To What Extent Can We Rely on Credit Ratings?

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Your insurance company, your pension plan, your retirement account, your bank and now your government often make investment decisions on the basis of credit ratings. It is your money they are playing with. That is why you should read this article.

Federal Reserve has Greatly Expanded Powers

With the passage of the Cares Act, the US Government and the Federal Reserve Bank have put into place various programs to give money to companies as well as state and local governments and to stabilize the Capital and Money Markets. It is possible to understand the importance of some of these programs without descending into finance jargon. To greatly simplify matters, Capital and Money Markets refer to stocks, bonds and other debt instruments. Money Markets usually refer to shorter term debt instruments.

In the beginning of March, the bond market and other debt markets came under excessive strain. The Treasury and Fed came up with programs which stabilized these markets. The Fed in particular has greatly expanded its powers by announcing that it would buy US Government Securities in unlimited amounts if necessary. It will now also be involved in making loans to small and medium-sized companies.

The Fed can now for the first time buy corporate debt, generally of large companies

Of particular interest is a new $750 billion program that has been created to stabilize the corporate bond market. The program consists of two facilities: the Primary Market Corporate Credit Facility (PMCCF) and the Secondary Market Corporate Facility (SMCCF). These programs authorize the creation of a Special Purpose Vehicle (SPV) to purchase investment grade bonds being issued (PMCCF) and also the purchase of investment grade bonds already in existence (SMCCF). The SPV will be funded by $75 billion in equity supplied by the Treasury and $675 billion in debt supplied by the Fed.

The bonds to be purchased need to have an investment grade rating - minimum of BBB- (by at least one credit rating agency) as of March 22, 2020. And, when purchased, any bond could not be rated less than BB- which means that the purchase of junk bonds is also allowed. Further modifications have been made to the program to also allow the purchase of leveraged loans and Exchange Traded Funds (ETFs) which invest in a broad range of corporate bonds including junk bonds.

Note that this is not a lending program. It is a program where the Federal Reserve in effect is buying corporate debt - which is something that has never happened before. The Fed will use Black Rock as its agent to conduct transactions. Black Rock is the largest Money Manager in the world with Assets Under Management of about $7 trillion.

The bonds and loans to be purchased are generally speaking obligations of larger companies in the US.

The Importance of Credit Ratings in the Capital Markets

Modern debt markets are highly reliant on credit ratings. Smaller companies generally do not have credit ratings. But medium-sized often do, and large companies invariably do have credit ratings. This gives them greater access to the Capital Markets for their bonds and in some cases their loans.

Corporate credit ratings therefore are not only important for the Fed programs outlined above; they are of crucial importance for almost any large company which needs to get debt financing.

It is not well known that the corporate bond market in terms of volume of deals is significantly larger than the stock market. Bonds are boring and stocks are exciting, so the latter gets much more attention. Big investors in corporate bonds include institutions such as insurance companies, pension funds and mutual funds. In more recent years, leveraged loans have also been bought by institutions as opposed to banks as in the past.

The approximate amount of corporate bonds and leveraged loans outstanding in the US is about $9 trillion. Leveraged loans outstanding are in the area of $1.5 trillion. More than half of investment grade corporate bonds (approximately $5 trillion) are now rated. BBB-. This rating is the lowest rung of "investment grade." Anything below is considered "below investment grade" (more familiarly referred to as junk).

An investor in corporate bonds or leveraged loans does not get to spend time with management and get to know the individual company. This investor, invariably a financial institution or a fund managed by a financial institution, is given information by the bank underwriting the debt issue. In such cases, a trusted third party would be helpful. And this is where the rating agencies come into the picture. There are three major rating agencies - Moody's, S&P and Fitch which account for 95% of the rating business.

In Downturns Credit Rating Agencies Attract More Scrutiny

An article ("Credit-rating agencies- Markers marked" - pages 55 and 56) in the May 9th issue of the Economist states: "In times of financial plenty credit ratings go largely unnoticed. In downturns, though, they attract more scrutiny - and are often found wanting." In the last crisis in 2008, the rating agencies were blamed because they gave certain debt securities undeserved, high ratings and were later branded as "…essential cogs in the wheel of financial destruction."

