



Rating agencies role in financial crises; lessons learned; the way forward



Abstract:

Rating Agencies (CRAs) give opinion as to relative strength of any entity to meet financial obligations. Like any business in the world, the business of CRAs comes with its own risk. The risk is: Opinion going wrong. The latest edition of financial crises brought this risk to limelight. This magnified their penetration into our financial decisions. Investors had to incur significant losses when a number of rating opinions faltered. They were either late in identifying the risk (subprime mortgage loans) or hasten the crises by magnifying some risk (Banks and sovereign rating). Were CRAs negligent, incompetent, or dishonest?; we are still looking for the answer. Raters are being rated.

Rating agencies are still around and growing. Investors continue to believe in their opinions. We as a system value the ratings. Why? Can't they fail us again?

Notably a lot has changed for positive. Regulators realize the importance of strong oversight on CRAs; new laws, comprehensive code of conduct are being implemented. CRAs, more than ever, know that while being transparent they have to be intelligent in their methodologies and practices, For investors rating opinions are key inputs for final decision, but not the only tool. It is a better system now.

We have to understand ratings. These are not just opinions – these are knowledgeable and independent. If done right a rating provides valuable information to investor – the likelihood of default; but on a relative basis, not standalone.

A case in study

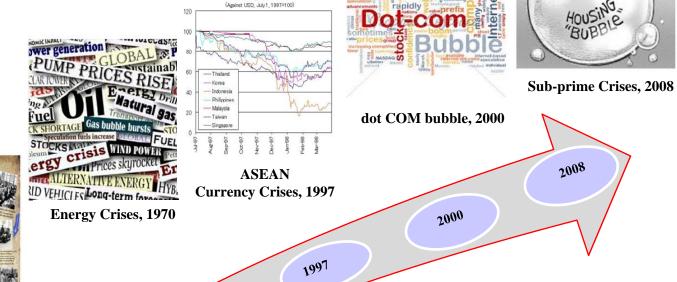
Securities and Exchange Commission of Pakistan (the apex regulator of CRAs in Pakistan) has comprehensively revised code of conduct applicable on CRAs. While ensuring that all relevant information is disclosed by CRA in a timely manner, the code goes deep into processes, systems, and human resource. It has structured the framework for robustness of rating methodologies so that opinion stays current.





CRISIS





1970

Collapsing Currencies

Great Depression, 1935

THE CREAT DEPRESSION



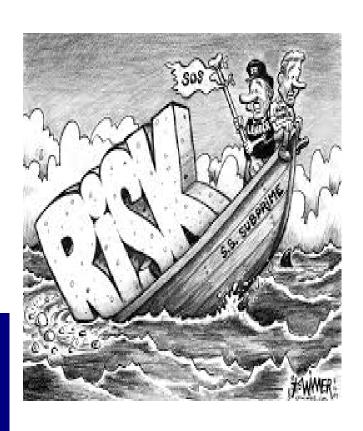
1935



2008



The Sub prime Crises, 2008



- Lost US\$5.7trn of potential GDP (Est for 2008 -2018*)
- Bailout package of more than US\$700bln**
- Key Institutions bailed out by Govts.

[Bear Stearns , Fannie Mae and Freddie Mac , Goldman Sachs , Morgan Stanley, AIG, Citigroup, RBS, Halifax Bank of Scotland, Chrysler, GM

LEHMAN BROTHERS

9815/95-8675

THE WATCHDOG THAT DIDN'T BARK

NAMES SECTION 1 Sairs WS Work burning

Crisis on Wall Street as Lehman Totters, Merrill Is Sold, AIG Seeks to Raise Cash

Fed Will Expand Its Lending Arsenal in a Bid to Calm Markets; Moves Cap a Momentous Weekend for American Finance

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Ultimatum By Paulson

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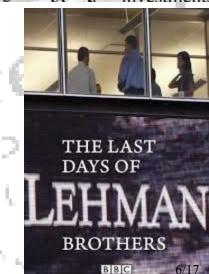
















Financial Crises | Who's blamed?

