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October 2009

Research Perspective – Credit Rating Agencies

For this Research Perspective, we will examine “credit rating agencies” and their primary product: “credit ratings.” Some of these agencies and their ratings have been in the press recently for contributing to the latest financial crisis, and we would like to address the following questions:

- I. What are credit rating agencies and credit ratings?
- II. Why are credit rating agencies and their ratings important?
- III. Why should investors not rely solely on credit ratings?

An executive summary with conclusion is below, and the full Research Perspective follows.

Executive Summary

- Credit rating agencies evaluate companies, municipalities, countries and asset-backed securities on their ability to meet their obligations in a timely manner. For example, paying back interest and principal on their bonds. The results of their efforts are credit ratings.
- Credit ratings are used by many market participants for various purposes, such as issuing bonds, making investments, and protecting bondholders. They have become embedded in regulations and legal documents. However, we believe some have relied upon these ratings too much, and that credit ratings are just one data point in analyzing investments.
- Our research and experience lead us to believe there are numerous reasons to be skeptical of relying solely on credit ratings to make investment decisions:
 1. Like all market participants, credit rating agencies have been imperfect in the past. More recently, their actions have contributed to the recent financial crisis.
 2. A few companies dominate the business of providing credit ratings. We believe a lack of significant competition has degraded the quality of ratings.
 3. Credit rating agencies face many pressures from their customers, investors, regulators, and other market participants. As a result, accurate credit ratings can be compromised, in our opinion, in order for the credit rating agencies to protect and grow their businesses.
 4. Communications among executives and employees of credit rating agencies were uncovered, giving more validity to our beliefs about the pressures the agencies face.
 5. Our experience leads us to believe that credit rating agencies may have deficiencies in their ratings process at times. For example, credit rating agencies may sometimes underestimate important factors and update credit ratings too late.

6. Regulatory changes are brewing in response to credit rating agencies' role in contributing to the recent financial crisis, and credit rating agencies may not exist in their current forms going forward.
7. Even if credit rating agencies correctly handicap a security's creditworthiness, their ratings may ignore other factors of importance to investors, such as sensitivity to interest rate changes and the potential upside of an investment relative to its risks.

Conclusion

Significant importance is placed on credit rating agencies by various market participants. As a result of credit rating agencies making mistakes that contributed to the financial crisis, the agencies are currently under tremendous scrutiny. New regulations, additional competition, and changes to the system are currently being contemplated in an attempt to improve the business of analyzing credits. Credit rating agencies can provide helpful data, but we acknowledge they are subject to pressures and faults, and we only use them as part of our analysis of bonds and stocks. We do not pretend to know what the credit ratings industry will look like in the future, but we use the data in the marketplace to make informed investment decisions.

Credit Rating Agencies

I. What are credit rating agencies and credit ratings?

Credit rating agencies (CRAs) are businesses that rate the creditworthiness of companies, municipalities, countries and their bonds. “Creditworthiness” is the ability to pay obligations such as interest and principal of bonds in a timely manner. CRAs also provide credit ratings for complicated structured financial products such as residential mortgage backed securities, commercial mortgage backed securities, and collateralized debt obligations. Some of these complicated securities have come to be known by another name that may be more familiar to you: *toxic assets*.

The business of providing credit ratings is dominated by three CRAs of which you may have heard: Standard & Poor’s, Moody’s, and Fitch. As you can see in the table below, the three primary CRAs rate on scales that are split into “investment grade” categories and “speculative grade” categories.

