Solving the Credit Crisis

Sean Egan saw the credit crisis coming. Now he talks about turning it around.

BY JONATHAN BARNES

If you're looking for straight talk on markets, try Sean Egan. The longtime critic of the big three rating agencies, who is also founding partner and president of Egan-Jones Ratings Company, is now receiving due credit for his early warnings on the financial crisis.

Despite a small staff of 15 analysts, Egan's firm has become a relevant voice in the rating industry, often beating rivals S&P, Moody's, and Fitch in marking changes to perceived credit quality. Relying on revenue from investor subscribers as opposed to the traditional issuer-pay ratings model, the company advised clients on the pitfalls of Enron, WorldCom, and Lehman Brothers months before those stories made the headlines. Last autumn, Egan testified on rating reform before the U.S. House Committee on Oversight and Government Reform and became a sought-after voice among financial commentators.

Egan-Jones, an NRSRO (Nationally Recognized Statistical Rating Organization) as of 2007, follows more than 1,300 companies and has grown its subscriber base by more than 30 percent in the past two years. In an interview with *CFA Magazine*, Egan discussed ways to get the securitization markets moving, the urgent need for government to get smarter, and taking a stand for investor interests in the rating industry.

Despite all the coverage, are you sensing that there's still a real lack of understanding about how to deal with this crisis?

Unfortunately, there is. And furthermore, despite the U.S. Fed's claim to the contrary, they're running out of bullets. U.S. government tax revenues in 2008 were approximately US$1.6 trillion. How much can the federal government borrow? As of the end of 2008, federal debt was close to US$5.8 trillion, but that's not the worst of it. Over the past 12 months or so, they've taken on exposures in excess of US$11 trillion for things like Fannie Mae, Freddie Mac, AIG, a couple of economic stimulus packages, Bear Stearns, GM, Chrysler. Simply put, the government has to be much smarter; it doesn't have an endless bag of tricks to throw at the market. It's stretching the rubber band to borrow significantly more money.

So what happens when you stretch the rubber band?

Well, there are limits to the money they can print, and the limits are really set by nerds in the market such as ourselves who say, "Wait a second. Can the federal government pay this back in any reasonable time?" And the reality is, it's becoming more difficult for them. Somebody asked whether the U.S. government was a true AAA, and my response was that if their revenue hasn't grown—and it hasn't—and if they take on a significant amount of debt and exposure via guarantees, then it starts to put pressure on their credit quality.

How do we get smarter?

The first step is to understand what caused the crisis. The securitization market is critical, and it's basically shut down right now. Why is the securitization market critical? Well, for one thing, it provides liquidity to the financial institutions. Furthermore, it's much larger than the actual banking market—I've seen figures as high as 5 to 10 times as large. So if the government gives money to Citigroup and if Citigroup doesn't have a way to sell the loans it makes, it'll be less willing to issue new loans. If the securitization market were up and running, Citigroup could take those new loans that it grants and throw them into a CLO (collateralized loan obligation) or a CDO (collateralized debt obligation), sell it to other investors, and then reissue that debt 10 to 20 times—so you get the multiplier effect.

Unfortunately, that whole securitization market is in shambles right now. And it's in shambles because the trust has been broken.

Washington does not—yet—have a handle on what the problem is. Number one, they don't understand that the banking market is really just a fraction of the whole funding mechanism. Number two, until they address the problem of rating shopping, they won't accomplish anything.

What's the core of the problem for securitization markets? What can be done to turn things around?

The problem is that we don't have the checks and balances. Currently, everybody involved has an incentive to complete the deal, and nobody has an incentive to make sure the deal makes sense. Now, the rating firms—and this is a dynamic which most people don't appreciate in the market—are supposed to be the adult supervisors. They're supposed to be making sure that the risk associated with the assets is properly assessed. And unfortunately, the dynamics in the rating industry have changed dramatically, so the rating agencies have difficulty issuing timely, accurate ratings.

What has happened over the past 10 years or so is that rating shopping has become common. In fact, Moody's issued a report complaining that when they tightened up their standards in the commercial mortgage-backed securities area, they lost market share. That means that if the investment banker isn't happy with the rating that Moody's assigns, the investment banker can easily walk down the street and get one from S&P or Fitch and it really becomes a race to the bottom in terms of standards. Normally, it's expressed in terms of how much of a structured finance deal you can rate AAA. So, if Fitch says, "We can rate 75 percent" and Moody's says, "Well, we can rate 78 percent," then S&P can say, "If Fitch is doing it and Moody's is doing it, we'll even go 79 percent."

