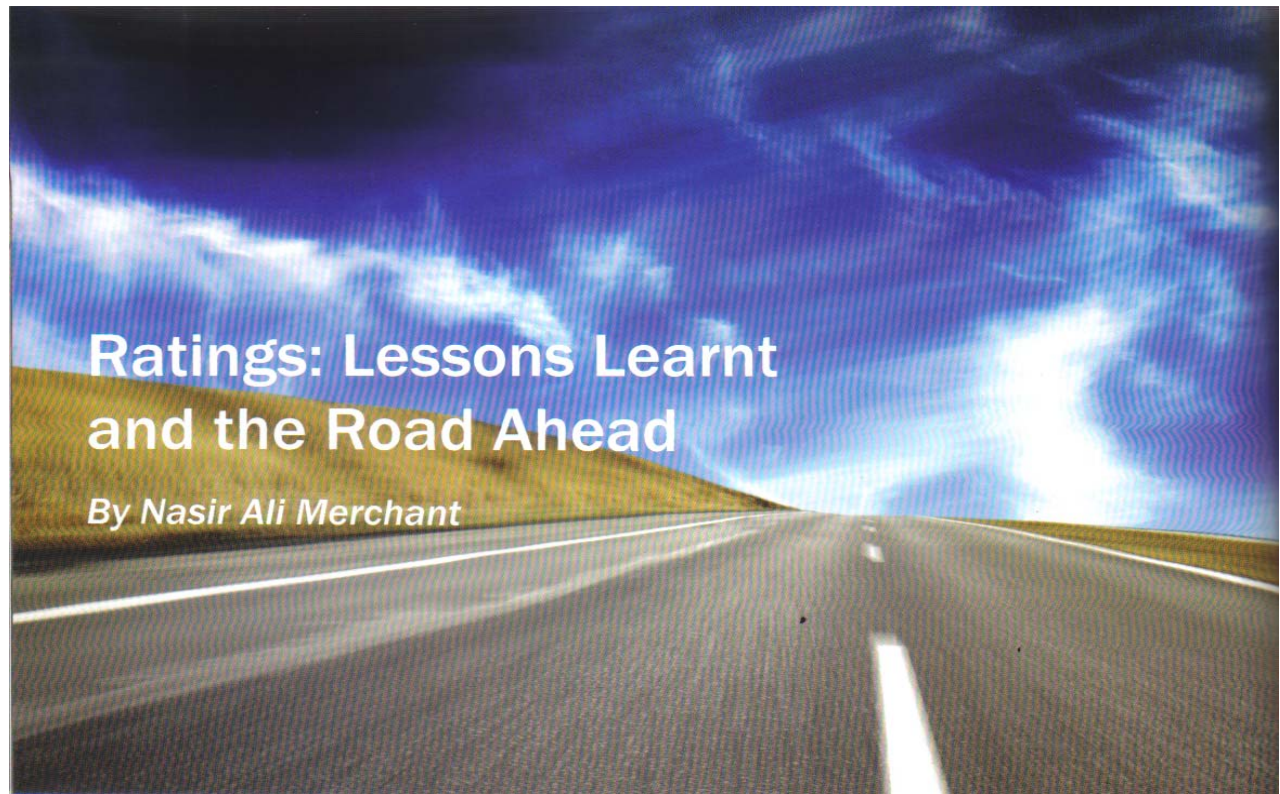


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# Ratings: Lessons Learnt and the Road Ahead

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## **Introduction**

The concept of ratings goes way back to 1909 when Moody's Investors Service (Moody's), inspired by Dun & Bradstreet, started this service in order to enhance value for its statistical manuals. Later on Fitch Ratings (Fitch) and Standard & Poor's (SP) emerged in the early part of the 20<sup>th</sup> century. These three were then and even today seen as the leading players in the rating industry.

In other parts of the world, the concept was gradually implemented from the 1980's onward. To date around 50 rating agencies have been established, some with the support of multilateral financial agencies like the International Finance Corporation. Most of these rating agencies are domestic in nature, focusing on their own country. These agencies have played a significant role in the development of capital markets in their respective countries like Malaysia, Pakistan, India, Bangladesh and Sri Lanka, to name a few.

Islamic finance, as we know, has been in existence since the early 1980's and has gained momentum in the last 15 years. While it has shades of similarity with conventional finance, there are certain distinguishing principles which form the backbone of Islamic financing.

The existing players in the rating industry have done appreciable work on this front. However, there was a need to have a rating agency which while

remaining a full service rating agency, focuses more on Islamic finance. With this in mind, the Islamic Development Bank took the initiative to form a rating agency. The move was supported by the leading market players of the Gulf Corporation Council countries including banks, Takaful companies and regulators. Thus Islamic International Rating Agency became operations in 2005.

## **The recent financial crisis**

In the current context, no discussion on rating agencies would be complete without first having a look at the recent financial crisis and the role played by the global rating agencies. Suffice to say, the rating agencies have to take the blame for it. However, all the stakeholders must realize that the rating agencies were a part of the problem and not the whole problem.

To explain this, let's recall that this whole crisis began from the US mortgage market (famously known as the sub-prime crisis). If we look at it more thoroughly, the root cause of the crisis was the government's desire to provide housing and shelter to the middle and lower middle income group. In order to fulfill this desire, institutions like Fannie Mae and Freddie Mac were given a more active role to play.

As a consequence, a large number of mortgage finance companies emerged and with rising home prices, and no government regulation, these mortgage finance companies devised high-interest,

high-fee schemes to entice families to take out loans that traditional savings banks would not give. Investors considered this high interest rate, sub-prime loans a goldmine. By 2007, the subprime business had become a US\$1.5 trillion global market for investors seeking high returns as Quoted by NHI president John Atlas and Occidental College professor Peter Dreier.

