

THE ESSENTIALS OF RISK MANAGEMENT

Third Edition (EoRM3)

ONLINE CONTENT FOR CHAPTER 10

Box 10-3 [Updated], Table 10-1, Table 10-2 of EoRM2

From pp. 338–341 of *The Essentials of Risk Management, Second Edition* (EoRM2)

BOX 10-3 [UPDATED]

ARE THE RATING AGENCIES UP TO THE JOB AND SHOULD WE RESTRICT THEIR ROLE?

There has been mounting criticism since the 2007–2009 global financial crisis (GFC) of the *role* and *performance* of rating agencies.

The main criticism of the role that agencies play centers on their dominance of the credit rating market and their source of income. The demand for ratings has been artificially encouraged by a growing reliance on ratings as a tool of regulation. Since 1975, U.S. Securities and Exchange Commission regulations have relied on ratings from “nationally recognized statistical rating organizations” (NRSROs) to distinguish between the risks of various credit-risky securities. Other regulators have required that many institutional investors hold only investment grade instruments with ratings from one of the 10 registered firms with the SEC.

The intention behind this is to protect investors. But the importance of complying with the SEC, and other government regulations that refer to officially recognized credit ratings, has given NRSOs a semiofficial status.

More recently, the Basel II Accord explicitly refers to the rating grades of the major rating agencies for the calculation of risk-weighted assets (RWAs) and regulatory capital. Meanwhile, the European Central Bank is required to sell all non-investment grade bonds in its portfolio.

The semiofficial status of the rating agencies is compounded by the fact that they are in a quasi-monopolistic position. As of 2011, there were 10 U.S.-approved credit-rating firms,* and as of 2013, the three major rating agencies held a collective global market share of “roughly 95 percent” (with Moody’s and Standard & Poor’s having approximately 40 percent each, and Fitch around 15 percent).

* The 10 are as follows, with the year each rating agency started set out in parentheses: A.M. Best (1907), Moody’s (1909), S&P (1916), Fitch (1924), Dominion Bond Rating Service (1976), Kroll Bond Rating Agency (1984), Japan Credit Rating Agency (1985), Rating and Investment Information (1986), Egan-Jones Ratings (1995), and Morningstar Credit Ratings (2001). As of 2011, and according to securities filings, the three major rating agencies have about 2.5 million ratings on corporate, municipal, sovereign, and other types of debt, while the other seven ratings firms overseen by the SEC have just 84,000 ratings.

Critics also point to a long-standing conflict of interest in the way that ratings are funded. Ideally, users of the ratings, such as investors, would pay agencies to rate companies: the company under the microscope would not make any payments at all to the rating agency. In reality, the largest rating agencies rely on issuer fees for the majority of their income, leading to fears that in certain circumstances they might lose their objectivity.

The potential for conflicts of interest might become worse in the future if the main agencies further develop risk consultancy and advisory services that take additional fees from the corporations that they rate.

The agencies respond by saying that they have put many processes in place to prevent any conflict of interest affecting a rating, and that they have a good track record of making accurate ratings.

Even so, rating agencies have been criticized for their performance. The main recent criticisms concern their rating of complex securitizations and the role this played in the 2007–2009 GFC. In Chapter 13 of *EoRM3* we discuss in detail why the methodology for rating structured credit products should be different from the approach used for corporate and municipal bonds.

However, there are also some long-standing concerns about the agencies' performance when rating corporations and corporate bonds. Some commentators said that the rating industry performed poorly in "calling" the 1997 crisis in the Asian markets. Many companies in the region were downgraded only after the crisis was well underway.

They also seemed to perform poorly in spotting very highly leveraged or poorly managed companies (such as the failed energy giant Enron) at the tail end of the millennial stock boom. The agencies themselves admitted that there were an unusually high number of "fallen angels"—that is, sudden downgrades from investment-grade status—after this boom turned to bust. But they pointed to their long-term record and said that many of the investors who use credit ratings in their investment decisions want relatively stable credit ratings, not ratings that jump up and down along with market perceptions.*

Another controversy surfaced in August 2011 when S&P downgraded the United States from AAA to AA+. Together with downgrades of sovereigns in Europe, particularly the sudden downgrades of Greece, Portugal, and Spain in April 2010, this fueled a debate on whether sovereigns should be rated by rating agencies. Politicians openly questioned the validity of the rating methodology for sovereigns and asked for an audit of the approach followed by the rating agencies.†

Ironically, the problem has arisen at least partly because of the semiofficial status awarded to ratings by regulators. Ideally, rating agency grades should not have any more value than the

* As a result of criticisms following the millennial stock boom and bust, regulatory authorities such as the U.S. Securities and Exchange Commission conducted a series of long-running investigations into the way the rating industry works—e.g., *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets*, U.S. Securities and Exchange Commission, January 2003, available at <http://www.sec.gov/news/studies/credratingreport0103.pdf>. In the years following the 2007–2009 great financial crisis, other reports examined rating agency practices, though often with a focus on structured finance—e.g., *Report to Congress on Assigned Credit Ratings*, U.S. Securities and Exchange Commission, December 2012, available at <http://www.sec.gov/news/studies/2012/assigned-credit-ratings-study.pdf>.