Credit Rating Scales			
<u>Fitch</u>	<u>Moody's</u>	<u>S&P</u>	
AAA	Aaa	AAA	Highest investment grade rating (safest rating)
AA+	Aa1	AA+	
AA	Aa2	AA	
AA-	Aa3	AA-	
A+	A1	A+	
A	A2	A	
A-	A3	A-	
BBB+	Baa1	BBB+	
BBB	Baa2	BBB	
BBB-	Baa3	BBB-	Lowest investment grade rating
BB+	Ba1	BB+	Highest speculative grade rating
BB	Ba2	BB	
BB-	Ba3	BB-	
B+	B1	B+	
B	B2	B	
B-	B3	B-	
CCC+	Caa1	CCC+	
CCC	Caa2	CCC	
CCC-	Caa3	CCC-	
CC	Ca	CC	
C	C	C	

CRAs typically rate bonds and securities when they are initially issued and can upgrade or downgrade them to different ratings at any time. Going forward in this Research Perspective, our references to CRAs will pertain to the three primary credit rating agencies unless noted otherwise.

II. Why are credit rating agencies and their ratings important?

We believe many analysts at the credit agencies are good people, are trained in analyzing the creditworthiness of bonds and complicated securities, and work hard to get ratings right. They also can legally receive nonpublic information from companies that may help the analysts assess the creditworthiness of those same entities and their bonds and securities better than other market participants.

Additionally, the ratings of the primary credit rating agencies have multiple uses and have become tools relied upon in the financial marketplace. Examples are below:

- Companies, municipalities, and governments (also known as “issuers”) that receive high credit ratings tend to have better terms on bonds, such as lower interest rates, than comparable institutions that receive lower credit ratings.
- Credit ratings can be used in bond covenants to protect bondholders such that a credit rating downgrade could put an issuer in violation of its debt covenants. This should reduce the chance an issuer takes risks that could jeopardize bondholders’ investments.
- Some pension funds and mutual funds have investment guidelines preventing them from owning bonds that have speculative ratings. Therefore, they may sell bonds that are downgraded and no longer receiving investment grade ratings, regardless of whether the bond has an attractive risk/reward profile.
- Regulators may require insurance companies and banks to hold more capital (rather than use the capital to make investments) if they buy bonds that receive ratings downgrades or have more speculative ratings at the initial time of purchase.
- Companies may choose not to do business with firms that have more speculative credit ratings.

The examples above reveal that various market participants pay significant attention to credit agencies’ ratings. We believe numerous market participants, including many investors, have become too dependent on credit rating agencies and essentially have outsourced their primary credit (and sometimes investment) analysis to Standard & Poor’s, Moody’s, and Fitch. We look at credit ratings as well, but we use them as only one piece of data in our analysis of securities, especially bonds. The truth is that these ratings can be useful, but we believe they have potential flaws and that investors need to do their own homework on individual bonds, stocks, and more complex securities. If an investor feels a bond or security is too complex to analyze, we recommend passing on it.

III. Why should investors not rely solely on credit ratings?

1) Like all market participants, credit rating agencies have been imperfect in the past. More recently, their actions have contributed to the recent financial crisis. A memorable example: Earlier this decade credit rating agencies came under fire for allegedly recognizing problems of companies like WorldCom and Enron too late (Enron's rating remained at investment grade levels until just four days before Enron filed for bankruptcy).¹ In recent years, credit rating agencies underestimated both the extent housing prices could fall and the prevalence of poor mortgage lending practices. At a congressional committee hearing on credit rating agencies in October 2008, the top executives of the CRAs made the following comments:

- The President of Standard & Poor's explained, "...events have demonstrated that the historical data we used and the assumptions we made significantly underestimated the severity of what has actually occurred."²
- Fitch's President and CEO stated, "...we did not foresee the magnitude or velocity of the decline in the U.S. housing market, nor the dramatic shift in borrower behavior brought on by the changing practices in the market. Nor did we appreciate the extent of shoddy mortgage origination practices and fraud in the 2005-07 period."³
- Moody's CEO said, "We did not, however, anticipate the magnitude and speed of the deterioration in mortgage quality or the suddenness of the transition to restrictive lending."⁴

As a result, some complicated bond-like securities deriving their value from assets such as residential and commercial mortgages incorrectly received high credit ratings, which compelled banks, insurance firms, and others to buy them. Again, you may know these securities more by another name used by the media: *toxic assets*. The incorrect ratings and these toxic assets have resulted in tremendous losses and have been key contributors to both the financial crisis and the current financial environment.

