Rating Agencies – Emerging Challenges

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Background

Information asymmetry lies at the heart of all credit transactions. The borrower knows his ability and willingness to repay much better than the lender. Intermediaries like banks often fill in this gap. They tend to know the borrowers better than ultimate lenders. However bank finance has an inherent disadvantage both for the borrower and the lender as they get less than optimal results from such intermediary led transactions. Bond market seeks to break this dominance as the issuers directly approach the lenders. The lenders need to know how likely it is that the issuer will default. Information about issuers is at a premium. Standard and Poors trace their origin to Henry Varnum Poor's publishing the "History of Railroads and Canals in the United States" in 1860 as the forerunner of securities analysis and reporting to be developed over the next century. John Moody and Company first published "Moody's Manual" in 1900. The manual published basic statistics and general information about stocks and bonds of various industries. It became an instant hit and from 1903 until the stock market crash of 1907, "Moody's Manual" was a national publication. This idea led to the creation of Moody's Investors Service in 1914 which in the following 10 years, would provide ratings for nearly all of the government bond markets at the time. Fitch ratings trace their origins to John Knowles Fitch who founded the Fitch Publishing Company in 1913 and published financial statistics for use in the investment industry via "The Fitch Stock and Bond Manual" and "The Fitch Bond Book". An obvious conclusion could be drawn from the above that the Credit Rating Agencies (CRAs) became so successful primarily because they had financial information and they were able to condense it into a few letters.

The CRAs became so successful and powerful that it led to Thomas Friedman's comment, even if a little exaggerated, that

"There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me it's not clear sometimes who's more powerful. (From Feb. 13, 1996 interview with Jim Lehrer.)"

Criticism

However, by the time Asian Crisis happened in the second half of the nineteen nineties CRAs started getting blamed for various things.

"The severe adjustments of sovereign credit ratings for many emerging market economies throughout the Asian financial crisis of 1997-98 have raised anxiety about the credit rating process and in particular about the usefulness of sovereign credit ratings. Indeed, critics have argued that the improvements in sovereign credit ratings during the first half of the 1990s and the subsequent sharp declines in the latter half initiated a pro-cyclical element into global capital flows by accelerating capital inflows during the mid-1990s and contributing to the collapse of these inflows after the Asian crisis emerged." (UNCTAD Discussion Paper No. 186, January 2008)

The failure of sovereign ratings was spectacular and widespread. Sovereign ratings came down by 3 to 10 notches within a period as small as 3 months for countries as diverse as Thailand, Indonesia, Malaysia, Korea, Russia, Romania and Uruguay.

The CRAs came under serious criticism in 2002 for their failure to provide reliable ratings. A few spectacular failures are given below[1]:

- ***Enron*** *was rated investment grade by CRAs four days before bankruptcy;*
- *The* ***California utilities*** *were rated "A-" two weeks before defaulting;*
- ***WorldCom*** *was rated investment grade three months before filing for bankruptcy;*
- ***Global Crossing*** *was rated investment grade in March 2002 and defaulted on loans in July 2002;*
- ***AT&T Canada*** *was rated investment grade in early February 2002 and defaulted in September 2002; and*

The Global Financial Crisis which originated in failure of US sub-prime securities brought further discredit to the CRAs. The criticism ranged from lack of business ethics to lack of competence. Even those who chose to speak on behalf of CRAs practically ended up saying that these venerated institutions were no better than the man on the street.

"They made the wrong call…….the entire American public was caught up in a belief that housing prices could not fall dramatically."

(Warren Buffet - testimony before Financial Crisis Inquiry Commission on June 2, 2010)

Regulation before the Crisis

Obviously, these criticisms have led to widespread calls to regulate CRAs. Attempts at regulating CRAs are not new. The first such attempt can be traced to recognition of three CRAs, viz. Moody's, Standard and Poors and Fitch as Nationally Recognized Statistical Rating Organizations (NRSROs) by SEC of USA in 1975 solely for determining capital charges on different grades of debt securities under the Net Capital Rule. The Net Capital Rule requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value of their proprietary securities positions. Higher rated securities needed lower haircuts. Over time, as marketplace and regulatory reliance on credit ratings increased, the use of the NRSRO concept became more widespread in various regulations ranging from securities markets, insurance, FDIC, to higher education. For example, Rule 2a-7 under the Investment Company Act of 1940 limits money market funds to investing in only high quality short-term instruments, and NRSRO ratings are used as benchmarks for establishing minimum quality investment standards.

