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John Thirlwell\*

## Credit Rating Agencies: The New Emperors and Their Clothes

- From humble origins as suppliers of information and arm's-length opinions, the major credit rating agencies have developed into powerful global institutions, whose positions are virtually unassailable by would-be new players and deeply entrenched in the workings of today's financial markets. This note maps the rating agencies' remarkable evolution and points to a number of critical and potentially problematic implications.
- The transformation of the agencies' role would not have been possible without the endorsement of regulators, which in essence have awarded the agencies effective control over the access to and the costs of funds in bond markets and beyond.
- Over time, the agencies have become increasingly commercially minded, with most of their revenues now generated from issuers, which contrasts with the self-restraint and investor-biased revenue mix they displayed until only a few decades ago.
- The protected position in their home market has helped the agencies to fund their rapid global expansion as well as the development of profitable 'bolt-on' services.
- Unsolicited and unpaid ratings, once the industry's mainstay in its early days, have turned into an effective means - intentional or not - to drive reluctant issuers into paid rating relationships and away from potential competitors.
- The agencies' dominant position has also been supported by the complicity of the markets, which have largely outsourced responsibility for the analysis that they should be undertaking themselves.
- Despite recurring disquiet about both their performance record and their dominant market position, which has led to complaints from politicians, regulators, investors and issuers alike, the agencies continue to remain largely unregulated and unsupervised, as well as effectively unaccountable for negligence or other professional wrongdoing.
- In another note the author will evaluate alternative proposals how the 'leviathan' can be tamed and how the agencies' core service to financial markets can be revitalised.

*\*John Thirlwell is an independent consultant and former senior director at the British Bankers' Association.*

### *A brief history*

Rating agencies date from the development of the US railroads, when the railroad companies were the largest borrowers in the bond markets at that time. Poor and Moody were there at the start. Henry Varnum Poor published his first manual of railroad companies in 1860, and John Moody his *Manual of Industrial Statistics* (1900). After the disastrous US crash of 1907, bias-free information and opinions were sought, which Moody supplied in his *Manual of Industrial and Corporation Securities* (1909). Agencies emerged; mergers followed; and, when Poor fell on hard times and merged in 1941 with Standard Statistics (which had published its first ratings in 1924), the US oligopoly was born. Expansion beyond the USA did not really follow until the 1970s with the advent of the euromarkets and with offices opened in major centres overseas, in the 1980s.

### *The rise of the oligopoly*

Niche players have since emerged, generally local, but some specialising in particular market sectors, so that there are now dozens of rating agencies around the world. But many have been bought, and consolidation has left a world dominated by the big two or, to be fairer, the oligopoly of the big three, Fitch, Moody's and Standard & Poor's.

In part, this oligopoly has been sustained by issuers wanting ratings only from agencies accepted by investors. And investors turn to the big three because of their exceptional coverage of the markets and also, quite simply, name awareness or the classic 'IBM buying syndrome'. Even if investors are looking for two ratings, almost invariably they need look no further than these three. It is convenient and cost-effective.

The major agencies' coverage and brand awareness among investors make their position almost unassailable. Establishing a similar position from scratch is difficult, if not impossible. It would require exceptional resource, as well as many years. The barriers to entry are insuperably high and, in some respects, reinforced by regulators, wittingly or otherwise.

### *Rating agencies and the regulators*

Transformation to the present oligopoly was essentially cemented by the development of nationally recognised statistical rating organisations (NRSROs) in the USA in 1975 following the Penn Central bankruptcy. Under the net-capital rules applying to broker-dealers, the SEC allowed preferential treatment for proprietary holdings of a range of securities which had been rated investment grade by at least two NRSROs. The SEC did not define an NRSRO, but Fitch, Moody's and Standard & Poor's (S&P) were admitted to this exclusive club. In 1997, IBCA acquired Fitch, which enabled IBCA to expand from rating banks to gaining at last a foothold in the lucrative US corporate bond market. Fitch/IBCA bought Duff & Phelps, which had itself achieved NRSRO status. Other than that, only Dominion Bond Rating Service from Canada has been admitted, in 2003.