However, once interest rates began to rise and housing prices started to drop moderately in 2006 to 2007 in many parts of the US, refinancing became difficult. Hence when borrowers couldn't or wouldn't keep up the payments on these high-interest loans, what looked like a bonanza for everyone turned into a national foreclosure crisis and an international credit crisis.

It is also important to understand that until the beginning of the crisis, all the stakeholders (and not only the rating agencies) thought it was a win-win situation. The recipients of the loans were getting the kind of housing they would not have dreamed of, and for prices they considered cheap.

The regulators were happy as these instruments help them provide housing and shelter to those from the middle and lower middle income group. The investment bankers were willing to engage in it as more securities would mean more money for them.

Investors got into the trap because they thought that they were getting higher returns for less risk. Insurance companies were willing to engage because they were able to generate more revenues from these securities and for rating agencies it meant more securities, more assignments and more revenues.

### Where did the rating agencies go wrong

In a post-event analysis of the crisis, there were several areas where the rating agencies could have done better. They include:

- An error in judgment of characteristics of these securities because the global rating agencies relied heavily on economic models like Coupola, which had flawed assumptions about the defaults of mortgage loans and the correlation between the defaults of the mortgage loans.
- It is alleged that the rating agencies seemingly had a conflict of interest in rating these securities as some of them in one way or the other were also 'advising'

on these securities which means that they first earned fees from advising on how to structure bonds and derivatives and then would earn fees on actually rating those particular securities.

- The investment in terms of having the right number and quality of staff was not in correlation with the amount of business received, leading to the belief that at times the rating agencies were too busy to do an in-depth analysis of the securities that they were rating.

The concerning factor for the rating industry is its oligopolistic nature wherein only a few rating agencies overwhelmingly dominate the rating business. In a testimony before the US House Committee on oversight and government reform, Sean J Egan, managing director of Egan-Jones Rating Co, mentioned that according to Moody's itself, the three companies are responsible for 95% of global ratings with Moody's and S&P having a share of approximately 40% each, and with Fitch having a share of 16%.

The reason for this is that the credit rating agency market is perceived as having high "natural" barriers to entry. This is due to the fact that credit rating agencies require highly qualified analysts, as well as "high-tech" rating methodologies, some of which are proprietary. Moreover, credibility is an essential asset of credit rating agencies, which creates a further barrier to entry, since reputation takes time to achieve.

The regulators' use of these "credibility" criteria in order to recognize credit rating agencies for regulatory purposes further compounds the problem and it is feared that if this so-called criteria is applied continuously, then it would further increase the dominant position of the established global credit rating agencies -and thus potentially diminish credit rating quality, since smaller, recently created or foreign credit rating agencies that might otherwise produce objectively reliable ratings obviously would not be able to fulfill this so-called criteria.

#### Looking ahead - 2010 and beyond

The crisis has generated a lot of debate about the role of rating agencies, even to the extent of whether the rating agencies are needed at all or not. While this could be an emotionally valid question, logically it is difficult to understand a market without a third party independent and competent institution informing the stakeholders about its opinion on issues and issuers. We must recall that this kind of incidents have happened to other similar industries like auditing, however the answer there was also not to abandon the industry.

Another reaction to this was to enforce very heavy regulations on the rating industry, to the extent of having regulators owning these companies or the regulators deciding on which issue/issuer were to go to which rating agency. These may look fancy but based on past history and experience, regulation alone would not be a solution, in fact it will -me a problem in itself after sometime.

Another proposal, which is by no means new, is an investor-pay model rather than the issuer-pay model. Again, while this may look extremely ideal and attractive, its effectiveness has been limited in the past and unless investors are willing to commit to it seriously on a consistent long term basis, the effectiveness of the model would continue to remain limited.

In our view, there are two important stakeholders in the industry i.e. the regulators and the investors, and each of them have to play a part in ensuring that the probability of such incidents happening in the future is reduced.

The regulators have to increase the supervision and monitoring of the rating agencies by having a periodic look at their methodologies and to ensure that those methodologies are implemented in letter and spirit in a consistent manner. Regulators also have a great role to play in promoting competition between the rating agencies. This can be achieved by recognition to the relatively new local or regional rating agencies.

While no one argues that such recognition should be given after a very thorough review of the management and procedures of the new rating agencies, nevertheless they should be given an opportunity to present their case. This will help not only to increase transparency and disclosure but also to provide regulators and investors of a chance to judge the quality of work and the rating basis of each of the competing organizations.

Perhaps the most important player in this whole chain is the investor community. Investors should realize that ultimately they are the victims of error by any other stakeholder.

Therefore if they encourage more competition in the rating industry, then the regulators would also frame regulations for this purpose and the rating agencies may themselves take steps to help broaden the market.

How the investor can help achieve this aim, is when they give-up their undue reliance on a few rating agencies and provide an opportunity for relatively new rating agencies to rate their instruments. If they continue to have the same herd mentality and do not participate in breaking down the oligopolistic nature of the rating industry, then this cycle may be repeated.

Another important outcome of the crisis for all parties involved was the standing of Islamic finance. With an asset-backed rather than an asset-based approach, and with limitations on leveraging, Islamic principles of financing have proven to be an alternative and more ethical way of financing, which if implemented globally in letter and in spirit, may have helped to reduce the impact of the crisis.

The challenge for the stakeholders in Islamic Finance for 2010 and beyond is to accelerate the pace of product and institution development to fulfill the desire and the dream of having Islamic principles becoming the main mode of financing in global markets. ☺

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