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On Focus and In Depth

Light Reform Keeps Credit Derivatives, Rating Agencies in Shadows

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Last in a series

Corporate greed, moral hazard, lax oversight and foolhardy underwriting all contributed to the crisis in finance. Another factor, less useful for sloganeers but no less insidious, was the simple mispricing of risk.

When this large-scale mistake was revealed, much of the blame fell to the credit rating firms that were supposed to help measure risk, and to the credit-default swaps that were supposed to help manage it.

But despite all the handwringing over conflicts of interest in the assignment of ratings, despite all the concern about the shadowiness of a derivatives market with such systemic implications, little by way of concrete regulatory reform has emerged to prevent the problems from recurring.

The capital markets "must be empowered with the right information to detect risky behaviors and penalize companies before it's too late," said Leo Tilman, the president of the L.M. Tilman & Co. advisory firm and author of "Financial Darwinism: Create Value or Self-Destruct in a World of Risk." "So far, this is not happening on the necessary scale."

Without a fresh approach to gauging and handling risk, Tilman said, a financial system overhaul that redesigns the supervisory structure, tightens capital standards and lays out new responsibilities for boards and executives is only half complete.

Last fall, the credit derivatives market looked to be a large enough source of systemic risk to argue for a government bailout of American International Group Inc. But no one examining the market could really tell who was on the hook for what. This information gap also fueled grave concerns about the potential counterparty risks posed by the failure of Lehman Brothers.

Up until then most of what was known about the credit-default swaps market came from twice-yearly surveys by the International Swaps and Derivatives Association, a private group that had estimated the size of the market at a notional $62 trillion in late 2007.

In a sign of the times, the market appears since then to have shrunk to half that amount, based on ISDA's survey for the first half of 2009.

"Obviously the market will bring in a certain amount of discipline itself," said Geoffrey Aronow, a partner at the Bingham McCutchen LLP law firm in Washington. But he said the government should play a stronger regulatory role in this market — a task that would require no small amount of resources and expertise to keep up with the industry.

In the weeks after AIG's rescue and the successful settlement of swaps covering the Lehman default, the Depository Trust and Clearing Corp., which operates a central registry for credit-default swap trades, started publishing weekly market data. The data did not show the accumulated exposures of individual buyers and sellers of derivatives, but it did disclose the amount of insurance-like protection written on individual bond issuers and credit-default swap indexes.

HOLES IN COVERAGE

Another layer of assurance entered the market in March when Intercontinental Exchange Inc. began clearing credit-default swap trades, standing between buyers and sellers as a central counterparty and marking positions daily to ensure that appropriate margins are kept on account.

ICE so far has cleared $4.3 trillion of credit-default swaps on a notional basis, primarily involving credit-default swap index

products. After winning regulatory approval last week, it is expected to start processing trades today on U.S. contracts covering single-name entities, beginning with utility companies.

But ICE is set up only to clear standardized contracts. This leaves out a swath of the market that is not easily sized up but was busy enough at one time for AIG to get in trouble. It wrote vast amounts of customized credit-default swaps on collateralized debt obligations, or CDOs, tied to mortgages.

By shedding light on even a portion of the market, the disclosures about standard credit derivatives have made investors safer, said Tim Backshall, the chief strategist at Credit Derivatives Research, which gives clients credit market trading ideas and analysis.

"However," Backshall warned, "the great majority of the efforts so far have been focused on standardization, margining and clearing — all laudable efforts, but they do very little for the real problem areas of the bespoke CDO market where leverage and opacity really lurk and, in fact, where most of the systemic threat appears."

The calamity at AIG may stop other companies from engaging in similar behavior. But there is no way to be sure of that unless proper controls are put in, and even that might not be a perfect defense.

The frustration of not having a handle on all the risks in this market is familiar to Aronow, the Bingham McCutchen partner. He was enforcement director at the Commodity Futures Trading Commission in the late 1990s when it lost a fight with former Federal Reserve Chairman Alan Greenspan and others who opposed the agency's suggestion that the burgeoning credit derivatives market be examined for potential regulatory issues.