The article further points out that the accuracy of the three credit rating agencies matters because they "wield great power over the capital markets."

The article cites various studies which question the accuracy of the ratings:

- One study found the agencies are more likely to issue accurate ratings in good times
- Several other studies found that given the high debt levels many companies had, ratings should have been lower
- NYU Professor Edward Altman, the guru of high yield (junk) debt in a working paper stated that there is "an over-rating problem." He concludes that over one-third of corporate debt that was at the bottom investment grade rung (BBB-) going into the pandemic, actually should have been rated as junk debt
- A Wall Street Journal article in 2019 found that the six largest credit rating agencies in the past seven years all made changes to rating criteria that at least briefly increased their respective market shares
- An OECD study found that downgrades to junk are rarer than those elsewhere in the ratings spectrum

My Own Experience Confirms a Degree of Skepticism of Credit Ratings

It is well known that credit rating agencies are slow to down-grade difficult credits. One example is Carnival Cruise which in April was able to raise over $5 billion in new bond financing. It was rated by two agencies-one gave it an investment grade rating and the other gave it a below investment grade rating. However, the pricing of the bonds (over 12%) indicated that the market considered the bonds as low-grade junk. In theory at least, this bond issue is eligible for purchase under the Secondary Market Corporate Facility because one agency rated it investment grade.

Ratings are often a substitute for independent analysis by prospective investors

One of the major problems to get a full credit rating, in my view, is an over reliance on them. Even more serious are those situations where ratings can often be a substitute for analyzing the investment. I have worked for various foreign banks in New York, and I was told more than once by foreign colleagues in New York and at the head offices that there was no problem with a particular investment because of the high credit rating. They did not think it necessary to dig in and try to understand the investment. In one such case, the head office made an investment contrary to our advice. After all, the rating was quite high. Within a year, the company was in bankruptcy, and I was involved in the work out. Other foreign banks had made the same mistake. If they had bothered to analyze the company, they would have realized that underlying the favorable numbers was a financial services company with very risky investments. The rating agencies had focused on the fact that this company had a diversified portfolio of debt investments; but when the bad times came, most of these investments were in trouble.

Credit ratings are subject to change, sometimes rapidly

It is important to understand that a credit rating is based on the current thinking about company prospects. If, for example, you make an investment for five years, do you really know what the company will look like in say four years. You can only make such an evaluation if you analyze the company in depth. Today's rating is for today - PERIOD! The counter argument to this is that the ratings guarantee a certain element of liquidity so one can always sell the loans. However, when trouble comes the market price of the bond or loan tumbles quickly.

Credit ratings are often numbers oriented

I am also convinced that what most matters to the agencies in rating a company are certain metrics including leverage ratios. A company with a lot of debt has a lower credit rating than a company with less debt. This is not an ideal way to make good credit decisions. Two companies can have similar metrics, but one may in fact be a really strong business while the other is not. I do not believe that the rating agencies in making their final decisions always give sufficient weight to good old-fashioned credit analysis. I think that a lot of their analysts have a sophisticated understanding of their corporate credits based on my experience; but very often senior management seems to be driven by certain simple metrics in issuing a credit rating.

Leveraged loans are risky because they have a good deal of debt. By and large, these are strong businesses which happen to be risky only because they have so much debt. This is why they have low ratings. But in recent years, the normal protections afforded to the lenders in terms of strong covenants have been eliminated probably because there is such a high demand for leveraged loans among investors. These days, loan agreements are called "covenant lite." I am not aware that this reduction in protections has been seriously dealt with by the credit rating agencies in assigning ratings.

The key metric in coming up with ratings is EBITDA

With respect to numbers, the key metric is EBITDA - Earnings Before Interest, Taxes, Depreciation and Amortization. A company's ability to generate cash from its business operations is considered the key element in valuing a business and in understanding the company's ability to service its debt. EBITDA is widely considered among financial professionals and the rating agencies to be an acceptable proxy for a company's cash flow from operations. Operating cash flow does not include money coming in from financing or money going out to pay off financing. Operating cash flow does not include any capital expenditures or sales of assets outside of the normal course of business. It is simply put the cash profits of a business.

