



## **S&P Says “We Don’t Expect Lehman to Fail”**

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One of the most disturbing aspects of the credit crisis was the abysmal job done by the ratings agencies in assessing the risks of the securities they rated. If they had not assigned AAA ratings to subprime collateralized debt, which are now trading at 20 cents on the dollar, a key element that facilitated the crisis would have been eliminated.

If you are among those who, like Nouriel Roubini in our accompanying [article](#), believe that Lehman is technically insolvent and worth only its franchise value, then it appears that very little has improved with regard to the ratings agencies’ ability to assess risk. The major ratings agencies remain cautiously supportive of Lehman in spite of its troubles. In a conference call on Friday, hosted by the Argyle Executive Forum, Standard & Poor’s analyst Scott Sprinzen said that “we don’t expect Lehman to fail.”

“The underlying business at Lehman is doing pretty well,” Sprinzen said. Its “basic business franchise is not impaired.”

S&P rates Lehman’s debt A and the Lehman operating group A+, the sixth highest investment grade rating — well above “junk” bond status. At the same time, credit default swaps (CDS) on Lehman indicate a 35% chance of default, and CDS spreads are wider than they were on Bear Stearns just prior to its takeover by J.P. Morgan.

Friday’s call provided a real-time glimpse into the process and thinking of the ratings agencies at a time when Lehman, one of four major independent investment banks, is in the throes of a struggle for survival.

### **Views on the Brokerage Industry**

Of the three other investment banks, S&P rates Merrill the same as Lehman, Morgan Stanley one level higher, and Goldman Sachs as the best of the bunch, one notch higher still.

The other analyst on the call, Tanya Azarchs, stood by these ratings, noting that S&P downgraded the brokerage sector a notch on June 2. S&P has learned its lesson from the recent turmoil, Azarchs said: “Liquidity can dry up rapidly in this kind of environment.”



One factor S&P has built into their analysis is that uncertainty leads to accidents. "This has been an extremely prolonged period of lack of market liquidity, driven by fear, uncertainty... that we have never seen before," she said. "The longer the period of illiquidity lasts, the more potential there is for accidents to happen." Azarchs also said it was an accident that Bear Stearns failed. "They had cash," she said, but could not stand a withdrawal of market confidence.

Azarch's references to "accidents" are telling. The seeds of the credit crisis were sown over the past several years, as investment banks rapidly increased leverage and underwrote increasingly risky debt securities. It is a worrisome leap to believe that this level of risk assumption could result in failure only by "accident."

Trusting the risk assessment of these agencies requires you share their confidence that the principal danger is accidental misfortunes befalling otherwise healthy institutions, to the neglect of logically sound analysis of their financial strength and market position.

### **Psychology versus Fundamentals**

S&P places a strong emphasis on market psychology in their analysis. "At some point, market sentiment becomes a reality," Azarchs said. "It creates its own reality and we have to include it." To gauge psychology, they look at CDS spreads, stock price movements, rumors, and questions asked in the press.

The problem with this approach is that outsiders can exert strong influences on market psychology. This has been spectacularly true in the case of Lehman, as David Einhorn, a hedge fund manager at Greenlight Capital, has been highly critical of Lehman while maintaining a very high public profile.

Azarchs said S&P is careful to minimize the influence of speculators and rumor mills in their ratings analysis. "We try to get to the facts," she said.

"But true or not true, if rumors are having a real impact, we have to act. If markets are shutting the access to capital, that is a reality. If that was started by someone with a short position, that is unfortunate, but we have to act," said Azarchs.

S&P cannot ignore the sentiment in the market, especially in the brokerage business where a lack of confidence can destroy the fortunes of a firm. But their comments in Friday's call will serve to encourage market participants to use public relations efforts to support their short (or long) positions. With respect to the ratings agencies, such public relations efforts work only to the extent that the market places value on the their analysis.



## **The Next Shoe to Fall**

“The next issue [after subprime] are the Alt-A securities, which we believe could have substantial losses as well,” said Azarchs. She noted that market prices on Alt-A securities are 50 cents on the dollar, and that approximately \$125 billion of Alt-A securities are outstanding.

Beyond Alt-A securities are prime, or conforming, loans and home equity lines of credit (HELOCs). Azarchs said “banks don’t really have a handle on how bad they can get. It is hard to model because this hasn’t happened before. So far there has not been an effect on prime securities.”

On the subject of prime loans, which comprise the bulk of the Fannie Mae and Freddie Mac portfolios, Azarchs said “there has not been a big market decline, but I guess we could anticipate there would be.”

Azarchs said Citibank is the most exposed to Alt-A risk, with \$19 billion of original face value, which they are carrying at \$16 billion. “Other institutions have not said very much about their exposure,” Azarchs said.

Investors are expected to have confidence that agencies, such as S&P, have conducted a thorough and detailed analysis of the financial stability of the institutions they rate. So, how exactly is S&P rating these institutions if they do not have access to the details of their loan portfolios?

Commercial real estate loans have experienced relatively mild writedowns. “The underlying assets are doing well,” Azarchs said. Azarchs compared the current commercial real estate market to that of the early 1990s, when price declines were due to “a large overhang of supply.” She believes that extensive securitization of commercial real estate loans has all but eliminated the problem of oversupply. “Luckily, not that many institutions have concentrated exposure to commercial real estate,” she said.

But, she added, Lehman Brothers is the exception.

## **Not a Pretty Picture**

Friday’s call did very little to instill confidence in the ratings agencies. Their risk management systems have not kept pace with the rapidly changing environment, and S&P’s analysts leave the impression that its ratings are overly influenced by market psychology. At the same time, they are shut out of accurate balance sheet information that any investor would consider essential. If Alt-A, HELOC, and commercial real estate suffer the same precipitous declines as subprime



securities – as many fear will happen – the failure of the ratings agencies to reflect these concerns in their ratings could prove to have been a disastrous blunder.

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