In September 2006, US Congress enacted the Credit Rating Agency Reform Act of 2006, which established a registration and oversight regime for CRAs. It requires a credit rating agency applying to register with the Commission to provide certifications from 10 qualified institutional buyers that they have used the ratings of the applicant to make investment decisions for the preceding three years. While this lowered barriers to becoming an NRSRO, it provided the Commission with broad authority to oversee NRSROs. In particular, the statute provided the Commission with authority to require NRSROs to disclose information about their activities, to make and retain records, to furnish annual reports to the Commission, to implement procedures to protect material nonpublic information, to implement procedures to disclose and manage conflicts of interest, to refrain from engaging in activities that the Commission determined created unmanageable conflicts of interest, and to refrain from activities that the Congress and the Commission determined were unfair, coercive, or abusive. Consequently the number of NRSROs in USA increased from three to ten viz.

- Moody's Investor Service
- Standard & Poor's
- Fitch Ratings
- A. M. Best Company
- Dominion Bond Rating Service, Ltd
- Japan Credit Rating Agency, Ltd
- R&I, Inc.
- Egan-Jones Rating Company
- LACE Financial
- Realpoint LLC

Before the outbreak of the financial crisis, the regulatory setup in Europe was based mainly on self-regulation in the form of the IOSCO Code. It included the following three elements: an annual public letter to Committee of European Securities Regulators (CESR) outlining how it had complied with the IOSCO Code and indicating any deviations from the Code; an annual meeting to discuss any issues related to implementation of the IOSCO Code; and an undertaking to provide an explanation to the national CESR member if any substantial incident occurred with a particular issuer in their market. Four rating agencies agreed to this voluntary framework (Moody's, Standard & Poor's, Fitch Ratings, and Dominion Bond). In January 2006 the European Commission concluded that no new legislative proposals were needed as things stood and considered that the existing financial services directives, combined with self-regulation by the agencies on the basis of the IOSCO Code, were sufficient to address all major issues of concern in relation to CRAs. On top of this, however, CRAs are also regulated directly in the EU by the Capital Requirements Directive, which implements Basel II in Europe. To be recognized as an external credit assessment institution (ECAI) under the standardized approach of the Basel II Capital Framework, an agency's rating methods must satisfy criteria set by supervisors concerning objectivity, independence, continuous monitoring, and transparency. ECAI recognition is a prerequisite for banks being able to use the agency's ratings to calculate their risk-weighted assets in accordance with the Capital Requirements Directive.

India took an early lead in regulating CRAs with SEBI (Credit Rating Agencies) Regulations, 1999 which contained a comprehensive Code of Conduct that included requirement of entering into a written agreement with the client and obligation to continuously monitor ratings. Transparency and disclosure are the mainstays of the regulatory regime. A recent circular in May 2010 provides for various disclosures (rating procedure, default studies, income), measures to deal with conflict of interest, obligations in respect of rating of structured products, unsolicited credit ratings etc.

Global Financial Crisis

Though the CRAs were generally held responsible for awarding highest rating to structured finance products which performed abysmally during the financial crisis yet in the beginning of blame fixing, the brunt was borne by the investment bankers from the Wall Street. It is recently that CRAs have been getting public attention through high profile public hearings in the USA. For example the Financial Crisis Inquiry Commission which was created by the Fraud Enforcement and Recovery Act of 2009, focused on CRAs in its hearing on June 2, 2010. Similarly the Senate Government Sub-committee on Investigation under Senator Carl Levin gave hearing to CRAs on April 23, 2010. Though the jury is still out on the subject, a foretaste of things to come can be had from the opening statement made by Senator Levin. After describing how Residential Mortgage Based Securities have been around for a long time and how these were re-packaged and re-re-packaged into CDOs, Senator Levin goes on to say;

"In exchange for large fees, Wall Street firms helped design the RMBS and CDO securities, worked with the credit rating agencies to obtain favorable ratings, and then sold the securities. Without credit ratings, Wall Street would have had a much harder time selling these products, because each investor would have had to rely on themselves to figure them out. Credit ratings helped make the sales possible by labeling certain investments as safe, using their trademark AAA ratings."

