There Is No Silver Bullet

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I am submitting my comments with respect to the FDICs's request for comments on the decision to eliminate the use of ratings issued by NRSRO's for bank regulatory purposes as part of the Dodd/Frank Bill.

Let me begin by stating that, in my opinion, credit analysis is an art and not a science. The is no magic ratio, no single market based indicator such as CDS spreads, equity prices or cash bond spreads that can predict default with a high degree of accuracy. In view of the default by some high profile companies in the corporate area and the generally poor performance of ratings as predictors of default in the structured finance area, I understand and agree with the decision to eliminate the sole reliance on ratings for bank regulatory purposes. The challenge, I believe, is what do we use in place of ratings and is there any single indicator that can relied upon to accurately predict default? It is important to note at the outset that if one examines objectively the performance of ratings in the corporate area (i.e. industrial and financial institutions ratings) over extended time frames, as evidenced by default studies published by the major ratings agencies, I think that one will come to the conclusion, that the ratings agencies have done a very credible job in the corporate sector. Clearly, there were some high profile defaults by companies who had been rated investment grade until shortly before default or at the time of default. I can give you the reasons for most of these events, but at the end of the day there were no excuses for these failures. At the same time, I should point out that the ratings agencies are held to a very high standard. They are expected to bat 1,000!

I believe, that rather than placing blame solely on the ratings agencies for these failures, one must ask the question….Did investors abdicate their own responsibilities and in effect outsource the credit decision process and place total reliance on the ratings agencies? Did they in effect outsource the credit decision process? The CEO of a major investment bank pointed this out in a fairly recent speech before the Council of Institutional Investors when he stated to the audience that “they had outsourced risk management to the ratings agencies”

However, at this juncture it is important that we look forward and not backwards to determine where we go from here? I have titled this submission, “There Is No Silver Bullet”. One can conclude that in the past there was too much reliance placed on the ratings of the major ratings agencies. I don’t think that moving to the opposite end of the spectrum, by completely eliminating the use of ratings, is the proper way to address the issue. Rather, in my opinion, ratings should continue to be used as AN indicator of credit quality but not the ONLY indicator for bank regulatory purposes.

I believe, that in addition to ratings that there are other inputs that should be part of the credit decision process and incorporated into the regulatory process. Some of the ones that are frequently discussed clearly have merit if used in conjunction with other inputs. However, I believe that it would be a grave mistake to rely solely on any one of these, just as it was a mistake to rely solely on ratings. Some of the more frequently discussed alternatives to ratings are the following:

CREDIT DEFAULT SWAPS SPREADS

I believe that CDS spreads provide useful input as they indicate how market participants view the probability of default for a particular entity over various time horizons. However, in my opinion they are prone to the “herd instinct” and frequently send out false signals (so called type 1 errors). There have been studies (Moody’s has published some very good work in this area) which have demonstrated that markets frequently tend to overreact to negative news and spreads widen only to return to normal when a more reasoned and less emotional analysis is performed. In addition, there are a relatively small number of credits where one can obtain quotes on CDS spreads compared to the total number of bank credit exposures.

CASH BOND SPREADS

Cash Bond Spreads have very similar characteristics to CDS spreads. They provide very useful information , but are also prone to type I errors and emotional overreaction by market participants. They can also be fairly volatile which could pose problems in analyzing a portfolio because they could vary significantly depending on short-term events which have no real impact on fundamental credit quality. Both CDS and CBS spreads can be impacted by the market sentiments and be overly optimistic or pessimistic.

FINANCIAL MODEL

Financial models which are developed using various ratios and trends derived from a company's financial statements can also be useful tools. Indeed, the starting point for all fundamental credit analysis is the analysis of financial ratios and trends. Various ratios used to determine profitability, debt burden, cash flow and leverage are key elements of credit analysis. While this analysis, in particular the trends that they indicate, is extremely helpful it is essentially backward looking. It tells you where a company has been, but not necessarily where it is going. Indeed, based on my own experience there have been many companies who looked like a relatively strong credit based on the "numbers", but upon further analysis were really fairly weak credits. Analysis of management, future strategies, market position, industry risk and other factors painted a very different picture than did the "numbers" In addition, many of these models fail to include significant off balance sheet items or other liabilities which could impact credit quality.

MERTON TYPE MODELS

There are several variations of these types of models, but in essence they all begin with an analysis of fundamental financial information and overlay this with the equity market's valuation of the firm. Once again these models provide valuable input to the credit decision making process. However, they also have potential problems. Firstly, the equity markets tend to be quite volatile, especially in this period of uncertainty. Indeed, during the extreme volatility that the markets exhibited in late 2008 and early 2009 many of these models failed to accurately measure credit quality because the value of many firms equity declined precipitously without any real change in the underlying fundamentals. In addition, many firms do not have any publicly traded equity which makes this type of analysis difficult in those circumstances.

CONCLUSION

I would conclude this submission by reiterating that there are no silver bullets. One cannot rely on any one indicator as the sole determinant of credit quality. In certain instances ratings may be the "best" indicator while in others CDS spreads may be more reliable because they incorporate market sentiment and the most current information. In others, Merton type models may be the best indicators. Clearly, in the recent past ratings were given much too much weight. But that does not mean that one should throw out the baby with the bath water. In the current environment one should have as many arrows in one's quiver as possible. Reliance on any one indicator would clearly be a mistake. Rather, any significant discrepancy between fundamental indicators such as ratings and financial models and market based indicators should raise a red flag and result in further analysis to determine the cause for the divergent views.

However, at the end of the day there really aren't any substitutes for an institution having a strong credit culture where strong internal credit analysis is part of the culture of an institution. A culture where saying no is just as, or maybe, more important, than saying yes should be encouraged. We are emerging from a period where many market participants lost sight of reality and got caught up in the euphoria of excessive reliance on quantitative models and lost sight of the fundamentals. I hope that as we emerge from this period that we do not once again place too much reliance on any one indicator. There is no silver bullet!

*Edward Emmer spent over 35 years at Standard & Poor's in analytical and management positions. From 2001-2005 he had global responsibility S&P's ratings of industrial companies, financial institutions, sovereign countries and municipal entities. He was head of S&P's International unit from 1979-1990 during which time ratings were introduced in the global capital markets He is a founding member of the Fixed Income Analysts Society and currently sits on the advisory boards of several companies. He has also testified as an expert witness and was an advisor to a start-up ratings agency in the Mid-East.