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## Rating Canada's Credit Rating Agencies

The case for a better system

By Arthur Donner and Doug Peters

*"In recent months, Moody's Investors Service and its rivals, Standard & Poor's and Fitch Ratings, have featured in virtually every account of the What-Went-Wrong horror story that is the financial crisis. The agencies put their seals of approval on countless sub-prime-mortgage-related securities now commonly described as toxic. The problem, critics contend, is that the agencies were paid by the corporations whose debt they were rating, earning billions in fees and giving the agencies a financial incentive to slap high marks on securities that did not deserve them."*

—David Segal, Warren Buffett unusually silent on credit rating agencies, *International Herald Tribune* web site, March 18, 2009.

Credit rating agencies (or CRAs) play an incredibly important role in the world of financial intermediation. These agencies have also had important effects on both the source and the events of the recent financial crisis. It is therefore important that they be carefully scrutinized for their effects on promoting this financial crisis. These privately run firms assign a credit rating for issuers of certain types of debt obligations and debt instruments. The issuers of debt securities are usually corporations, governments (foreign or domestic), or non-profit organizations.

The largest of the American CRAs, which also operate world wide, are Moody's Investors Service, Standard & Poors, and Fitch Ratings, Ltd. In Canada, the Dominion

Bond Rating Service (DBRS) is the largest credit rating agency.

The published credit ratings are particularly important to investors, both retail and professional, since they rely on the ability and accuracy of the rating agency in providing an assessment of the risk involved in purchasing a particular form of debt security. Will the issuer be able to meet its contractual obligations to the lender, and of course, what are the chances of the debt issue going bankrupt or becoming insolvent?

Thus CRAs not only increase the supply of risk capital to the financial markets, but they also add to the overall efficiency of the capital market. On the supply of credit side, they provide credit risk information to a range of investors who normally could not undertake their own research. On the demand for funds side, the assigned rating of a credit agency allows borrowers such as small governments or even start-up firms to tap a source of funds that they might otherwise not have access to. But these positive effects are only there if the CRA's analysis is fair, unbiased, and accurate.

Because of the recent financial crisis, there has been widespread criticism of the large rating agencies, particularly related to the ratings of the mortgage-backed securities of the sub-prime borrowers and to the collapse of the collateralized debt obligation markets, many of which were provided with fairly high credit ratings.

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For example, according to Wikipedia, the losses on \$340.7 million worth of collateralized debt obligations (CDOs) issued by Credit Suisse Group added up to about \$125 million, despite being rated AAA or Aaa by Standard & Poor's, Moody's Investors Service, and Fitch Group.

Another U.S. example quoted by David Segal is as follows:

"Moody's rated Lehman Brothers' debt A2, putting it squarely in the investment-grade range, days before the company filed for bankruptcy. And Moody's gave the senior unsecured debt of the American International Group, the insurance behemoth, an Aa3 rating, which is even stronger than A2, the week before the government had to step in and take over the company in September as part of what has become a \$170 billion bailout."

Canada was of course not immune to all of this. When the \$32 billion Canadian asset-backed commercial paper market froze in August of 2007, it turned out that most investors believed that they were investing in safe, short-term investments, very similar to government Treasury bills.

DBRS was the only agency that rated Canadian asset-backed commercial paper issued by non-bank-sponsored trusts. Other rating agencies, notably Standard & Poor's, refused to rate the Canadian asset-backed paper, because of its potential for a liquidity crisis. DBRS nonetheless provided a fairly strong rating, and since then has received considerable criticism. DBRS is also the recipient of a major law-suit over its role in the failure of Canada's non-bank asset-backed commercial paper market.

Professor Edward J. Kane has noted: "Given the high proportion of revenues earned in recent years at the top three ratings firms (Moody's, Standard & Poors, and Fitch) from rating securitizations, individual managers and analysts must have been sorely tempted to risk the firms' reputation to secure or retain the repeat business of the biggest issuers." (Edward J. Kane, *"Who Should Bear Responsibility for Mistakes Made in Assigning Credit Ratings to Securitized Debt?"* Boston College, July 8, 2008.)

It is clear to us that, in both Canada and the United States, the method of remuneration of the rating

agencies have the distinct possibility of influencing decisions on ratings. The flaw in the rating of bond and money market instruments is that the private agencies are paid for their ratings by the issuers of those securities. This method of remuneration raises distinct questions of conflict of interest that might inhibit them from providing accurate and honest ratings.

The ratings of the sub-prime mortgage securities in the United States as investment-grade securities were clearly not warranted by the recent disastrous results. In Canada, the strong ratings of the non-bank asset-backed commercial paper were likewise not warranted. The rating agencies perform important tasks for the effectiveness of financial markets, but the question of conflicts of interest in their method of remuneration remain. Thus, the question these events raise is whether there is a better way to rate security issues?

We would prefer a marketplace with multiple credit rating firm options rather than the reliance on the dominant agencies, which may have conflicts of interest. In addition, we argue that there should be a regulation against debt obligation issuers paying the CRAs directly for the ratings. Either investors should pay for the ratings themselves or, if public ratings are deemed essential, they should be publicly provided.

The proposed Canada Securities Commission may be a first step in getting an independent domestic credit rating system. If the government were truly interested in an independent system of securities rating, then such ratings should be made free to the interested public, and should be provided by fully independent analysts and reviewers.

In other words, because of the importance of the credit rating service, such services could be provided and financed as a public good.

Such a system might work in the following way. First, the credit rating agencies approved by the Commission must be totally independent of the companies whose securities they rate. But where would their income come from?

When a new money market or debt security issue is proposed, the Commission would ask for bids on rating these securities from an approved list of firms and analysts. From those bids some three to five would be chosen to produce detailed reports. Those reports

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would be paid for by the Commission and, when completed, would be made available to the public on the internet.

The reports would include the details of the analysis made by the analysts, their findings, and a rating given by the analyst. With three to five independent reports available, the purchaser of debt securities would have clear independent advice. As well, the investor would potentially be able to make better decisions than in the past.

The current reports of the rating agencies are in most instances well researched and historically quite

accurate. But the question of independence remains as long as the rating reports are sponsored by the companies that issue or underwrite the securities.

In designing the new Canadian Securities Commission, the Canadian government should carefully consider the role of rating agencies and the question of their independence.

*(Arthur Donner is a Toronto-based economic consultant. Doug Peters is the former Chief Economist of The Toronto-Dominion Bank.)*