It is possible that in the aftermath of missing the financial and housing crises, the pendulum has swung in the other direction so that some CRAs may be too conservative or stringent with some of their ratings.

2) A few companies dominate the business of providing credit ratings. We believe a lack of significant competition has degraded the quality of ratings. In 1975, the U.S. Securities & Exchange Commission (SEC) designated Standard & Poor's, Moody's, and Fitch as the only "Nationally Recognized Statistical Ratings Organizations" (NRSRO) that may be used for rating bonds' creditworthiness.⁵ As mentioned earlier, these three companies continue to dominate the credit ratings industry, and barriers, such as regulatory hurdles and brand awareness, make entering

this industry very difficult. Therefore, the industry leaders may not have as much incentive to get ratings correct because issuers of debt and complex securities almost *have* to do business with at least one of them. The President and CEO of Fitch, the smallest of the three primary credit rating agencies, explained (or rather complained about) the abuse of market power in the credit ratings industry to the SEC in 2002 (emphasis added via underlining):

“Moody's and S&P are a dual monopoly, each possessing separate monopoly power in a market that has grown to demand two ratings. Each engages in practices designed to perpetuate its market dominance and extend it to otherwise competitive markets such as structured finance. As we have publicly stated for more than a year, through their discriminatory practice known as "notching", Moody's and S&P are successfully altering competition in the commercial and residential mortgage-backed securities market by leveraging their monopoly position in other markets.

No matter what the ultimate outcome is in the debate concerning the NRSRO system, new entrants will have limited success competing with Moody's and S&P until their anticompetitive behavior is appropriately addressed. Despite a decade of effort, multiple mergers and millions of dollars of expense devoted to our effort to become fully competitive with Moody's and S&P, Fitch may still be marginalized in formerly competitive markets because of the monopoly power Moody's and S&P wield.”⁶

3) Credit rating agencies face many pressures from their customers, investors, regulators, and other market participants. As a result, accurate credit ratings can be compromised, in our opinion, in order for the credit rating agencies to protect and grow their businesses.

- *Credit rating agencies are paid by the issuers they are supposed to objectively rate and monitor.* In order for an issuer and its bonds or securities to receive credit ratings, that issuer pays one or multiple credit rating agencies. Therefore, CRAs are paid for ratings by the very same entities they are supposed to rate. Additionally, if the issuer does not like the credit ratings it might receive from a CRA, the issuer can sometimes “shop around” and take its business to the other two primary CRAs (in certain situations, issuers have been able to receive feedback from the rating agencies on what their credit ratings would be prior to those ratings being released to the public). Therefore, issuers may be able to play the rating agencies off against one another for better quality ratings. As a result, the credit rating agencies can be torn between providing a quality rating and achieving higher revenues.
- *The primary credit rating agencies are also owned by publicly traded companies that try to satisfy their investors' expectations, potentially at the expense of ratings quality.* The pressure to deliver good financial results on behalf of shareholders can further increase pressure on rating agencies to sacrifice producing quality ratings for higher revenues. CRAs' executives are also given stock and options, which could also magnify this potential conflict of interest.
- *Pressures from other forces (i.e. regulators, large investors, politics) could influence ratings as well.* For example, if regulators threaten to use a different ratings system, that action might change a rating agency's behavior. As another example, an investor we follow discovered that a company might have been rated to protect its value, not based on its true creditworthiness.

“In early September [2007], a senior Moody's executive confirmed this suspicion at a small private dinner sponsored by one of the brokerage firms. He said, “Moody's would never lower the credit ratings of a financial guarantor, because that would put the guarantors out of business.”⁷

As a result of the pressures and potential conflicts mentioned above, it is no surprise that credit rating agencies walk a fine line and can sometimes be influenced to the detriment of their ratings.

