Crisis Origins and Historical Comparisons:

Lessons from Ivar Kreuger and the Credit Rating Agencies

Professor Frank Partnoy, George E. Barrett Professor of Law and Finance, University of San Diego
Two Key Causes

- Financial innovation

- Regulatory licenses
Related Entity Corporation

↓

Numerous Subsidiaries (Havens)

Related Entity Corporation

↓

Parent Corporation

↓

Offshore Subsidiary Corporation (Haven)

↓

Domestic Subsidiary Corporation (US)

↓

Another Offshore Corporation (Haven)
Dutch Kreuger & Toll

Numerous Subsidiaries (Havens)

Kreuger & Toll Co.

Continental Investment Corporation (Liechtenstein)

Swedish Match Corporation

International Match Corporation (US)

Related Garanta Corporation (Holland)
<table>
<thead>
<tr>
<th>ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.2%</td>
</tr>
<tr>
<td>8.1%</td>
</tr>
<tr>
<td>9.9%</td>
</tr>
<tr>
<td>10.9%</td>
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<tr>
<td>10.0%</td>
</tr>
<tr>
<td>9.4%</td>
</tr>
<tr>
<td>10.2%</td>
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<tr>
<td>10.7%</td>
</tr>
<tr>
<td>Year</td>
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<tr>
<td>------</td>
</tr>
<tr>
<td>1923</td>
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<td>1924</td>
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<td>1926</td>
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<td>1927</td>
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<tr>
<td>1928</td>
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<tr>
<td>1929</td>
</tr>
<tr>
<td>1930</td>
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Source: Hildebrand (1985)
<table>
<thead>
<tr>
<th>Year</th>
<th>Kreuger ROE</th>
<th>Madoff ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1923</td>
<td>9.2%</td>
<td>11.7%</td>
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<tr>
<td>1924</td>
<td>8.1%</td>
<td>11.5%</td>
</tr>
<tr>
<td>1925</td>
<td>9.9%</td>
<td>13.0%</td>
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<tr>
<td>1926</td>
<td>10.9%</td>
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<tr>
<td>1927</td>
<td>10.0%</td>
<td>14.0%</td>
</tr>
<tr>
<td>1928</td>
<td>9.4%</td>
<td>13.4%</td>
</tr>
<tr>
<td>1929</td>
<td>10.2%</td>
<td>14.2%</td>
</tr>
<tr>
<td>1930</td>
<td>10.7%</td>
<td>11.6%</td>
</tr>
</tbody>
</table>

Source: Hildebrand (1985); Fairfield Sentry Performance Data (2005)
Reported vs. Actual Profit

The graph illustrates the trend of Reported Profit from 1923 to 1930. The profit increases steadily over the years, with a notable rise from 1925 onwards. The x-axis represents the years from 1923 to 1930, while the y-axis indicates the Reported Profit in Kroneer thousand (Kroneer 000).
Reported vs. Actual Profit

-10,000
0
10,000
20,000
30,000
40,000
50,000
60,000
70,000

1923 1924 1925 1926 1927 1928 1929 1930

Reported Profit
Actual Profit
“In an era of faceless organizations owned by other equally faceless organizations, Bernard L. Madoff Investment Securities LLC harks back to an earlier era in the financial world.”
## Theory I: Reputation

<table>
<thead>
<tr>
<th>Pure Gov’t Rater</th>
<th>Pure Private Rater</th>
</tr>
</thead>
<tbody>
<tr>
<td>USDA</td>
<td>Good Housekeeping</td>
</tr>
<tr>
<td></td>
<td>Financial Publishers</td>
</tr>
<tr>
<td></td>
<td>S&amp;P/Moody’s?</td>
</tr>
</tbody>
</table>
Theory I: Reputational Capital

“We’re in the **integrity business:** People pay us to be objective, to be independent and to forcefully **tell it like it is.**” John Bohn, Jr., President, Moody’s (1995)

“**Ratings are of value only so long as they are credible.**” S&P Debt Ratings Criteria (1986)
Theory I: Reputation