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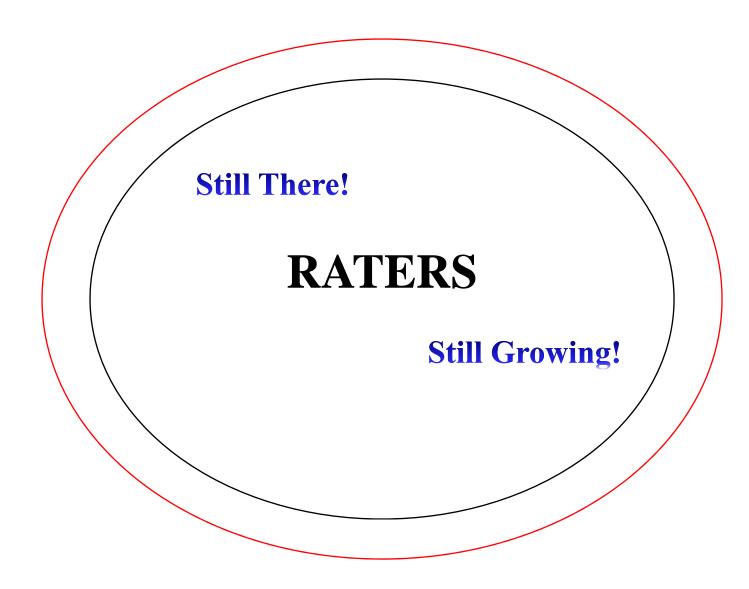
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Credit

