The Quiet Power of the Ratings System

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In a landmark judgement, the Federal Court of Australia ruled in early November 2012 that one of the big three rating agencies, Standard and Poor's (S&P), put out assessments of the safety of complex derivatives issued by ABN Amro and named constant proportion debt obligations (CPDOs) that were either "false" or "negligent misrepresentations". When ABN Amro launched these instruments in 2006, the Financial Times (November 13, 2006) defined a CPDO as a structured product that is "essentially a leveraged bet on the credit quality of a bunch of US and European investment-grade companies. It aims to generate income by selling protection on the two main indices of credit default swaps – which offer a kind of insurance against non-payment of corporate debt – the iTraxx Europe and the Dow Jones CDX." These indices measure the performance of holding the respective CDS contracts.

S&P had awarded its highest triple A rating to ABN Amro's CPDOs, implying that the probability of loss in the value of those instruments was negligible. But their value collapsed two years later. The Australian court held that S&P and ABN Amro had "deceived" and "misled" 12 local councils, which invested in these instruments, and suffered considerable losses. John Walker, the executive director of IMF Australia, a litigation company that fought the case, is quoted by the Financial Times as estimating that the councils could receive as much as $16.5 million in damages. The judgement, some expect, would also strengthen the case for regulating the ratings agencies and make them financially responsible for their assessments.

The substance of the judgement is no surprise. The financial crisis of 2008 showed that many instruments, especially mortgage backed derivatives of various kinds, which had been rated high by the likes of S&P, Moody's and Fitch, could quickly turn into junk. This had badly damaged the credibility of these agencies. To add, an intensifying battle among the big three (besides some new entrants) for a larger share of the ratings business, has led to each accusing the others of shoddy and inadequate research to back the ratings they give. Thus the industry itself gave credence to the view that the scores they award were not to be trusted, even if for partisan reasons. As a result, the rating agencies have little credibility left. But they still ply their business and are routinely quoted, because the financial industry does not want them replaced.

What comes as a surprise, however, is that the court admitted the case and ruled the way it did. Ratings agencies were not brought to book in the past because they build a firewall around themselves. In the fine print containing disclaimers in documents giving their scores, ratings agencies normally indemnify themselves from any claims against losses incurred by investors on investments motivated by these ratings. In addition, they have hidden behind the claim that their ratings were just opinions, and were, therefore, protected by constitutional guarantees of freedom of speech. Above all, it is difficult to establish conscious negligence when assessing a wrong rating, making victory in a case of fraud against a ratings firm difficult to achieve. So courts have tended to dismiss cases alleging fraud on the part of ratings firms.

The Australian judgement could mark a turning point. There are strong reasons to expect that there could be a spate of copycat litigation against the ratings agencies in jurisdictions outside

Australia, including the United States and Europe. This is not merely because of the strong judgement, but because of another case that has recently been admitted by Manhattan District Judge Shira Scheindlin. In that case filed in 2008, a set of institutional investors, including Abu Dhabi Commercial Bank and King County in Washington state, accused Moody's and S&P of having engaged in fraud by giving inflated ratings to a set of derivative products backed by subprime mortgages issued by Morgan Stanley through a structure investment vehicle called Cheyne. The admittance places the burden of assessing whether the ratings agencies were misleading investors on a jury. The case was admitted on the basis of evidence in the form of instant messages between two S&P analysts, which seemed to suggest that they were in the know that they were inflating ratings for poor products. "That deal is ridiculous," one analyst reportedly messaged, declaring that "We should not be rating it." "We rate every deal," the other analyst reportedly replied, leading to a response from the first analyst which said, "It could be structured by cows and we would rate it."

Even though it is not certain that this conversation was about Cheyne, it does suggest that analysts were being pressured into rating and offering good scores on products they held worthless. The judge ruled that the "plaintiffs have also offered sufficient evidence from which a reasonable jury could infer that the rating agencies did not believe the ratings when they issued them," while noting that, "Morgan Stanley manipulated the Cheyne SIV modelling process to create the ratings it desired," and "can be liable for aiding and abetting fraud."

There are about 70-odd other cases, related to mortgage backed instruments that went sour during the financial crisis, filed against the ratings agencies in the US, Germany and Italy. Forty have been dismissed or withdrawn and the others are in process. The Australian and US judgements could turn the tide against the ratings agencies as well as embolden others to turn to the courts, if their cases are not time barred by statutes of limitations. It could also dilute the fear that has thus far favoured the ratings companies, that an adverse judgement in one jurisdiction could lead to a flight of business to safer financial centres.

Moreover, anger against the agencies has been on the rise. As noted earlier, they were discredited during the global financial crisis because their ratings proved to be completely wrong when the crisis struck. They are seen to have overreacted to this error of theirs by turning over-cautious and conservative in their ratings, including on sovereign bonds. S&P even downgraded US Treasury bonds during the last standoff between the Democrats and Republicans over ratifying an increase in the prevailing ceiling on US public debt. And they are seen as having played a procyclical role in the current crisis in Europe, downgrading sovereign debt when governments were desperate to borrow more, and needed to be provided credit to prevent adverse fallout on other countries.

The ratings system as it exists is peculiar. Issuers of financial products turn to private firms to provide an 'independent' certificate of the safety and strength of their offers. That certificate is useful when canvassing buyers for these products among investors. Over time, regulators make the rating given by a recognised agency mandatory, especially because products become more complex and may be beyond the ken of investors or asset managers to fully comprehend and assess. In fact, in many instances those with fiduciary responsibilities (such as managers of pension funds) are required to invest only in triple-A or similar rated products. So a rating determines the market an issuer has. Finally, in many contexts, ratings are used to calibrate the risk-weights attached to financial instruments, when implementing the capital adequacy

requirement for banks under the of Basel norms. Banks would be more willing buyers of highly rated securities because they are required to set aside less regulatory capital against them. In sum, the ratings system and, therefore, the ratings firms have become a part of the regulatory framework in many countries.

There is a catch here, however. The independence of the agency could in principle be compromised because the issuer pays for getting the rating done, especially since ratings agencies are corporates treating their work as a source of revenues and profits. Having a reputation of being strict when awarding a rating could see business shifting to competitors. On the other hand, having a reputation for being lenient could damage reputations among investors, making issuers turn to agencies with a better reputation. As a result, the agencies perform a tightrope walk between colluding with issuers to win business, and winning a reputation among investors of being independent to attract issuers seeking their certificate for its value. The evidence seems to be that during the pre-crisis boom they had fallen off the rope, erring on the side of being excessively optimistic.

Clearly it is time to resolve the fundamental conflict of interest involved in making scores provided by a paid examiner the basis for financial regulation. That was a conclusion forced on the system by the 2008 crisis. However, this need to be part of a package of more stringent regulation on other segments of the financial system as well. Not surprisingly, the calls for regulating the rating agencies or changing their ownership structure have thus far not been adequately heard. Perhaps the Australian court's initiative will change matters.

* This article originally appeared as the H T Parekh Finance Column in the Economic and Political Weekly, Vol. XLVII, No. 50, December 15, 2012.