There is actually a better indicator than EBITDA - Cash Flow from Operating Activities, which is easily found in financial statements. This is not used perhaps because this is often a lower figure than EBITDA.

The key metric in arriving at a credit rating compares debt to a company's operating cash flow

A key ratio in arriving at a rating is Debt/EBITDA. This is referred to as an indicator of financial leverage. The higher the ratio, the riskier the customer is and therefore the lower the rating should be.

However, the calculation of EBITDA in recent years has been adjusted upward. In more recent years, EBITDA was not sufficient - adjusted EBITDA was the metric used. Adjusted EBITDA is a problem because the adjustments are often quite large, accounting for up to 25% of EBITDA. Invariably these adjustments are positive meaning that they increase EBITDA.

EBITDA is not a figure presented in financial statements

EBITDA is considered a non-GAAP (Generally Accepted Accounting Principles) metric, which means that it is not a figure presented in the financial statements which have been audited by an accounting firm. Adjusted EBITDA is simply a company's indication of what it considers its cash flow from operations after adjusting it for unusual, non-recurring items.

In these days of Covid-19, some companies are presenting EBITDAC - this stands for Earnings before Interest, Taxes, Depreciation, Amortization and Covid. To put it bluntly, a good deal of what is presented as a company's cash flow from its business is highly subjective.

If all this seems like a numbers game designed to make a company look good, well perhaps that is the case.

Ratings apply to individual classes of debt

Ratings, it needs to be mentioned, are not about the company alone. What is rated is a particular piece of debt. Assume that a company has a leveraged loan rated and also a bond rated. It is generally understood that the bond is a more risky investment and this should be reflected in the ratings. We live in a period where many loans have few protective covenants. Could it be that the bond in fact is not "beneath" the loan? Is the bond specifically subordinated to the loan?

What I am arguing for is this- ratings are the first step. They should not be a substitute for due diligence and analysis

What rating agencies do not do in arriving at a rating

It is very important to understand what the rating agencies do not do. There was a syndicated loan put together by a major US bank some 40 years ago. The company borrowing the money was not credit worthy but the loan was guaranteed by a major international bank in Europe through a mechanism known as a standby letter of credit. Because of this unconditional guarantee a rating agency gave the loan the same (high) rating as that of the bank. When the maturity date came, the Agent Bank called on the standby letter of credit. The European bank issuing the LC refused to pay on the advice of their lawyers who said that the underlying legal documents were flawed and therefore the LC was legally invalid. In the history of banking, LCs are honored if the underlying terms and conditions have been met. In this case, the underlying terms and conditions in the documentation were met and the bank refused to pay. This was the first time that a solvent bank failed to honor its commitment under a letter of credit and it caused shock waves in the international banking community.

My bank was involved as a participant in this credit. I asked the rating agency why they had given the loan such a high rating. The answer was because the loan was supported by the guarantee of the European bank. I then said: "But the documents are flawed. Didn't you (the rating agency) examine the documents?" The answer I got was blunt and to the point - I was told politely: "It not our job to review legal documentation."

The company being rated picks the credit agencies and pays them

A final problem is that the issuer or borrower pays for the ratings. This gives the company being rated the incentive to shop around and get the best rating. This "ratings arbitrage:" is well known but has never been dealt with. This is also called "ratings shopping."

Summary and Conclusions

To what extent then, can we rely on credit ratings? I think we should rely on them only as a preliminary first step. Making decisions solely on the basis of credit ratings is, in my opinion, a big mistake. I do not know to what extent that Black Rock or the Fed will look beyond the ratings in making investments. I understand that the Fed reserves the right to look into the ratings and to make its own determination. This is the way it should be.

It is not my purpose to denigrate corporate ratings or to denigrate the rating agencies. They do a decent job of reviewing corporate credits. I have been especially impressed over the years with the knowledge of individual analysts working for the credit rating agencies. One can learn a lot about a company by speaking directly to an analyst.

My problem is with those who think that decisions should be made solely on the basis of credit ratings. Ratings in my view give one the feeling of precision in reviewing different debt investments. This precision is illusory as I have tried to point out in this article.

There is no substitute for doing your homework.