4) Communications among executives and employees of credit rating agencies were uncovered, giving more validity to our beliefs about the pressures the agencies face, and their potential willingness to sacrifice ratings quality for more business. Examples are below:

- Moody's CEO recently summarized his firm's situation in a presentation to Moody's Board of Directors in October 2007:

"The real problem is not that the market does underweights [*sic*] ratings quality but rather that, in some sectors, it actually penalizes quality by awarding rating mandates based on the lowest credit enhancement needed for the highest rating. Unchecked, competition on this basis can place the entire financial system at risk. It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want rating downgrades; short-sighted bankers labor short-sightedly to game the rating agencies for a few extra basis points on execution. Moody's for years has struggled with this dilemma. On the one hand, we need to win the business and maintain market share, or we cease to be relevant. On the other hand, our reputation depends on maintaining ratings quality (or at least avoiding big visible mistakes)... [Moody's] Analysts and [Managing Directors] are continually "pitched" by bankers, issuers, investors – all with reasonable arguments – whose views can color credit judgment, sometimes improving it, other times degrading it (we "drink the kool-aid")."⁸

- A conversation between two employees at Standard & Poor's in April 2007 communicating via instant messenger:

Employee 1: btw – that deal is ridiculous

Employee 2: i know right...model def does not capture half of the risk

Employee 2 (again): risk

Employee 1: we should not be rating it

Employee 2: we rate every deal

Employee 2 (again): it could be structured by cows and we would rate it

Employee 1: but there's a lot of risk associated with it – I personally don't feel comfy signing off as a committee member.⁹

- Another document revealed this comment from an employee at Standard and Poor's:

"Rating agencies continue to create [an] even bigger monster — the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters."¹⁰

5) Our experience leads us to believe that credit rating agencies may have deficiencies in their ratings process at times. Examples follow:

- *Credit rating agencies may underestimate the importance of various factors.* For example, we have come across companies that have cash approximating their debts, a good track record of cash flow generation that is highly likely to persist, no bond covenant violations, and various margins-of-safety that should make those companies' bonds quite safe (i.e. if something really bad happens, the companies have lines of credit extended from the banks and/or saleable assets

to make good on their obligations). However, CRAs have rated some of these companies as more speculative than we would have thought. We have recently purchased bonds with these types of characteristics for appropriate account styles, and the outcomes so far have exceeded our expectations.

- *We believe credit ratings are not always updated on a timely basis.* Some recent events have helped us conclude this:
 - We own bonds in companies that have seen vast improvements in their balance sheets and operations relative to expectations this year, and yet they have not received upgrades from CRAs.
 - As bonds get closer to maturity and companies that issued those bonds have the resources available to easily retire them, we feel those bonds' creditworthiness increases. However, we feel rating agencies do not take this into account appropriately.
- *We believe credit rating agency rules may not always differentiate the varying creditworthiness of various bonds issued by the same company.* For example, a company may issue bonds that are backed by certain assets of the company (i.e. property) in the event of a default and bonds that are not backed by any assets in the event of a default (called "unsecured" assets). We believe some ratings may not adequately distinguish the safety profile of some of these different bonds issued by the same company.
- *Sometimes no ratings for bonds exist, so you have to do your own homework if interested in those bonds.*
- *The same rating may not mean the same thing across different asset classes.* For example, data from Standard & Poor's and Moody's show that *municipal* bonds receiving any investment grade ratings (at least BBB and Baa respectively) have lower historical default rates than *corporate bonds* receiving Standard & Poor's and Moody's highest investment grade ratings (AAA and Aaa respectively). This is an important data point that could lead one to argue some municipal bonds might receive lower ratings relative to corporate bonds. One CRA has acknowledged this "dual rating system" and intends on changing its ratings to improve comparability.¹¹

6) *Regulatory changes are brewing in response to credit rating agencies' role in contributing to the recent financial crisis, and credit rating agencies may not exist in their current forms going forward.* In the aftermath of the most recent financial crisis, regulators are scrutinizing the credit ratings industry and trying to improve it. At the same time, new competitors and business models may be emerging.