† The Treasury said that the S&P analysis that led to the U.S. downgrade revealed "a basic math error of significant consequence," while S&P argued that it was not an error but simply a change in assumptions that did not affect its final decision to cut the rating. The proposed SEC rules would require rating agencies to submit regular self-assessments of their internal controls to regulators. Also, rating agencies would be required to notify the public of "significant errors" that they find in their methodologies.

opinion of other analysts or economic experts.* In reality, when a sovereign loses its AAA rating, or a corporation loses its investment-grade rating, then institutional investors are required to sell the downgraded securities. This leads to a fall in the price of the relevant security and to an increase in the financing cost of the issuer, worsening the issuer's economic condition.† This perverse feedback played a significant role in the crises affecting Ireland and more recently Greece, Portugal, and Spain.‡

How to reform the current system? One solution proposed by the Dodd-Frank Act in the United States is to suppress references to ratings in legislation and securities regulation,§ starting with Basel II and Basel III. The thinking behind this is that assessing the credit quality of borrowers is the core competency of banks, so banks should use their own internal rating system provided it has been validated by the regulators. It is also the responsibility of investors to perform their own due diligence and base their investment decision on their own judgment and the opinion of a range of experts.

An alternative proposal by the European Commission involves the creation of an official rating agency under the control of a new single regulatory authority, the European Securities and Market Authority. This solution may not be ideal as it is difficult to believe that such an agency would remain free from political interference.

* Credit opinions are not the only avenue. CDS spreads provide a market measure of default risk that can be used to complement the rating assessment.

† When S&P downgraded Greek debt from A- to BBB+, then to BB+, the yield on the new Greek bonds went up from 5.5 percent to 10.7 percent.

‡ So far, U.S. debt has been less affected because it continues to be viewed as a safe haven by most international investors. There is currently no alternative to U.S. Treasuries for countries such as China, given the sheer size of their currency reserves.

§ The SEC and other U.S. agencies are reviewing and changing their rules in accordance with the Dodd-Frank Act—e.g., *Report on Review of Reliance on Credit Ratings*, SEC, July 2011.

From pp. 346–347 of *The Essentials of Risk Management, Second Edition* (EoRM2)

TABLE 10-1 S&P Ratings Category Definitions

AAA	An obligation rated AAA has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.
AA	An obligation rated AA differs from the highest rated obligations only in small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.
A	An obligation rated A is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.
BBB	An obligation rated BBB exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.
BB	An obligation rated BB is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
B	An obligation rated B is more vulnerable to nonpayment than obligations rated BB, but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.
CCC	An obligation rated CCC is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.
CC	An obligation rated CC is currently highly vulnerable to nonpayment.
C	The C rating may be used to cover a situation where a bankruptcy petition has been filed or similar action has been taken, but payments on this obligation are being continued.
D	The D rating, unlike other ratings, is not prospective; rather, it is used only where a default has actually occurred—and not where a default is only expected. Standard & Poor's changes ratings to D either: • On the day an interest and/or principal payment is due and is not paid. An exception is made if there is a grace period and S&P believes that a payment will be made, in which case the rating can be maintained; or • Upon voluntary bankruptcy filing or similar action. An exception is made if S&P expects that debt service payments will continue to be made on a specific issue. In the absence of a payment default or bankruptcy filing, a technical default (i.e., covenant violation) is not sufficient for assigning a D rating.
+ or –	The ratings from AA to CCC may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.
R	The symbol is attached to the ratings of instruments with significant noncredit risks. It highlights risks to principal or volatility of expected returns that are not addressed in the credit rating. Examples include obligations linked or indexed to equities, currencies, or commodities; obligations exposed to severe prepayment risk, such as interest-only or principal-only mortgage securities; and obligations with unusually risky interest terms, such as inverse floaters.

Source: Corporate Ratings Criteria of S&P for 1998.

TABLE 10-2 Moody's Rating Category Definition

Aaa	Bonds that are rated Aaa are judged to be of the best quality. They carry the smallest degree of investment risk and are generally referred to as "gilt edged." Interest payments are protected by a large or by an exceptionally stable margin and principal is secure. While the various protective elements are likely to change, such changes as can be visualized are most unlikely to impair the fundamentally strong position of such issues.
Aa	Bonds that are rated Aa are judged to be of high quality by all standards. Together with the Aaa group, they comprise what are generally known as high-grade bonds. They are rated lower than the best bonds because margins of protection may not be as large as in Aaa securities or fluctuation of protective elements may be of greater amplitude or there may be other elements present which make the long-term risk appear somewhat larger than the Aaa securities.
A	Bonds that are rated A possess many favorable investment attributes and are to be considered as upper medium-grade obligations. Factors giving security to principal and interest are considered adequate, but elements may be present that suggest a susceptibility to impairment some time in the future.
Baa	Bonds that are rated Baa are considered as medium-grade obligations (i.e., they are neither highly protected nor poorly secured). Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well.
Ba	Bonds that are rated Ba are judged to have speculative elements; their future cannot be considered as well assured. Often the protection of interest and principal payments may be very moderate, and thereby not well safeguarded during both good and bad times over the future. Uncertainty of position characterizes bonds in this class.
B	Bonds that are rated B generally lack characteristics of the desirable investment. Assurance of interest and principal payments or of maintenance of other terms of the contract over any long period of time may be small.
Caa	Bonds that are rated Caa are of poor standing. Such issues may be in default or there may be present elements of danger with respect to principal or interest.
Ca	Bonds that are rated Ca represent obligations which are speculative in a high degree. Such issues are often in default or have other marked shortcomings.
C	Bonds that are rated C are the lowest rated class of bonds, and issues so rated can be regarded as having extremely poor prospects of ever attaining any real investment standing.

Source: Moody's Credit Ratings and Research, 1995.