

Rating the Raters

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.



DURING 17th CENTURY'S TULIPMANIA ONE BULB COULD REACH THE PRIZE OF AN AMSTERDAM TOWN HOUSE



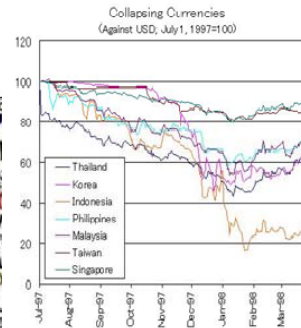
Tulip Bubble , 1637



Great Depression, 1935



Energy Crises, 1970



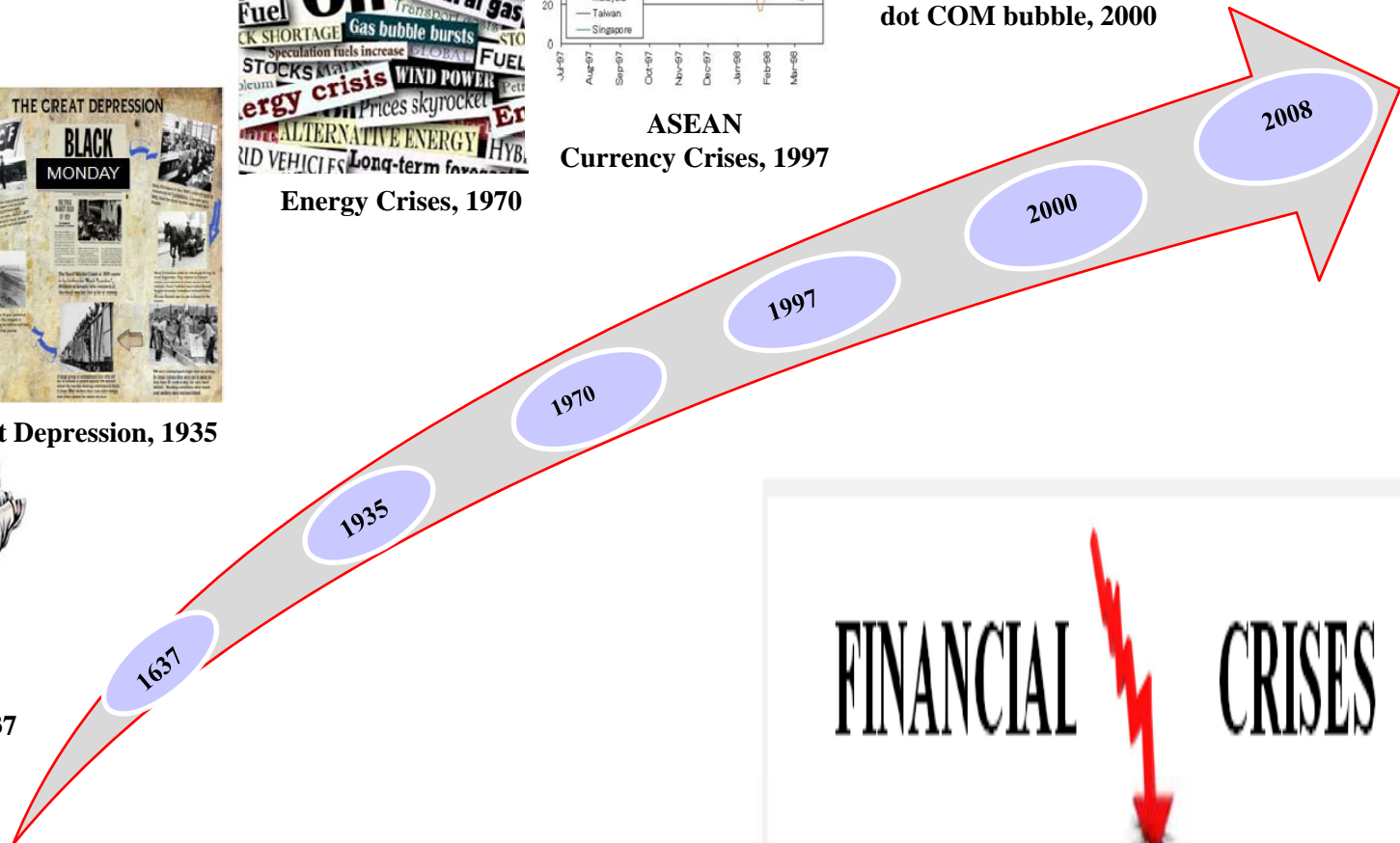
ASEAN Currency Crises, 1997



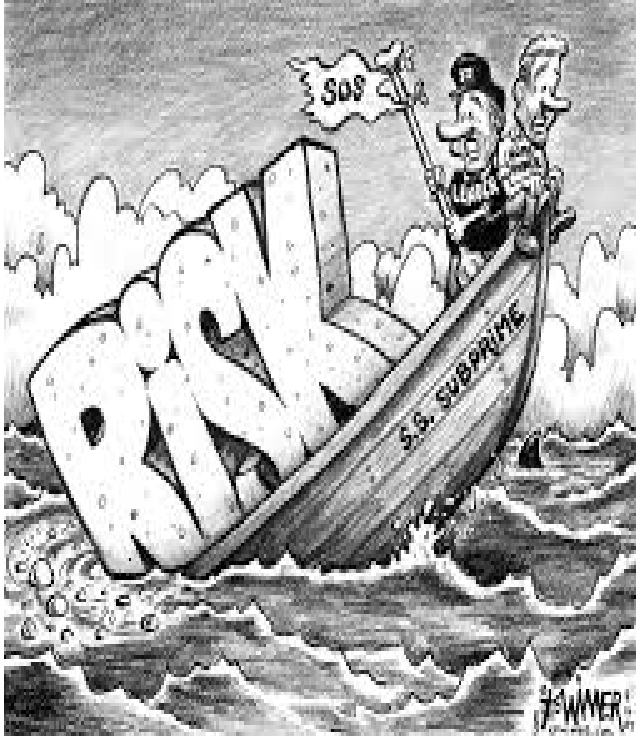
dot COM bubble, 2000



Sub-prime Crises, 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

THE WATCHDOG THAT DIDN'T BARK



By Carrie Malenka, Suzanne O'Leary, Serenely and Anne Luchetti
The U.S. government, which talked out Merrill Lynch and AIG, agreed to the terms to rescue the firm in a move to stabilize the financial system. Though it's not clear, the Fed's move to stabilize the financial system, which talked out Merrill Lynch and AIG, agreed to the terms to rescue the firm in a move to stabilize the financial system.



THE WALL STREET JOURNAL.

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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

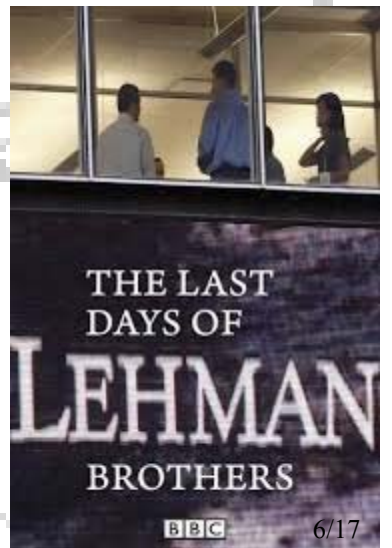
The American financial system is shaken to its core on Monday as Lehman Brothers filed for bankruptcy protection, Merrill Lynch was sold to Bank of America, and AIG sought to raise cash to avoid bankruptcy. The U.S. government, which talked out Merrill Lynch and AIG, agreed to the terms to rescue the firm in a move to stabilize the financial system. Though it's not clear, the Fed's move to stabilize the financial system, which talked out Merrill Lynch and AIG, agreed to the terms to rescue the firm in a move to stabilize the financial system.