7) *Even if credit rating agencies correctly handicap a security's creditworthiness, their ratings may ignore other factors that may be of importance to investors.* For example, a bond with a high investment grade rating still may be difficult to buy and sell at reasonable prices (liquidity risk). Additionally, we believe bonds with speculative grade ratings can actually be good investments. Acceptable bonds with speculative grade ratings would have good margins-of-safety, have large upside relative to their risks, and be part of a diversified portfolio.

Conclusion

Significant importance is placed on credit rating agencies by various market participants. As a result of credit rating agencies making mistakes that contributed to the financial crisis, the agencies are currently under tremendous scrutiny. New regulations, additional competition, and changes to the system are currently being contemplated in an attempt to improve the business of analyzing credits. Credit rating agencies can provide helpful data, but we acknowledge they are subject to pressures and faults, and we only use them as part of our analysis of bonds and stocks. We do not pretend to know what the credit ratings industry will look like in the future, but we use the data in the marketplace to make informed investment decisions.

¹ Borrus, Amy, Mike McNamee, and Heather Timmons. "The Credit -Raters: How They Work and How They Might Work Better." *BusinessWeek* 8 Apr. 2002: 38+. Print.

² United States. Cong. House. Committee on Oversight and Government Reform. *Committee Holds Hearing on the Credit Rating Agencies and the Financial Crisis*. 110 Cong. H. Doc. Committee on Oversight and Government Reform. Web. Sept.-Oct. 2009. <<http://oversight.house.gov/story.asp?ID=2250>>.

³ United States. Cong. House. Committee on Oversight and Government Reform. *Committee Holds Hearing on the Credit Rating Agencies and the Financial Crisis*. 110 Cong. H. Doc. Committee on Oversight and Government Reform. Web. Sept.-Oct. 2009. <<http://oversight.house.gov/story.asp?ID=2250>>.

⁴ United States. Cong. House. Committee on Oversight and Government Reform. *Committee Holds Hearing on the Credit Rating Agencies and the Financial Crisis*. 110 Cong. H. Doc. Committee on Oversight and Government Reform. Web. Sept.-Oct. 2009. <<http://oversight.house.gov/story.asp?ID=2250>>.

⁵ Borrus, Amy, Mike McNamee, and Heather Timmons. "The Credit -Raters: How They Work and How They Might Work Better." *BusinessWeek* 8 Apr. 2002: 38+. Print.

⁶ Joynt, Stephen W. Message to Jonathan G. Katz. 12 Nov. 2002. E-mail.

⁷ Einhorn, David. 17th Annual Graham & Dodd Breakfast. Heilbrunn Center for Graham & Dodd Investing, New York City. 19 Oct. 2007. Speech.

⁸ United States. Cong. House. Committee on Oversight and Government Reform. *Committee Holds Hearing on the Credit Rating Agencies and the Financial Crisis*. 110 Cong. H. Doc. Committee on Oversight and Government Reform. Web. Sept.-Oct. 2009. <<http://oversight.house.gov/story.asp?ID=2250>>.

⁹ United States. Cong. House. Committee on Oversight and Government Reform. *Committee Holds Hearing on the Credit Rating Agencies and the Financial Crisis*. 110 Cong. H. Doc. Committee on Oversight and Government Reform. Web. Sept.-Oct. 2009. <<http://oversight.house.gov/story.asp?ID=2250>>.

¹⁰ United States. Cong. House. Committee on Oversight and Government Reform. *Committee Holds Hearing on the Credit Rating Agencies and the Financial Crisis*. 110 Cong. H. Doc. Committee on Oversight and Government Reform. Web. Sept.-Oct. 2009. <<http://oversight.house.gov/story.asp?ID=2250>>.

¹¹ Grossman, Robert, et al. *Exposure Draft: Reassessment of Municipal Ratings Framework*. Rep. Fitch Ratings, 2008. Print.

Disclosure: The information provided by third parties has been obtained from sources believed to be reliable, but accuracy and completeness cannot be guaranteed