Rating

Agencies

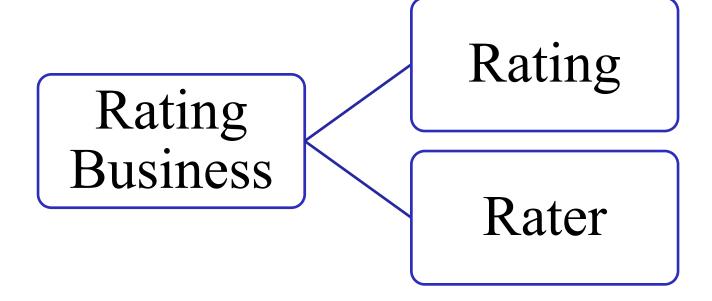








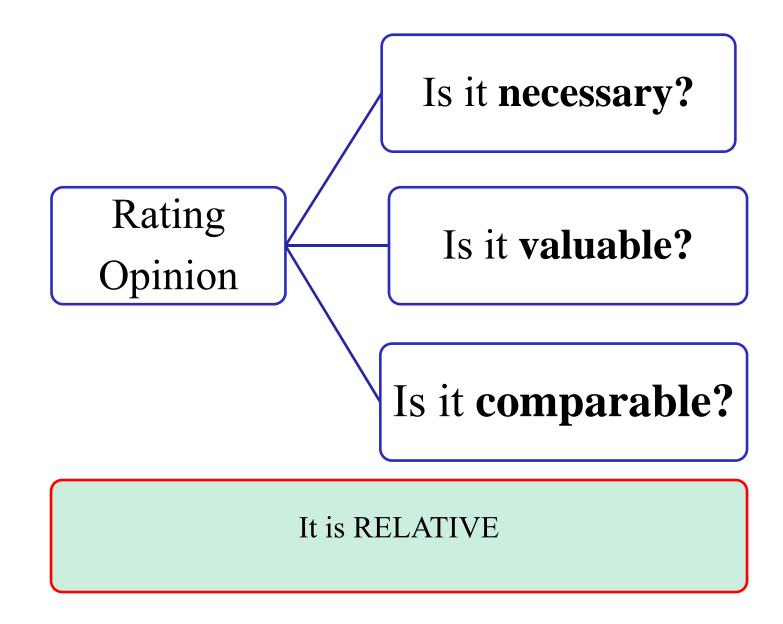
Understanding Rating Business







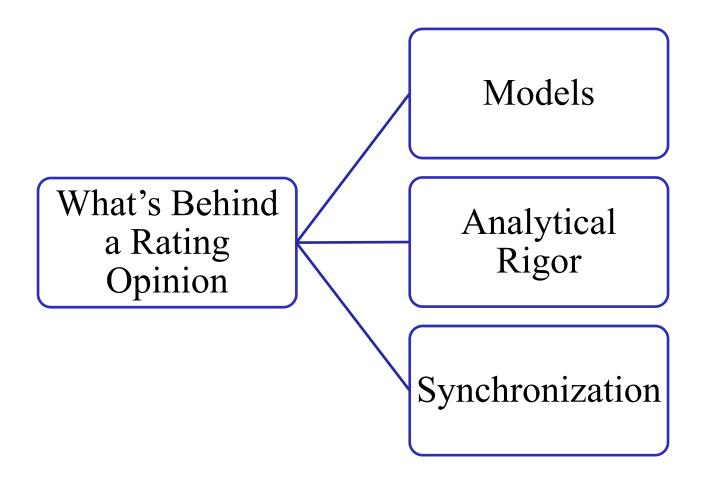
Understanding Rating Opinion





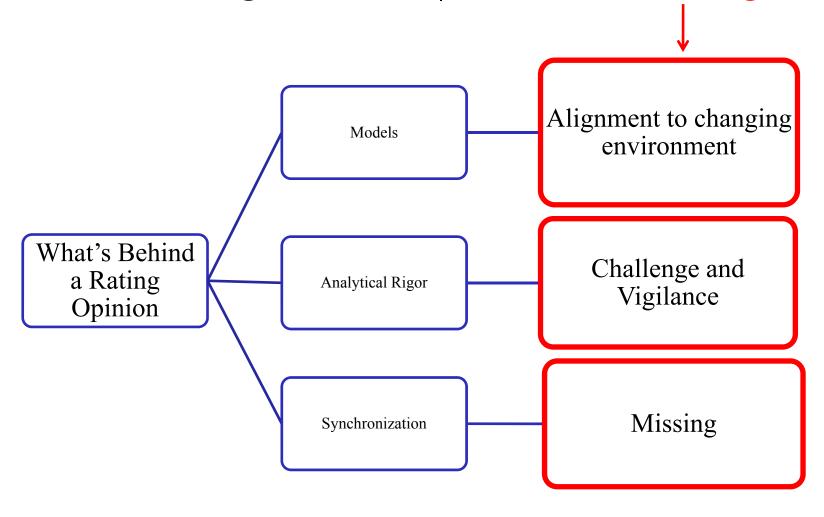


Understanding the Rater





Understanding the Rater | What went wrong?







Lessons learned | Rating Business post crises

RATER being RATED by

Regulators

- Enhanced disclosure requirements
- Strict Codes of Conduct
- Vigilant eye on the Rating processes and policies

RATER being RATED by

External Environment [Investors, Competition]

- Ratings to be used in conjunction with other risk parameters
- Competition | Domestic, Global

RATER being RATED by

Credit rating Agencies themselves

- Opportunity to reflect and improve
- Strengthening of internal control environment





Today



Today

CRAs are conscious as to the fiduciary responsibility

Regulated vigilantly

More CRAs are around

Investors understands that Rating is an input to decision; not the decision Opinion

Knowledge

Independence





Unanswered Questions

Conflict of Interest

Who pays for the RATING

Timeliness

We haste, We trigger We wait, we loose value





A case in Study | Close to Home

Two CRAs



Two Apex Regulators

Comprehensive CoC



Better Oversight - a benefit of being small



It is a better system now!

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