Bank of America to Buy Merrill

Ultimatum By Paulson Sparked Frantic End

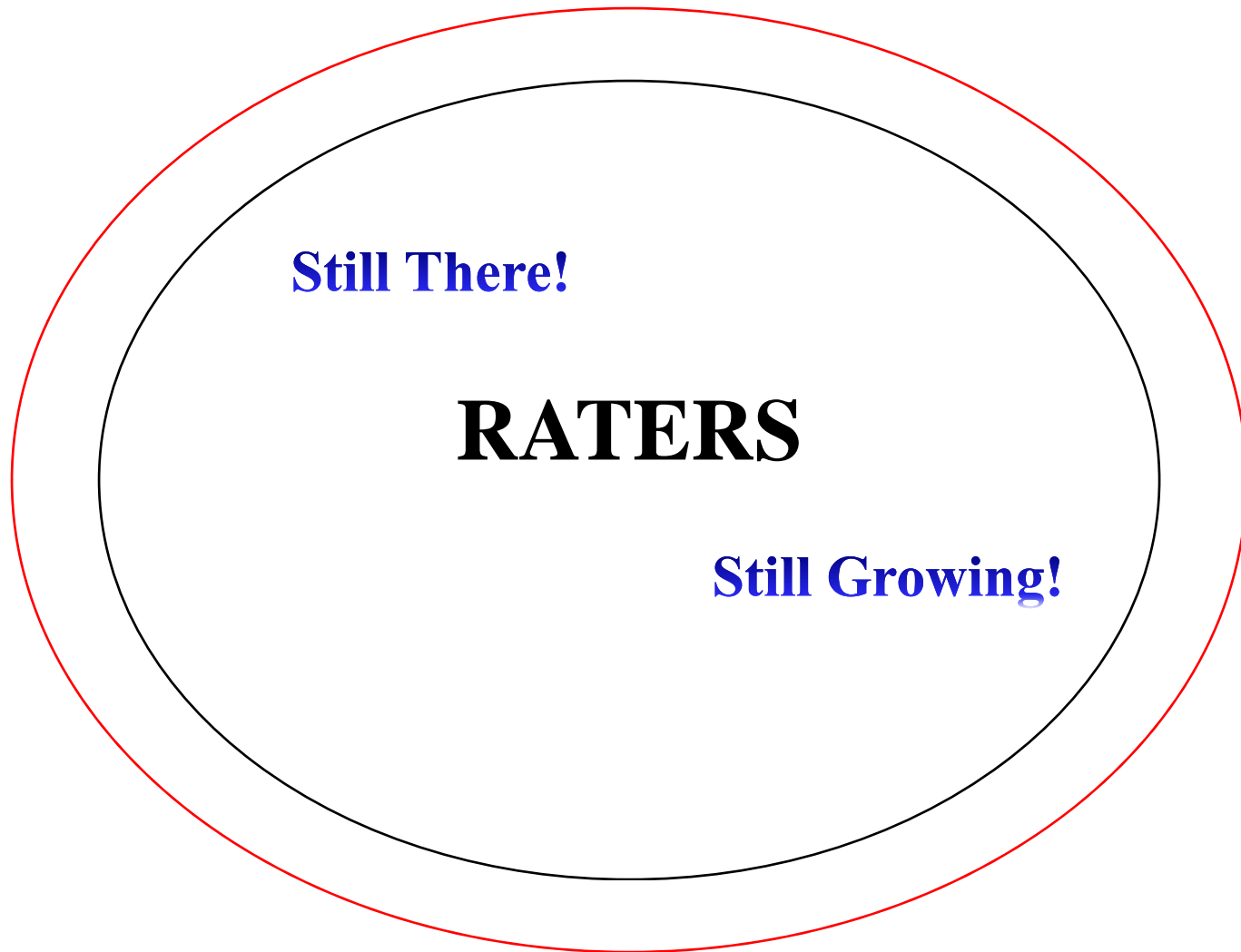


Markets plummet
Recession ahead
Bankruptcies feared

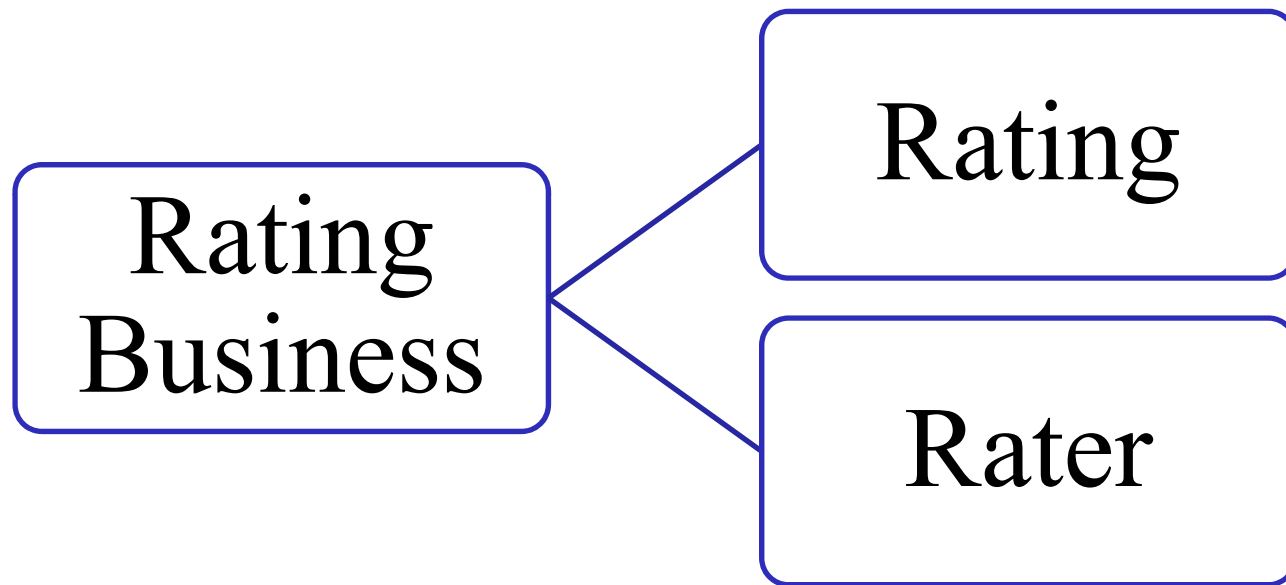


Financial Crises | Who's blamed?

