's choice for a rating.

The remainder could be firms of 5 to 50 people with deep industry and capital markets knowledge that would qualify them to render an opinion on the credit worthiness of issuers. They could depend on getting a certain amount of business by lottery and if they proved to be authorities in a given sector, odds are that issuers would seek them out and appoint them as a rater.

Qualifications to be a boutique rating company will depend on several broad criteria including: in depth expertise of the industry sector rated, an understanding of fixed income securities and an articulated framework for rating absolute and relative risks. One could easily see a series of boutiques with in depth industry knowledge serving particular sectors.

This investor centric model is a well constructed fire break that will help avert a financial system break down of the nature we are currently experiencing. But, as time passes and the causes of the current financial disaster are more fully diagnosed, I am convinced that United States Congress and the SEC must move to an investor centric ratings model. The main concern is that the lobbying efforts by entrenched interests will be prevent a clean sheet approach. The SEC has already begun to lead in identifying the rating agencies as the proximate root cause of today's financial crisis. It must now lead in galvanizing the efforts of investors to help protect their own interests in assuring an accurate and timely ratings system.