

Rating the Risks in Credit

By Sara Statman, Aug. 2007

Credit Ratings

The objective of rating agencies such as S&P, Moody's, and Fitch is to provide an objective, independent, credible, transparent and consistent credit opinion based on a set of precise criteria. Their opinion is expressed in the form of a series of credit ratings, each of which reflects the credit quality of the issuer or facility (loan or security), regardless of region, and implies a worst-case scenario through the credit cycle. Structured finance ratings are typically assigned to each tranche on the basis of various stress scenarios in combination with its relative seniority, prioritization of cash flows and other structural mechanisms.

Credit ratings should not be viewed as a snapshot of the present but rather of the long-term, through the course of the credit cycle. Agencies try to factor in business cycles, both sector and macro-economic issues, but cycles do not necessarily repeat in terms of length, magnitude and dynamics. Generally, ratings incorporate average cyclical effects. This implies ratings may under/over-estimate during deviations from average economic conditions. Academic Research suggests transition matrices (tables predicting the probability of migration between rating categories from one period to the next), which ignore the economic cycle, are not stationary over time.

Although ratings are meant to be forward-looking, they indicate a risk bucket rather than a precise default probability. Higher ratings are associated with lower default rates; default rates increase with the horizon and large differences are noticeable between investment and non-investment grade. Issuers with lower ratings have a greater tendency to default, and this is one of the justifications used by rating agencies to support their claim that ratings are an appropriate assessment of creditworthiness. However, rating agencies perform no due diligence nor vet data provided by issuers. Furthermore, a rating provides no information about a security's price, relative value or volatility. Higher-rated securities are more creditworthy, but the rating does not indicate which bond is rich or cheap within a rating class.

It is also important to realize that S&P and Moody's credit ratings provide different information. S&P ratings express an opinion as to the likelihood of default, whereas a Moody's rating expresses an opinion as to the expected loss, based on the default probability times the loss severity. Fitch's ratings express an opinion as to the likelihood of default as well as relative expectations of loss given default.

Current Issues

The sub-prime situation arose from a global imbalance between the supply and demand for credit. Traditional borrowers did not require, or could not access, funds in the wake of Enron/WorldCom. Monetary policy took an almost unprecedented, accommodative stance. As company profits grew, firms had less need to tap into the debt markets. With other assets offering lower returns investors sought out higher yields, such as ABS/sub-prime. On the supply side, the growth and increasing sophistication of the ABS and Credit Derivatives markets, enabled assets to be packaged and sold into tranches, to match the investor's risk profile, and

investors assumed that from a risk perspective a AA-rated CDO equated to a AA-rated corporate issue.

Some of the most serious risks facing investors and lenders alike are liquidity, correlation, ratings and valuation methodologies. A fund with long sub-prime positions will face margin calls, and unlike banks, which set aside capital reserves, funds will need to liquidate other securities, often prematurely at below-peak levels, in order to fund margin calls. Increased supply lowers the prices of other securities and further depresses collateral values. Many long-only asset managers are restricted to holding only investment grade securities, which was a key driver in the structuring and high ratings assigned to certain ABS and CDO tranches. Once these securities are downgraded, funds are rebalanced and sell orders are triggered. Issuers are forced to curtail new issuance and lending standards are tightened. This reduces liquidity and fuels the fear factor, which in part explains why volatility returned to levels last seen regularly in the late 1990s. Aside from the fact that there is no liquid market to hedge ABS or CDOs of ABS, valuation is particularly complex as each CDO is different and these assets are typically marked-to-model.

I suggest we focus our attention on three groups in particular: rating agencies, prime brokers and auditors. It is now being questioned whether rating agencies stepped over the mark, by earning fees from structuring and pricing, as well as from rating structured finance transactions. Corporate issues do not require this type of structuring, so the same potential conflicts do not arise for corporate issues. Although investment banks earn fees from structuring and benefited from an easy credit environment, as well a wider investor base for complex products, rating agencies must maintain independence. As outlined above, rating agencies are meant to provide an objective, independent, credible, transparent and consistent credit opinion. Their credibility and independence have most certainly been brought into question, and just as the accounting scandals caused the separation of accounting and consulting functions, similar restrictions may have to be forced upon the ratings agencies.

The other two groups worth considering are prime brokers and auditors. If counterparty and asset correlations were not fully priced in, it is conceivable that some prime brokers will face counterparty losses, further reducing market liquidity and exacerbating the downward spiral. It is also quite plausible that auditors lack sufficient technical expertise to understand valuation methodologies for complex financial products and, in particular, the newer product sets. There are no checks and balances nor certifications, to ensure auditors are up to this task. If an external auditor gave a clean bill of health to a credit fund earlier this year, and if this opinion led to new inflows, that auditor is at risk from the same types of litigation claims currently being filed against the rating agencies.

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