FT REPORT - FUND MANAGEMENT: Time to rate the ratings agencies

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This is the time of year when incentive compensation is calculated and distributed. Or would have been distributed, I should say, in the case of loss-making trading desks and hedge funds. Naturally, there is no greater object of obsession than in the financial world than one's bonus. Everyone agrees that's why you get up early, leave late, and keep the payor's interests in mind.

For some reason, though, there's one group of rats in the maze that are supposed to ignore the cheese when they turn this way or that. I refer to the leading ratings agencies, led by Moody's, Standard & Poor's, and Fitch, which are paid by the issuers to serve the interests of the buyers. Even after the structured credit markets, designed with their endorsement, have been kicked into flinders before our eyes, we're supposed to believe that their compensation structure has had no influence on their thinking. Any sitting judge who has a mutual fund or unit trust with a few shares in a party's company will recuse himself from the case or face censure.

Yet even now, the agencies blithely assume they can continue with this charade. Last week, in a paper from Moody's called "Archaeology of the Crisis", written by Pierre Cailleteau, the firm's chief international economist, it was pointed out that: "In plain English, it is not clear that existing compensation mechanisms effective y ensure that traders take into account the long-term interests of the bank for which they work, ie its survival." Mr Cailleteau went on to say: "Ratings agencies were supposed to bridge some of the information asymmetries (in subprime securitiation), but this proved to be somewhat unrealistic when the incentive structure of (sub-prime) loan originators, sub-prime loan borrowers, and market intermediaries also shifted in favour of less information."

Something missing in that list, perhaps? Such as the "incentive structure" of the ratings agencies themselves? Their compensation only lasted as long as the flow of the defective issuers. When it slowed and finally stopped, their own earnings and stock price went into reverse.

So far, the established agencies have refused to consider the possibility of changing their own compensation structures. However, on December 21 last year the US Securities and Exchange Commission finally agreed to license the Egan-Jones ratings agency as what it calls a "Nationally Recognised Statistical Rating Organisation". Egan-Jones, based in Philadelphia, does not accept any compensation from the issuers whose paper it rates; the only revenue it receives is from the subscribers to its service, mostly buy-side firms.

Sean Egan, the chief executive of the firm, first applied for that NRSRO status 11 years earlier. That "licence", originally devised by the SEC to anoint firms that would determine the adequacy of broker-dealers' capital, became the safe harbour for fiduciaries worried about being punished for picking a bad bond issue. If the ratings agencies said it was "investment grade", it wasn't your fault if it failed to pay out.

Oddly, while the agencies had been around for decades, it was only about the time they acquired official licences in the 1970s that their compensation system shifted overwhelmingly to issuer-pays. When their compensation was based on market choice, rather than official imposition, they had more incentive to come up with ratings that served the interests of the buyers.

It was on this sand that the multi-trillion securitisation industry was founded. And, in fairness, it worked as you would expect after studying rodents seeking food pellets.

This isn't to say that it will be desirable, or even possible, to go back to a system where credit is dispensed by bank credit committees or old boys' bond market networks. There just aren't the people, structures, or capital available in the banking system to do that. Some form of systematic third party, arm's length, rating of risk, and the allocation of tranches of risk among appropriate parties, is inherently more efficient.

Mr Egan doesn't plan to rate American municipal issuers, which had been a base business of the established firms. "The core of the whole debacle was the rating of structured securities. S&P and Moody's have failed so miserably at this that I am now sure we can do a better job." While Egan-Jones has analysts who cover corporate and bank issuers, it still needs to set up systems for structured securities ratings. "I wasn't convinced of the demand before, but now I am. We will be doing this in the future."

So far, it's only the housing-based securitisation market that's frozen up, with the commercial real estate securities beginning to ice over. Problems are only beginning for credit card and auto paper, and securitisations of corporate paper have not really hit the wall. But we're early in the cycle.

European buyers were cheerful enablers of the ratings-driven securitisation mess, but now they and their regulators may take the lead in ratings reforms. Mr Egan says: "In general, European officials are more open to looking at alternatives, because S&P and Moody's, as well as the major broker-dealers, are based in the US more than in Europe. European institutions are suffering the pain from paper that gets downgraded from AAA to D within a month."

But the agencies were being paid perhaps a couple of million dollars for rating mid-sized structured issues. As we now see, being paid by the wrong people.

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