One of the first steps to reestablish the securitization markets is to offset the concerns of those parties that have been burnt over the past two and a half years—those who bought into supposedly AAA credits that turned out to be far from AAA. How do you do that? The easiest way is to issue timely accurate ratings. I don't think it takes a genius to figure it out.

That makes it sound easy. Do you think investors have any confidence that ratings can be timely and accurate?

Here's the litmus test. We got a call several months ago from the CIO of a French insurance company. The guy was spitting mad. He was told by his superiors to invest only in investment-grade securities, and he invested in AAA securities. He wasn't looking to double or triple his money; he only wanted to earn about 3 or 4 percent. He thought his investments were AAA. He didn't have the resources to do his own work and had to rely on some agents, which is entirely reasonable. And the securities that he thought were AAA were cut to D in a period of two days.

So, instead of getting his money back with a little interest, he was told he wasn't going to get *any* of his money back. He said, "This is incredible. I am not going to do this again. I can't stand it." He felt cheated, and he was. He was defrauded, basically.

He was calling to get ratings from you?

We didn't rate these particular securities. He was calling because he was livid. And rightly so. So, that's the litmus test —when that investor feels secure enough to get back into the market.

I was in a meeting last summer where the head of BlackRock, Larry Fink, asked, "How can we get foreign investors back in the market?" Well, you can only get them back if you give them a reason to believe in these ratings because they don't have the time, the inclination, or the information to do their own work. It's normal to rely on some third parties in these transactions. Just the offering documents alone are about 200 pages. They need somebody to help them through it. Until that is addressed, the market is going to remain frozen.

So what can be done to give investors "reason to believe"?

A couple things. You can't just police every rating decision by S&P and Moody's. You also cannot easily take away the freedom-of-speech defense, so that's a nonsolution too. The best way is to make sure there's an alignment of interests between the ultimate investors and the rating firms. And there's not an alignment; there's a total misalignment. Actually, it's true in the marketplace that the tough rating firm is the underemployed rating firm. So, you have to set up a structure where there's at least one independent rating for every security issued.

And you could provide that?

We could provide that, but there are a lot of sources for that. We're not the only ones.

You've been highly critical of the issuer-pay structure of the major rating agencies that's getting so much attention. The policy doesn't seem likely to change anytime soon.

Well, it could! Fitch could conclude that they'll make much more headway if they give up issuer pay and go completely to investor pay. That's entirely conceivable. Or DBRS (Dominion Bond Rating Service) could shift, and a number of others could too. But until you have a reason for that French investor to come back, you're going to have a stuck market. It doesn't matter how many TARP (Troubled Asset Relief Program) packages you have, you're still going to have an impaired market.

That doesn't fill me with hope—if we're relying on Fitch or S&P or Moody's in order for the markets to move again. Are there other ways to get things flowing?

Actually, it's very easy. Just put in the requirement that fiduciaries need to seek a second opinion from a nonconflicted source, and that puts a spotlight on these things.

So, you're looking for government to do something like that or maybe CFA Institute?

If CFA Institute took a stand [on nonconflicted ratings], it would help a huge amount. You need somebody to stand up and say, "This is what we need." [*Editor's note: For a summary of the CFA Institute position on CRAs, please see the Market Integrity section on page 19 in this issue.*]

And in lieu of that, investors are—

Sitting on the sidelines. Waiting.

Why haven't we seen a requirement put in place? Why hasn't this idea gained more traction?

Well, I think it's going to. It will likely come out of the legislature rather than the SEC. The SEC is tied up with responding to other crises. Also, the SEC needs some legislative support to take action in this area; it doesn't have the power right now.

I think the direction it will probably take is to make it obvious that fiduciaries have to *do their jobs*. Fiduciaries that either don't do their own due diligence or who rely on agents whose interests aren't aligned with theirs will have increasing exposure. If there's a significant difference in the ratings from an independent firm and nonindependent firms, then the money manager has to do some due diligence and find out what really is going on. In fact, we're in the process of giving out our ratings, making our ratings publicly available.

All of them, across the board?

Pretty much, yes.

There's no disincentive for you in that?