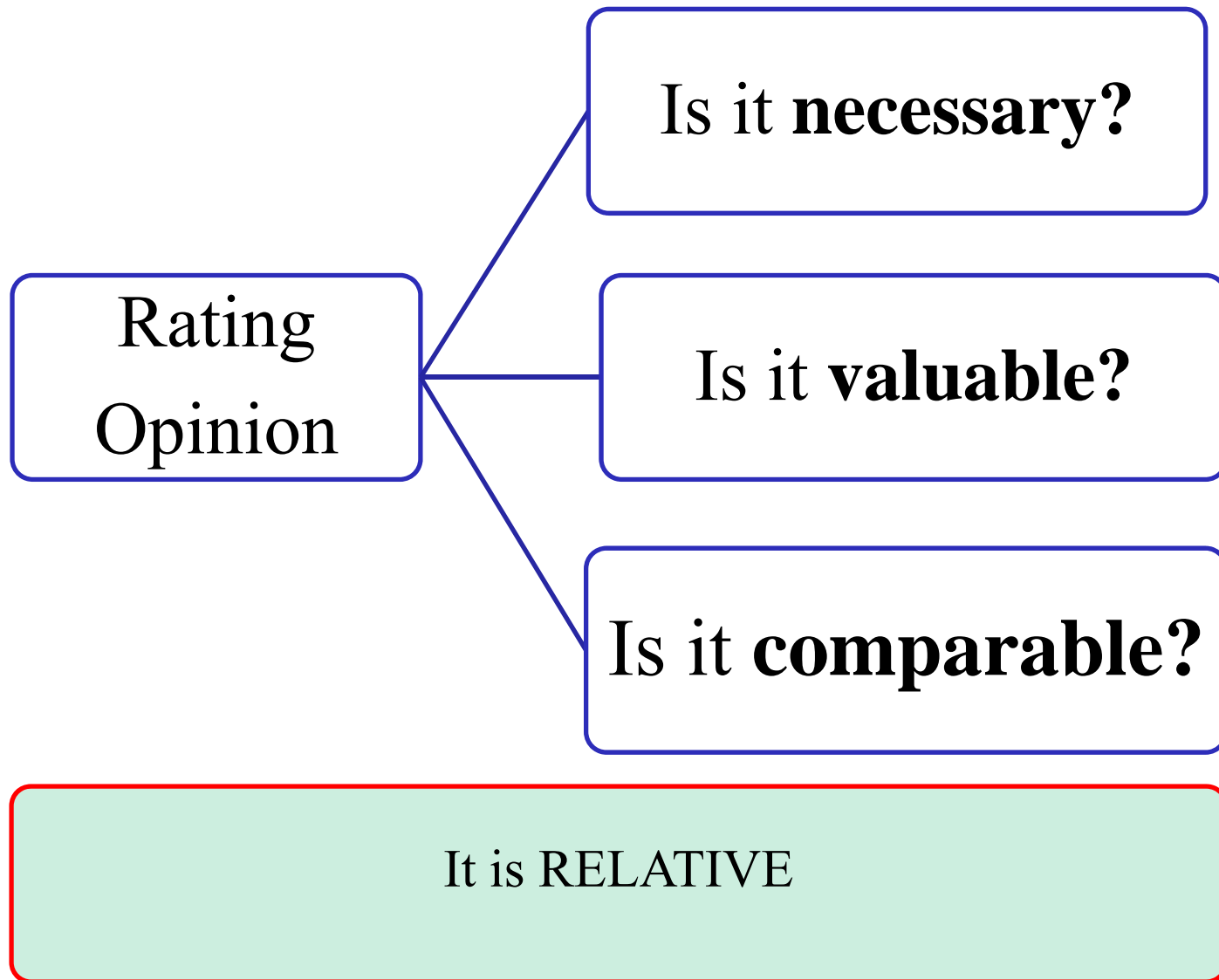
C	R	As
Credit	Rating	Agencies



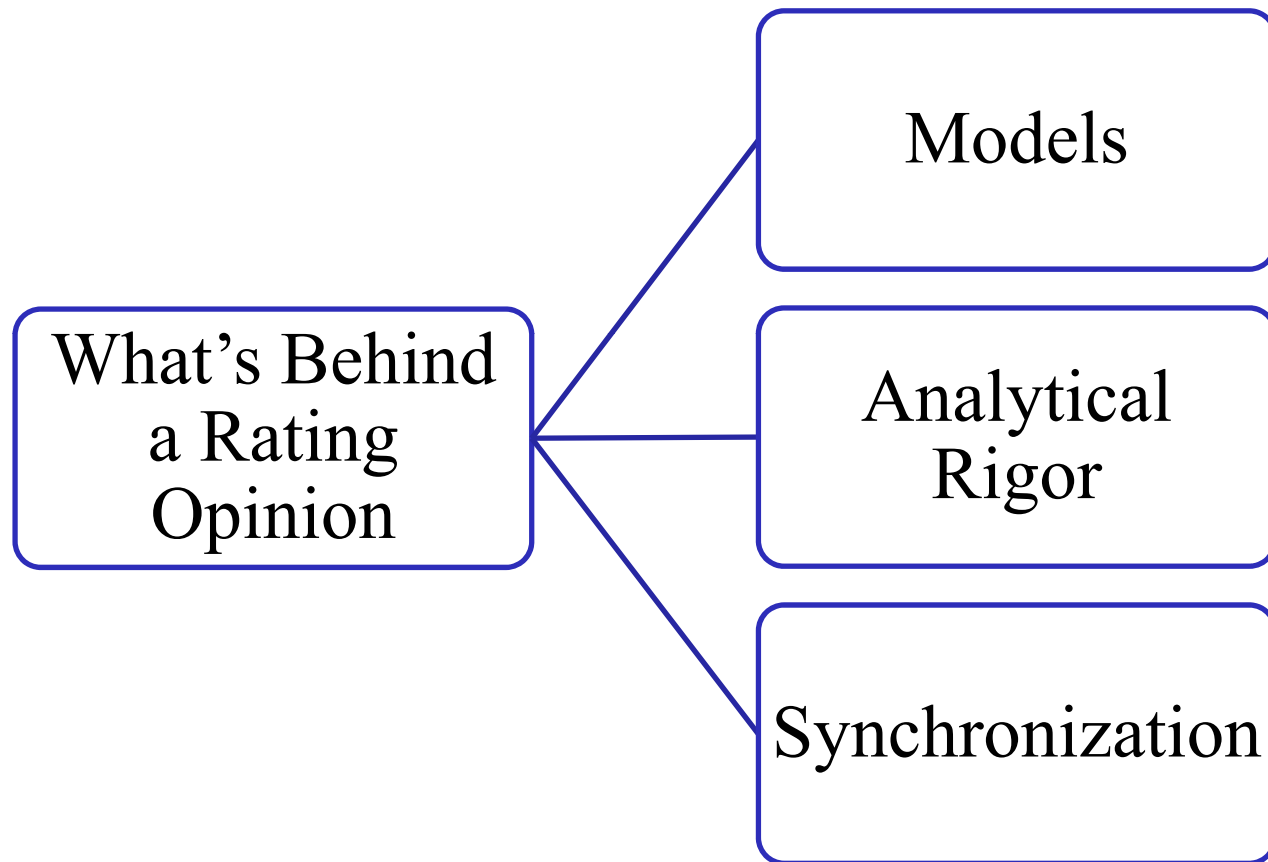