“Indeed, the only reason that rating agencies are able to charge fees at all is because the public has enough confidence in the integrity of these ratings to find them of value in evaluating the riskiness of investments.”
Theory II: Regulatory Licenses

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<td>Good Housekeeping</td>
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<tr>
<td></td>
<td>Financial Publishers</td>
</tr>
<tr>
<td>Year</td>
<td>Event</td>
</tr>
<tr>
<td>------</td>
<td>-------</td>
</tr>
<tr>
<td>1929</td>
<td>- Crash</td>
</tr>
<tr>
<td>1930</td>
<td>- Osterhus, NY Fed “desirability” ratings</td>
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<tr>
<td>1931</td>
<td>- Federal Reserve examinations</td>
</tr>
<tr>
<td>1932</td>
<td>- State “legals”</td>
</tr>
<tr>
<td>1933</td>
<td></td>
</tr>
<tr>
<td>1934</td>
<td>- Fed/SEC prohibitions, capital charges</td>
</tr>
<tr>
<td>1935</td>
<td></td>
</tr>
<tr>
<td>1936</td>
<td>- Treasury/Comptroller adoption</td>
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</table>
Feb. 15, 1936 – Comptroller Ruling:

“The purchase of ‘investment securities’ in which the investment characteristics are distinctly and predominantly speculative, or ‘investment securities’ of a lower designated standard than those which are distinctly and predominantly speculative is prohibited.*

*The terms employed herein may be found in recognized rating manuals, and where there is doubt as to the eligibility of a security for purchase, such eligibility must be supported by not less than two rating manuals.”
Response: “It’s a Mistake”

“We further believe that the delegation to these private rating agencies of the judgment as to what constitutes a sound investment is unprecedented in our history and wholly unwarranted by their records in the past.”

Resolution of the Missouri Bankers Association at its 46th annual convention, Kansas City, Mo., May 5, 1936
Response: “I Didn’t Mean It”

“[T]he responsibility for proper investment of bank funds, now, as in the past, rests with the Directors of the institution, and there has been and is no intention on the part of this office to delegate this responsibility to the rating services, or in any way to intimate that this responsibility may be considered as having been fully performed by the mere ascertaining that a particular security falls within a particular rating classification.”

J.F.T. O’Connor, Comptroller of the Currency, Address at a convention of the California Bankers Association, Sacramento, Cal., May 22, 1936
Theory II: Regulatory Licenses

“Over the last three decades, we have embedded [the use] of credit ratings into our rule books. Recent events have awakened us to the unintended consequences of our behaviors. Credit ratings have become a crutch.”

Paul Atkins, SEC Commissioner, June 2008
Annual Federal Agency Decisions Based on NRSRO Status

2008 SEC Report

“One analyst expressed concern that her firm’s model did not capture ‘half’ of the deal’s risk, but that ‘it could be structured by cows and we would rate it.’”

Source: SEC Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies, July 2008, at 12
Role of Ratings in the Crisis: CDOs and SIVs

Rated Collateral
L/T+150bp (MBS, CDS, and/or CDOs)

Special Purpose Entity

Senior
L/T+30bp
AAA

Mezzanine
L/T+180bp
BBB

Equity
Residual
Not rated
## Spread-for-rating comparison

<table>
<thead>
<tr>
<th>Rating</th>
<th>Underlying</th>
<th>Spread</th>
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<tbody>
<tr>
<td>AAA</td>
<td>Corporate bonds</td>
<td>&lt;5</td>
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<tr>
<td>AAA</td>
<td>Credit card ABS</td>
<td>15</td>
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<tr>
<td>AAA</td>
<td>iTraxx CDS index</td>
<td>22</td>
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<tr>
<td>AAA</td>
<td>CMBS</td>
<td>25</td>
</tr>
<tr>
<td>AAA</td>
<td>Cash-flow CDO</td>
<td>32</td>
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<tr>
<td>AAA</td>
<td>CPDO</td>
<td>200</td>
</tr>
</tbody>
</table>

Bear Stears 5-year CDS Market Spreads (bp) (Source: Markit)

Source: Markit Group Limited