There's a huge disincentive, actually. The disincentive is that we worry about jeopardizing our revenue base. But what we've concluded is that most investors want to understand *why* we're taking a certain position.

You've spoken of a 10K or 10Q type reporting system for structured securities. What's your vision of how that would look?

In the U.S. corporate market, investors can rapidly get a sense of issuers just by reviewing the SEC filings. It begs the question of why a similar approach can't be used in the structured finance market, and we've yet to see a strong argument against it. Certainly the broker/dealers will argue that that shouldn't happen, and perhaps the issuers also. But from an investor's standpoint, it's been proven time and time again

> "[Ratings reform] proposals are well-intentioned and some certainly move in the right direction but they share a common defect: they proceed from the erroneous premise that the major rating agencies are in the business of providing timely and accurate ratings for the benefit of investors when, in fact, these companies have, for the last 35 years, been in the business of facilitating the issuance of securities for the benefit of corporate issuers and underwriters, i.e., the entities which pay them."
>
> SEAN EGAN, in testimony before the House Committee on Oversight and Government Reform, October 2008

that when high-quality information is available to all market participants, it benefits everybody involved in the market.

What about conflicts of interest with your own clients in the investor-pay structure that you use?

I'm glad you brought that up. S&P and Moody's say there are conflicts with all the business models. In our case, we don't know whether our clients are long or short, and we don't want to know. Furthermore, even if they had a position we were aware of, they might be wrong, so it does us no good. [*Editor's note: For more on different pay models, conflicts of interest, and competitive challenges for CRAs, see Analyst Agenda on page 22 in this issue.*]

Is there a particular company that has been of interest to you? What's interesting about it?

How about MBIA? We call it a *monoline* insurance company. It should be called *dual* line, because if it had stayed monoline, it probably wouldn't have the difficulty it's experiencing now. As a result of MBIA separating itself, Moody's cut the company by eight notches, from Baa1 to B3. That's a massive cut. Historically, in the monoline industry, a lot of the executives came from the rating industry, but also, the rating firms reviewed every significant risk the monolines took on. So, there were supposed to be some real checks to the sort of business they were doing. Our view of MBIA has been that they're nowhere near the AAA level and that if they're not at the AAA level, then they're in runoff mode.

What's your rating of them?

We had them at single-C as early as June 2008. We had Lehman Brothers at BBB, beginning May 2008. If the Reserve Fund and some of the other money market funds had listened to an independent rating firm, they would have avoided blowing through their franchise.

Ken Lewis of Bank of America was on CNBC recently talking about not taking more money from the government, even paying back the loans in three years or so. Do you think any of that is realistic?

No.

There's been a whole series of claims like that—Bill Ford saying he doesn't need the government's money, but at the same time, he's going to run out of cash [by the third quarter of 2009]. It's kind of pathetic, the statements that are made by these CEOs. The ultimate was Lehman Brothers' Dick Fuld saying they're in terrific shape and a couple weeks later filing for bankruptcy.

Have you ever seen a time when so many companies were so poorly capitalized?

I don't think anybody in the market has seen anything like this. This is worse, actually, than the Great Depression.

In what terms? By what measure?

During the Great Depression, when a bank was in trouble, it was easy for regulators to come in, assess the true state of affairs in the bank's loan portfolio, make the adjustments quickly, and reorganize the bank on sound footing. Why was it easy? You could get a handle on it within 15 minutes of looking at each loan. It was simple. If you had a grocery store and the guy could only pay half of what he paid before, you marked down the loan by 50 percent and you were good to go.

Now, you have a tranche of this mortgage-backed security that never trades in the market. Tell me again what the value is? Previously, the government could just guarantee big portions of loans. They'd say, "OK, fine, any loan to this public utility, we will guarantee." In the structured finance market, they can't do that because it's parceled all around the world. They're not going to guarantee everything associated with a CDO just because a bank might have a 2 percent position. Are they going to guarantee the 2 percent and the 98 percent? That makes no sense.

It doesn't seem like the momentum in the media is about reestablishing the securitization market.

No, it's not. What we're hearing is that we need a "shock and awe" strategy. Some senior portfolio managers are saying that we need to have a transfer of wealth, basically, from the taxpayers to the marketplace to support the value of these securities and that we need a shock-and-awe economic stimulus and bank bailout. I'm not sure what round of bailout we're on, but there have been a number to date—for the most part, they haven't worked.

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