Even as CRAs have not been indicted formally, a large number of international reports have identified several factors that were responsible for their poor performance.

Conflict of Interest

Conflict of interest is almost an unavoidable circumstance in financial business. Eliminating conflict of interest amounts to eliminating the business opportunity as well. Most of the regulatory structures are built around managing conflict of interest.

The first and foremost conflict arises because the credit rating agencies primarily adopt 'issuer pays' model. CRAs are public companies and are under tremendous pressure to show earnings. No CRA is in a position to annoy a large investment bank who employs the agency for rating hundreds of issuances. Even though formally the raters are not allowed to be in the teams that procure business, the organizational pressure is not easy to resist. CRAs had certain procedures in place for resolving this kind of conflict. As discussed earlier, public hearings are in progress and the issue is a hot topic of discussion among regulators.

Secondly, CRAs are in the business of offering consulting and advisory services too. These take the form of advising the companies as how various hypothetical scenarios would affect their ratings. If a CRA advised that a particular merger is not likely to affect the ratings of the companies, it would find it extremely difficult later to downgrade a ratings due that merger.

A related problem arises when the CRAs whether as a part of transparency exercise or in their advisory role tell the manufacturer of a structured product as to the factors / parameters that are taken into account while assigning a rating. The product manufacturers prime the product to have exactly those features which will just bring in the desired rating. Such a product is more likely to perform badly under stressed conditions.

Thirdly, there is the issue of unsolicited ratings. Though unsolicited rating are a way in which the conflict of interest inherent in 'issuer pays' model can be resolved as ratings from those who did not have any financial dealings with the issuer are available for comparison. However, it gives rise to its own conflict of interest. There have been instances when having been spurned by an issuer; the CRA went ahead issued an adverse unsolicited rating which undermined the public issue as it was in progress. The courts did not punish the CRA as the rating was just an 'opinion' and protected from litigation. It is worthwhile to remember that 'issuer pays' model was not always the norm. In the beginning , the 'user pays' model was prevalent. Even today, in niche areas like Mutual Funds, the 'user pays' model is remarkably successful.

Finally, it is possible to have common directors between CRAs and rated companies. For example, Moody's had a director common with WorldCom.

Inadequacy of data and models

It has been alleged that while rating CDOs, the rating agencies did not have loan level data of the underlying pool and simply relied on the pool level data. Moreover, they presumed that the loan performance was uncorrelated and accorded the diversification benefits. The models did not take into account fat tails of the distribution. Some authors have challenged the efficacy of normal distribution used in the models.

Whatever might have been the reasons, the fact remains that the actual default rates of the rated securities far exceeded the default probabilities implied by the ratings accorded to these.

Competition Issues

The NRSRO regime in the USA perpetuated the dominance of the established players. It was almost impossible for a new company to become NRSRO. The situation is very succinctly put by US SEC commissioner Cynthia A. Glassman

"Our no-action process for recognizing NRSROs is opaque. The process can only be described as Kafkaesque. Rating agencies cannot be an NRSRO unless their ratings are nationally recognized, yet they cannot achieve national recognition without being recognized by the SEC staff as an NRSRO, a classic "chicken and egg" problem. The requirement that a rating agency be nationally recognized acts as a "nearly insurmountable" barrier to entry for new credit rating agencies. Keeping the national recognition requirement entrenches the existing NRSROs and eliminates the possibility of NRSRO status for any innovative models."