"It just seemed unreasonable to have a market of this size with the kind of risks and leverage that go with it and not insist on knowing more about what was going on there," he said.

Aronow was not certain then that the market needed substantial curtailing, and a decade later he still sees a place in the system for a thriving credit derivatives market. What he is less sure of is the government's ability to keep up with the complexities that Wall Street has a habit of spawning, including those embedded in credit derivatives.

But he does expect some form of supervision to crystallize as soon as regulators and derivatives dealers resolve their biggest disagreements over the reach of supervision, and after the regulatory agencies fight their own turf battles.

"I'm still optimistic that at the end of the day there's a final push and all these issues that seem to be dividing people either get resolved or put off to another day and something is done," Aronow said. "We generally are pretty effective at solving the last problem. It's a lot more difficult to see where the next one is going to come from."

STICKY RATINGS ISSUES

A similar challenge presents itself on the credit ratings front, where companies that last year looked to be an easy target for reform have not yet faced their day of reckoning with regulators.

The calls that Moody's Investors Service, Standard & Poor's Corp. and some of their smaller rivals made on a long list of credits, ranging from big corporations like Lehman to esoteric products like CDOs, burned many of the investors that relied on these opinions and turned a spotlight on the process by which ratings companies are paid by the issuers being rated.

But ratings system reform has proved difficult, in part because the alternatives are not always palatable.

Sure, having investors pay for credit analysis would avert the conflict of interest that the ratings companies have because they collect fees from rated issuers. But investors are self-interested, too, and might lobby for artificially low ratings that could juice up the yields on securities.

The process could be made a public function, but does the U.S. government — aside from potentially having a conflict itself as the largest debt issuer on the planet — have room on its plate for the task?

Washington also needs to decide what role it wants the rating companies to play in the financial system. The companies, commonly referred to as "ratings agencies" in a nod to their special status, figure into all kinds of contracts and mandates. Investments by public pension funds, for example, often are governed in part by ratings criteria, and ratings companies have long enjoyed broad protection in litigation with unhappy customers.

In September, the Securities and Exchange Commission adopted some measures and proposed others that would remove references to ratings from some of its rules and forms and root out the practice of "ratings shopping," whereby an issuer throws its business to the company pledging the best grade.

Congress, meanwhile, is considering bills that would make ratings companies more vulnerable to lawsuits and broaden the SEC's supervisory authority.

But aside from the call to open up the companies to legal consequences, itself a Pandora's box that could stifle the industry and make its opinions so watered down as to be meaningless, much of the debate's focus has been diverted from what some people see as the most pressing issue: the skills of the people issuing ratings and the reliability of their models.

"They short-cut their work," said Edward Kane, a finance professor at Boston College and a founding member of the Shadow Financial Regulatory Committee policy study group. "They were dealing with a lot of complex new products, without any experience that covered a recession or a downturn, so relying on a year or two of historical experience amidst a boom in real estate was irresponsible from a statistical point of view."

Moody's officials did not return a call seeking comment. S&P spokesman Edward Sweeney said the potential for a downturn was not ignored but that its severity was no doubt underestimated.

"Unfortunately, our assumptions about the housing and mortgage markets in the second half of this decade did not account for the extraordinarily steep declines we have now seen," Sweeney said. "Had we anticipated fully the severity of the declines in these markets at the time we issued our original ratings, many of those ratings would have been different."

As Washington struggles to come up with a plan that will remove fallibility from the ratings process, or at least restore public trust in the system, credit ratings companies are making some self-directed adjustments.

S&P, which rates $32 trillion of securities, has brought in new executives for areas such as compliance, structured finance and quality review. It has appointed an ombudsman to investigate internal complaints about the rating assignment process and has started doing "look back" reviews when an analyst leaves to work for an issuer. Among other moves, it also has changed its ratings criteria for CDOs and U.S. residential mortgage-backed securities.

But the absence of a radical overhaul, self-directed or government-imposed, leaves plenty of room for investors and issuers to do their own work on rethinking the concepts of risk and risk management.

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