

# Credit Ratings Agencies – meeting the needs of the market?

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*“The strong growth in the credit ratings industry enjoyed by just a few CRAs (credit ratings agencies), combined with recent corporate scandals of a global nature not foreseen by CRAs, as well as the US sub-prime market crisis has stimulated demands for greater security and regulation of CRAs work,” said Professor Angus Duff of the University of West Scotland.*



Speaking at a panel discussion co-organised on the 4th June by AMCHAM (the American Chamber of Commerce in Luxembourg), PRiM (the Luxembourg Association of Risk Management Professionals) and ICAS (the Institute of Chartered Accountants of Scotland), Professor Duff was joined by a distinguished panel including; Professor Avinash Persaud, Chairman Intelligence Capital Ltd., Blaise Ganguin, Managing Director & Chief Credit Officer Europe with Standard & Pooers, Maurizio Trenti, Vice President Treasury Operations with SES, Héliène Séré, Head of Credit Research, Global Markets at

Fortis and Henri Reiter, Director of Fund Market.

## CRAs: scapegoat for current troubles?

The financial sector is in the grips of a credit crisis, with a lack of liquidity and a great deal of uncertainty about the future, where the role of CRAs has been called into question; does an oligopoly exist or are CRAs being made scapegoat in a crisis where all players need to shoulder their share of the blame? It was to address these questions that the panel was brought together before a packed audience at Fortis Bank on Boulevard JFK.

Duff provided a summary of research carried out entitled, “Credit ratings agencies – meeting the needs of the market?” Undertaken for the ICAS Research Committee and published last year, the survey of 2400 interested parties found that, “The items rated most highly by all stakeholder groups related to the integrity of the CRA, their ethical standards and credibility. Rated almost as highly were those items related to the competence of CRA output such as accuracy of ratings and associated reports as well as the education and qualification of staff,” almost exactly what is being called into question now.

## Robotic banking

Persaud, however, called the banking model itself into question. “The rapid growth in the CRA business coincided with a change in the banking model to the Originate, Rate & Relocate model,” (referring to the number of off balance sheet transactions that took place). He said that it was everyone blindly following the ORR model which has led to today’s systemic crisis. “Everyone was thinking and doing the same thing; it was like robotic banking. We ended up with only one view; that of the CRAs.”

Henri Reiter agreed that there was/is an over dependency on >>



» CRAs, adding that, "It is important not to depend on ratings, but to fully understand the product." He believes that today's situation has come about thanks to the fact that, "We still believe in, and are still teaching, the Efficient Markets Theory, despite the fact that the markets clearly show that it doesn't work." Reiter said that CRAs had been relying on this, but that, in his view, "It is too backwards looking." What happened then was that, "Products were being developed based on inefficient analysis, then leveraged on. A lot of banks finished up using SIVs that were well over-leveraged."

### Conflicts of interest?

Reiter continued that a more qualitative basis for credit rating is better, but that this can

lead to conflicts of interests as, "Who pays for this qualitative assessment? The issuer; and this means that only those reasonably certain of their status will ask for a rating."

Blaise Ganguin came to the defence of CRAs. "Credit ratings are an opinion on fundamental credit risk and I still believe them good indicators of the probability of default." He explained that CRAs' activities are regulated in two ways; the US CRA Reform Act of 2007 and, in Europe, by Basle II. "The first looks at the processes but not the content of our analytics, and the second contains some very serious triggers that regulate the content." Ganguin agreed that, "We need to take our responsibility very seriously," but, referring to the US sub prime crisis, added, "Don't forget that, of those

products rated AAA, around 80% still are."

### A useful decision making tool...

Maurizio Trenti and H el ene S er e presented the point of view of CRA "users". S er e (as an investor) said, "Credit ratings maybe incomplete but they are, nevertheless, a decisive tool in investment decisions. They can be a barrier to investment and used to calculate capital requirement, which has legal implications." Having said that, she admitted that, although credit ratings are a decisive tool, "they are not the only one; investors also have many other issues to consider."

Trenti (from a corporate point of view) explained that, "We tap into the global capital markets

and therefore, credit ratings are a very useful tool in our decision making. We rely on strong brands like S&P and Moody's, but in the long run I would like to see more CRAs to encourage competition." He felt, as did several other members of the panel, that the market would be better served by increased competition as this could reduce the possibility of conflicts of interest like that mentioned earlier by Reiter.

### ...but not a guarantee

Avinash Persaud finished by making a very important point, "We mustn't forget that credit ratings are research on the likelihood to default. They are not, and have never pretended to be a guarantee of performance."

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