



Investment or Junk Grade Raters?

It's true what they say; too much of something cannot be good for you. In this regard, I am specifically referring to investors' ever growing dependence on credit rating agencies (CRAs). Admittedly, in these extremely uncertain and volatile times in the global financial markets, I would usually turn to these guys in an instant for updated information on sovereigns and corporations. However with the recent spate of negative events surrounding these well established rating agencies, in my view, their credibility has become even more questionable leaving many asking the same question; who rates these raters?

Despite a growing list of credit rating agencies, undoubtedly, many of us are all too familiar with the three internationally known rating agencies; Standard & Poor's, Moody's Investor Service and Fitch Ratings. For those who are unfamiliar and for those who need a refresher, here's a quick snapshot of what CRAs are supposed to provide. CRAs assign credit ratings for issuers of certain types of debt as well as the debt instruments themselves. In even more detail, a credit rating assesses the credit worthiness of an individual, corporation or a country. These ratings are utilized by practically everyone including investors, issuers, investment banks, broker-dealers as well as governments as they play an essential role in securities markets by helping to reduce information asymmetries between issuers and investors.

As investors, the benefits of these CRAs are quite obvious. To name a few, they increase the range of investment alternatives while providing easy to use measures of credit risk, which in turn, increases the efficiency of the market and lowers costs. Whilst I agree that CRAs have played a vital role in the evolution of the global financial markets, there are significant drawbacks to solely relying on these rating agencies when making investment decisions. Some noteworthy criticisms include;

1. CRAs fail to downgrade companies in a timely manner. For instance, Enron remained at investment grade status four days before the company went bankrupt.
2. Conflicts of interest arise that might inhibit them from providing accurate ratings.
3. Due to high barriers to entry and low competition, CRAs are sometimes accused of holding oligopolistic positions.
4. Recently, CRAs have made errors of judgment in rating structured products which in several cases have subsequently been downgraded or defaulted.

Whilst CRAs have always been subject to much scrutiny, and understandably so given the nature of the business, accounting scandals such as Enron and Worldcom paved the way for a wave of initiatives by both the United States and the European Union since early 2000. According to these regulatory bodies, these programs were designed to examine

the activities of credit rating agencies, question their reliability as well as determine the degree of regulation required. One noteworthy measure came in December 2004 when the International Organization of Securities Commission (IOSCO) published its Code of Conduct Fundamentals for Credit Rating Agencies, dubbed the 'IOSCO Code'. Not surprisingly, while this code focused on corporate governance such as ensuring quality, independence as well as responsibility, it failed to address the issue of how to enforce the code.

In my opinion, this lack of enforcement may very well be the root of the recent surge in internal errors detected in these rating agencies. According to reports, Standard & Poor's informed regulators of a computer model error underpinning the credit ratings of complex debt products. Coincidentally, only a month before, Moody's Investor Services incorrectly assigned triple-A ratings to selected structured products due to a computer glitch. To add fuel to the fire, CRAs are now the target of blame for the sub-prime mortgage crisis in the United States as the Securities and Exchange Commission recently concluded that CRAs failed to properly manage conflicts of interest in assigning top ratings to bonds backed by sub-prime mortgages and other assets.

In light of these developments both the US and the EU have proposed stricter enforcement of CRAs in the near future. While this is certainly a positive step towards minimizing the current dilemma, it is only part of the solution. On the flip side, it could be argued that there is no need to regulate CRAs in order to ensure the accuracy and independence of credit ratings. Increased disclosure of conflicts of interest as well as methodologies should be sufficient for sophisticated investors to assess whether credit ratings are reliable and to discourage them from using such ratings if deemed to be unreliable. In this current uncertain market environment, it certainly pays to be diligent!

It should be clear that work needs to be done on both sides of the equation. Based on past actions, it seems that enforcement initiatives with respect to the CRAs will only be taken upon the occurrence of disasters and not as preventive steps. As sophisticated investors, not only should we strive to reduce our reliance on CRAs but we should continuously monitor the rules and regulations implemented by these governing bodies to determine if and how they contribute to improved CRA performance, compliance and securities markets efficiency.

FINANCIAL & ECONOMIC INDICATORS

As at 7 August, 2008

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	109.44	108.13
Euro	1.53	1.56
Jamaica	72.03	72.23
Guyana	204.70	203.70

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	120.02	126.77
Natural Gas (US\$/mmbtu)	8.78	9.00
Gold (US\$/Troy Ounce)	873.05	906.10

Eurobond Indices (Return % YTD, as of 7-August-08)

Lehman Brothers Global Aggregate Index	3.08
JP Morgan EMBI+ (percentage change)	15.60
CMMB Eurobond Index	n/d

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	1.50	1.75
Euro Zone	4.25	4.25
Japan	0.51	0.52
Brazil	13.00	13.00
Trinidad	8.50	8.50
Jamaica	13.50	13.50
Barbados	4.50	4.50

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	1.65	1.66
US 10-Yr Treasury	3.93	4.05
3-month UK Libor	5.78	5.78
Japan 90-day T-Bill	0.51	0.53
Brazil 90-day T-Bill	13.62	13.20
TT 90-day T-Bill	7.17	7.17
Jamaica 90-day T-Bill	14.46	14.46
Barbados 90-day T-Bill	4.02	4.02

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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