EVOLUTION OF CREDIT RATINGS – PART I

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Last week we looked at what a credit rating is … and is not … and how it can be applied to just about any debt instrument. Today we take a brief walk down history lane to understand the origins of credit ratings and the evolutionary path to their current state of application. This background will allow us to understand more readily the role that credit ratings can play in the 21st century debt markets of the Caribbean.

Credit ratings trace their roots back to 1850 and the creation of a large market in US railroad companies bonded debt. While bond markets had already existed for about three centuries, prior to 1850 bonds mostly comprised the sovereign debt of a few countries with representative governments whom investors trusted as being willing and able to meet their commitments – primarily the Dutch, English and later the American governments. European businesses raised money by bank loans and stock issues.

The US economy, on the other hand, was fundamentally different from the European economies. For one thing the scale of domestic operations was vast – the country was virtually a continent and their most pressing capital need was that of trying to connect the country from end to end. The connectivity technology of the time was railroads, introduced in the 1820s. Railroad companies were primarily private corporations which initially located in settled parts of the US and raised capital via bank loans and equity issues.

By 1850, the railroad companies were pressed to expand into "the wild west". The scale and uncertainty presented by the expansion meant that the railroad companies were no longer able to raise sufficient capital from banks and equity investors.

The solution to the capital needs of the railroad companies was the rapid development of a huge market in railroad company bonded debt. Indeed, by the early 1900s the railroad corporate bond market was several times larger than that of the Dutch, English or US sovereign debt bond markets. (The US actually paid off its entire national debt in 1836!)

This new wave of corporate bond activity created a pressing need – transatlantic European investors demanded to know critical credit information about the companies in which they were being invited to invest on an unprecedented scale. The traditional means of obtaining information via family, business and banking relationships became insufficient. Investors wanted independent, third party information upon which to make investment and pricing decisions.

In response to this market need, a gentleman by the name of Henry Varnum Poor, who took over as editor of the American Railroad Journal in 1849, started to publish systematic information on the property of railroads, their assets, liabilities and earnings. This proved so popular with investors that after the American Civil War ended in 1865, Poor and his son started their own publication, Poor's Manual of the Railroads of the United States. This annual volume remained the industry's authoritative information source for several decades. These statistics were the forerunner of modern-day credit ratings.

In 1909, another gentleman, John Moody, took the publication of credit information a step further and assigned the first credit rating by publishing an opinion on the creditworthiness of the corporate debt paper issued by railroad companies. His opinions were based on extensive company and industry information and rigorous analysis. The Poor company followed suit in 1916. It later merged with Standard Statistics, another information and ratings company, to form Standard & Poor's. Fitch Publishing Company started publishing financial information in 1913 and in 1924 introduced the now familiar "AAA" to "D" rating scale.

With three companies providing opinions on creditworthiness and the US bond market expanding to include increasing issues by local and state governments, public utilities and industrial corporations, the credit rating industry was well and truly established. The rating agencies themselves became known for independence, integrity and reliability.

Interestingly, the US stock market crash of 1929 sparked even greater demand for credit ratings as investors worried about high bond default rates and credit risk. By the end of the 1920s the vast majority of bond issues were rated by the rating agencies.

There is a key event that signals the importance of the role of the credit rating agency by the 1930s. In 1931 the US Treasury Department, through the Comptroller of Currency, adopted credit ratings as appropriate measures of the quality of the bond accounts for the national banks. This was the first formal rule incorporating credit ratings. Indeed, the importance of the rating agency's independent role is further highlighted by court decisions that relied explicitly on ratings to assess whether fiduciaries had satisfied their duties in exercising due care and prudence when investing the funds in their trust.

The next boom of the credit rating industry is owned to another recession, this time in 1970 during which the infamous default of Penn Central Railroad on $82 million of commercial paper obligations occurred. Investors recognized anew the need to have independent evaluation of credit risk available. This renewed and extensive demand by investors allowed the rating agencies to adopt the current business model of charging issuers in order to provide a valuable service to investors.

We can see from this brief history lesson how today's ratings were a response to the market's need for independent credit information. The ratings themselves started first as credit reporting, the publication of statistics and specialized publications on financial data only to rapidly evolve into the future oriented opinions on creditworthiness that they are today. The reason that credit ratings were innovated in 1909 is the same reason that they remain relevant today: the demand of investors for a reliable opinion on the creditworthiness of investments.

Next week, we will briefly examine the global expansion of credit rating agencies, the further development of credit ratings and the application to the Caribbean environment.