The situation has improved considerably after the passage of Rating Agencies Reform Act of 2006 in the USA after which about ten such agencies exist. There are also a large number of niche agencies which are doing business in specialized areas such as 'Morning Star' in Mutual Fund space.

Certain issues beyond the obvious

Over Expectations

Ratings came to be revered and much more was expected of them than they were ever designed for. Primarily the rating only indicates the probability that the issuer will be able to meet his obligations for repayment of the interest and the principal. If, however, a large number of holders of the securities try to sell these, the chance is there that will be no buyers. If a buyer thought that holding a AAA bond ensured liquidity at all times, it was not what the rating agency promised when it issued AAA ratings. Panic to sell any bond unleashes a cascade of consequences. As panic spreads, all sources of finance to the issuer dry up and an otherwise strong issuer might actually face business closure. Many investors began to treat ratings as buy/sell recommendations and relied entirely on credit ratings instead of performing their own due diligence.

There is a need to de-emphasize the importance of ratings. Higher ratings should not be attributed all the desirable qualities such as liquidity.

Regulatory Prescriptions

Over-expectation from ratings was not limited to investors. Even regulators tended to rely excessively on the ratings. Since a long time insurance and pension fund regulators have mandated that investment by their regulated entities will be made only in highest rated debt securities. The ratings became a benchmark above which the insurance companies and pension funds would invest without doing any further assessment. Reliance on ratings reached a new high when the standardized approach of Basle 2 accord required national regulators to accredit rating agencies and laid down substantially lower capital requirements for highly rated debt.

These regulatory prescriptions started a race for highly rated paper. No one wanted a lower rated paper. Obviously, it is not a sustainable proposition.

Compensation

Rating agencies are, in a way, quasi-regulatory organizations. The analysts there generally stick to the beaten track and there is no incentive for them to develop such expertise and insights that would have been useful in detecting the inherent weaknesses in the structured products that they had been rating. They try to advance their careers by simply doing more ratings rather than trashing complicated products. Their compensation structure does not encourage them to think contrary and take risks. When these analysts are pitted against highly motivated and trained financial engineers, they tend to be followers rather than leaders. Michael Lewis in his book 'The Big Short' paints the scenario rather uncharitably

"*They're underpaid," said Eisman. "the smartest ones leave for Wall Street firms so they can help manipulate the companies they used to work for. There should be no greater thing you can do as an analyst than to be the Moody's analyst. It should be, 'I can't go higher as an analyst.' Instead it's the bottom!*

The way forward

The issue of regulating and reforming the CRAs is being discussed vigorously in various forums. The recommendations cover a wide range viz. laying down registration requirements, disclosure norms and various measures to resolve potential conflict of interest. There is surfeit of proposals to reform the CRAs. The latest perhaps being Larry Harris' article in Financial Times of June 3, 2010 wherein he suggests putting rating fees into an escrow account and releasing the money to CRAs after a few years when the ratings have performed as expected. On 9th June, a response from D. Patrick McCullagh was published pointing out that this will lead to another conflict of interest.

"When a rating agency analyses a bond with characteristic on the cusp of maintaining or downgrading a rating, a downgrade will cost it future revenue."

The short point is that there are no easy solutions and each suggested solution has trouble attached to it. However I am willing to tread where angels are afraid.

The first issue is that of over expectations. The minimum the regulators can do to curb such expectation is to lay down norms for investment appraisal for their regulated entities. These norms should provide not only for independent credit appraisal but also assessment of other risks such as market risk and liquidity risk.

Secondly, the Basle Committee might consider a rethink on the standardized approach. The idea is not to foist advance approaches on smaller banks but to provide for a matrix for assessment of capital requirement in which credit ratings form an element and not made to bear the entire responsibility.

Finally, the compensation issues of limiting compensation of employees of banks and other financial institutions that are being discussed widely might indirectly bolster the status of the rating agency analysts. The managements of CRAs might try to devise rewards to the star analysts based on their long term performance and standing. The aim should be to bestow status to the CRA analysts.

The views expressed are those of the author and do not necessarily represent the organisation for which he works