Understanding Rating Business



Understanding Rating Opinion

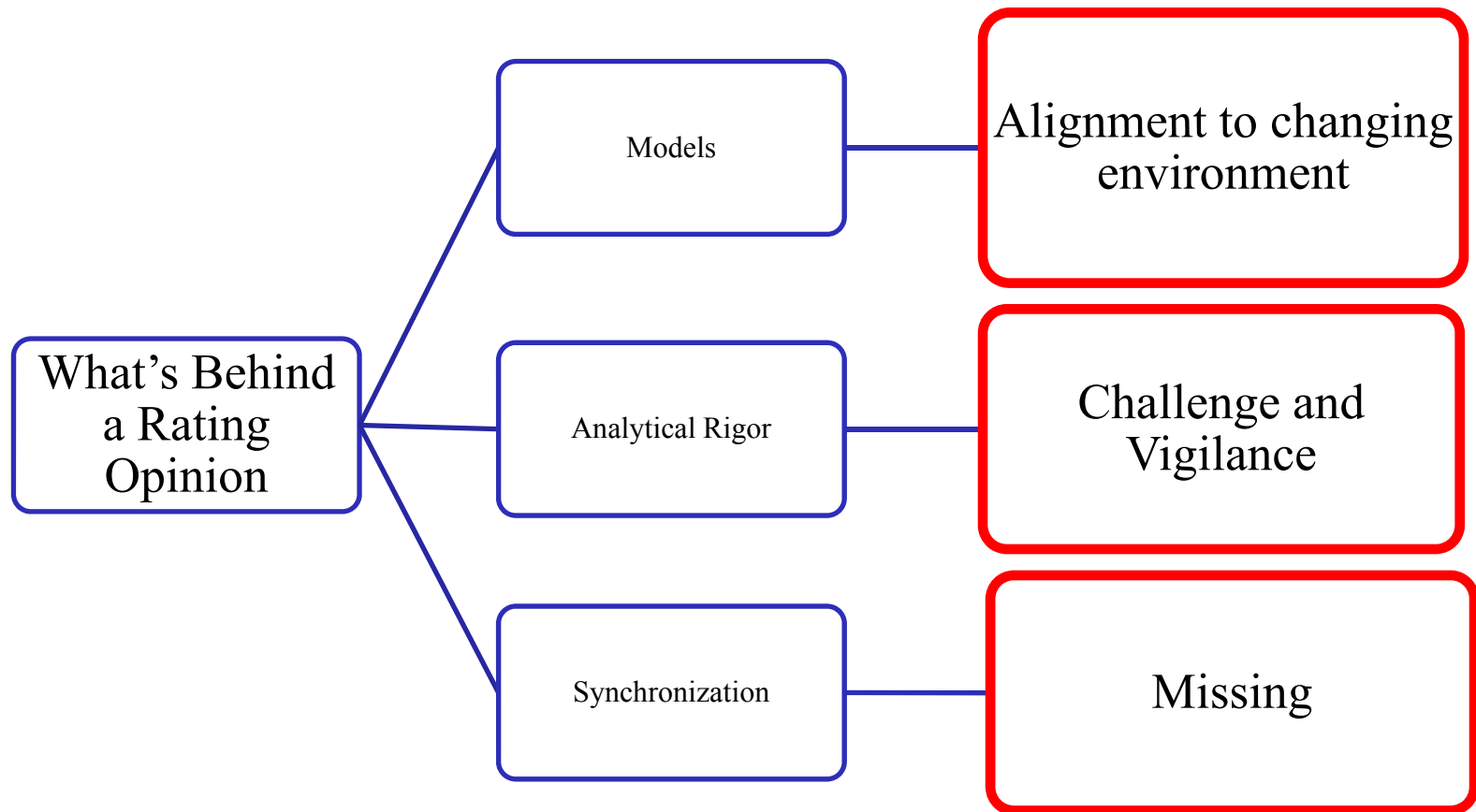


Understanding the Rater

