Photography: Getty Images

A political culture of blame is pointing the finger at ratings agencies for not spotting all the flaws in the shiny credit markets of 2007. By **Martin Fagan**

ALL THAT GLISTERS

Last summer, just as the new chancellor, Alistair Darling, was getting his feet comfortable under his desk, the problem of Northern Rock landed on it.

It's generally felt that all governments are keen to pass any buck that they can, which is why, once the mooted general election failed to happen last year, critics were quick to point out that Darling threw some of the blame for Northern Rock's collapse at the credit ratings agencies (CRAs). The chancellor's line on this – and cynics could say this was to deflect attention from the government's subsequent butter-fingered handling of the Northern Rock crisis – was that the CRAs should have seen the global credit crunch coming and issued stark warnings.

But Jonathan Newman, an analyst at stockbroker Brewin Dolphin, thinks this is a case of the Chancellor showing his business naivety. "Practitioners in the financial marketplace who understand what credit agencies do won't have expected them to sound the alarm bells at an impending global credit crunch," says Newman. "That's not what the agencies exist to do."

Nonetheless, for everyone from politicians to embarrassed banks holding large tranches of US sub-prime debt (and eager to find someone to blame), CRAs make a convenient scapegoat. So should the credit referencing agencies have seen the US sub-prime mortgage fiasco – and subsequent global credit crunch – coming and scrambled up to the roof to fire off the warning flares?

The warnings were out there

"We saw deterioration in the US sub-prime mortgage market in early 2005 and commented on this to the market," says Martin Winn, spokesman for Standard & Poor's. "Bear in mind that what's now happened has been an unprecedented deterioration in recent vintages of sub-prime debt in circumstances that have never been seen before. For instance, many of the holders of these sub-prime mortgages chose to default on their mortgage payments before they defaulted on credit cards and auto loans. In normal circumstances, for people in financial difficulties, the priority is to keep the roof over their head, but not in this instance."

Winn says many casual observers of the financial markets have an unrealistic belief of what a credit rating is actually endorsing: at base, it's the opinion on the possibility of a security defaulting. "That's its definition," says Winn. "It's not a guarantee of investment performance or a stamp of approval."

Ratings are not recommendations

Another credit reference agency – Moody's – declares that its rating is the opinion "of the ability and willingness of an issuer to make timely payments on a debt instrument over the life of the instrument". Moody's is at pains to leave investors in no doubt that its ratings are not a recommendation to buy or sell, nor are they a guarantee that default will not occur.

"We perform a significant but limited role in the credit markets," says Fran Laserson, vice-president of corporate communications at Moody's. "We issue reasoned, forward-looking opinions about credit risk; our opinions are objective and not tied to any recommendations to buy or sell."

S&P's Winn admits the global liquidity crisis is a severe problem, but the advance warning of it is not what CRAs are meant to address. "We assess the risk of default and the issues we're currently seeing are less related to defaults – which remain low – and more an issue of the reassessment and repricing of credit risk, which, for many years, had been massively under-priced," he says. "This led to a severe drying up of liquidity across the credit markets, which, in turn, contributed to the severe market writedowns suffered by the banks."

And this is what did for Northern Rock. Last August, it had deposits of £26.7 billion, but had lent a total of £86.7 billion on assets worth £115 billion. The bank was due to refinance a large tranche of its mortgage securities in early September 2007; however, the way in which Northern Rock's management had engineered the company's finances required frequent roll-overs of the financing and, with liquidity evaporating, the company had to approach the Bank of England for an emergency loan.

As happened with Enron, the lag between the state of Northern Rock in early summer 2007 and changes in its credit rating makes clear that the market doesn't necessarily take its cues from rating agencies.

> "You didn't need to read the credit ratings agencies' reports to know Northern Rock was a company in trouble"

Never rely on CRAs alone

"But you didn't need to read the credit ratings agencies' reports to know Northern Rock was a company in trouble: the share price was telling you everything you needed to know," says Georgina Mitchell, head of investment services at stockbroker Redmayne Bentley. "We thought Northern Rock had a dangerous business model, so we were recommending our clients to sell from the spring of 2007."

Even managers of bond funds only give the output of CRAs a limited amount of credence. "It's difficult to ignore ratings agencies in terms of their opinions on a credit," says Ariel Bezalel, fixed interest fund manager at Jupiter Asset Management. "But while it's useful to hear what they have to say, it's just one of many factors we take into account when forming an opinion on the credit worthiness of a company's bonds."

Brewin Dolphin's Jonathan Newman believes that some investors – both corporate and private – interpreted CRA ratings to suit their own ends, a point with which S&P's Winn concurs. "Clearly, there is a growing recognition in the market that investors may have been using credit ratings for purposes for which they were not designed," says Winn. "They were being used as a benchmark of investment risk, rather than default risk."

Since early 2005, Winn says S&P has rated securities such as collateralised debt obligations (CDOs) and other structured products to the value of $3 trillion. Of those securities, only 9 per cent had their rating downgraded and only 0.25 per cent defaulted.

But the agencies themselves make a huge slice of their total revenues from such services. According to Neil Godsey, an equity analyst at US-based Friedman, Billings, Ramsey Group, in 2006, Moody's earned $884 million – or 43 per cent of total revenue – from rating so-called structured notes (securities that package asset and mortgage-backed debt). This was more than triple the $274 million generated in 2001.

A chief criticism of CRAs is the conflict of interest that seemingly arises from a company paying the agency to rate its debts and that rating becoming the basis on which the risk is then sold into the market.

Late last year, Jean-Claude Trichet, president of the European Central Bank, said lessons needed to be learned from the fact that the fees of the credit rating agencies are paid by the financial institutions whose financial securities they are assessing.

"It's a business model that's been in place for 40 years now and one that's much valued by the market," says Winn. "The way the agencies are financed means they can cover a wide range of securities in depth and it enables us to offer the ratings free of charge to the whole market. Some feel we should adopt an investor-paid subscription model, but regulators believe this creates a privileged class of investor and doesn't encourage market transparency."

In fact, in late February, the House of Commons Treasury Select Committee inquiry into financial stability and transparency reported it could find "no practical alternative business model to the current one" of a company paying a CRA to rate its own debt.

Newman wasn't surprised the credit referencing agencies didn't see the sub-prime crisis and subsequent credit crunch coming, because the sell-side analysts didn't see it coming either. "The nature of all financial analysis is backwards looking," he says.

"Equity analysts might predict how much they expect a company to grow its earnings and base both a recommendation and a target price for the share on that, but it is subjective opinion based on historical data. To paraphrase Warren Buffett, most debt analysts look at the rear view mirror and not through the windscreen." ■