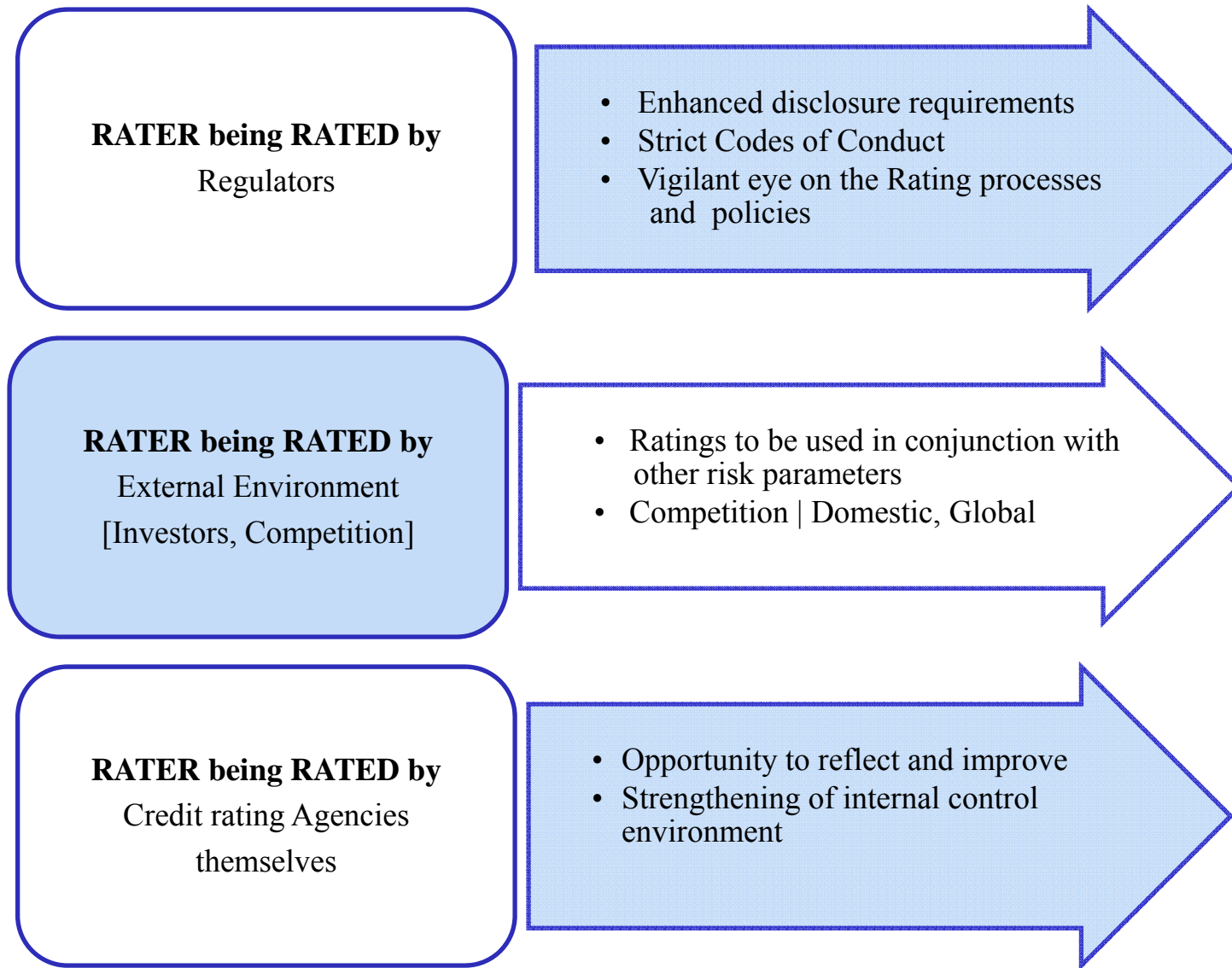




Understanding the Rater | What went **wrong**?



Lessons learned | Rating Business post crises





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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