The agencies' role has been continually reinforced in the USA and internationally by regulators' use of ratings as a proxy for the prudential standards they wish to impose. The SEC, for instance, uses ratings in its investment rules for money market funds. Japan's

Ministry of Finance has used them to determine which issuers could sell debt in their markets. The Commission des Opérations de Bourse in Paris uses ratings to reduce disclosure requirements. Even insurers in the UK find that proposed regulations governing with-profits capital assessments in part use a matrix of maximum yield spreads against each rating grade offered by leading agencies.<sup>1</sup> Against this background, obtaining a rating has become virtually mandatory for issuers seeking to access the financial markets, especially the US public markets.

But the only people to have the necessary coverage are the current oligopoly. In a speech in February 2004, Callum McCarthy, Chairman of the UK's FSA, called for more competition for the major agencies and especially for action by the US government to achieve this.

A laudable aim, except that his regulatory colleagues internationally seem to be working in precisely the opposite direction. The proposed new Basel Capital Accord for banks will place ratings at the heart of the assessment of their capital adequacy. Banks on the advanced approaches will be able to use their own internal ratings – although external ratings will still govern assessments of ABS and repos. For the vast majority of banks around the world, however, the risk and therefore capital assessment of their assets will be predicated on external credit ratings, as will the base cost of finance for their clients.

The regulators, through the Accord, keep high the hurdle over which new agencies must jump if they are to join the charmed circle and so enable diversity to challenge the current oligopoly.

### *Who pays the piper?*

Frank Partnoy, in the Washington University Law Quarterly<sup>2</sup>, concluded that this shift towards “selling regulatory licences” to the agencies had “not only caused a decline in the informational value of credit ratings, but also [created] incentives for the agencies to provide inaccurate ratings and for market participants to pay for regulatory entitlements stemming from the agencies’ ratings, instead of paying for the informational content of the ratings”. Others have suggested that this privatisation of policy-making narrows “the legitimate sphere of government”.<sup>3</sup>

In the early decades of the agencies’ development, they operated tight, ethical self-restraint. In the late fifties, the President of Moody’s could state categorically (in an interview published by *Christian Science Monitor*) that Moody’s would never charge rating fees. Taking money from rated issuers would inevitably erode the credibility and integrity of the rating system.

It seems like another age. The quasi-regulatory powers they have been granted, together with the way in which the markets have developed, have gradually changed the commercial basis of their business.

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<sup>1</sup> Financial Services Authority, *CP195 – Enhanced capital requirements and individual capital assessments for life insurers* (August 2003)

<sup>2</sup> Frank Partnoy, *The Siskel and Ebert of financial markets? Two thumbs down for the credit rating Agencies*, Washington University Law Quarterly, vol 77 (3) (1999)

<sup>3</sup> Michael R King & Timothy J Sinclair, *Grasping at Straws: A rating downgrade for the emerging financial market architecture*, University of Warwick Centre for the Study of Globalisation and Regionalisation (November 2001)

A credit rating's primary purpose should be to provide investors with an independent view of an issue or transaction. According to Moody's, it is an opinion "of the future ability, legal obligation and willingness of a bond issuer or other obligor to make full and timely payments on principal and interest due to investors."

That implies that investors should be the principal buyers of the agencies' services. Not so. Investors represent only 10% of agencies' revenue, the real money coming from issuers. An obvious conflict, if the service is actually paid for by those who are seeking to appeal to the investors. As a senior executive of Moody's once admitted, "It puts bargaining leverage in the hands of the issuers who sign the cheque".<sup>4</sup>

### *Rating evaluation service*

The agencies' dominant position has also enabled them to develop commercial opportunities, such as the rating evaluation service offered by both S&P and Moody's for issuers and their intermediaries. S&P's 2002 report showed that evaluations were growing rapidly, from 16 in 1997 and 21 in 1998 to 227 in 2002. The service represents another conflict with their role in providing independent ratings to the market. By offering evaluations they become part of the deal. They can influence the structure of transactions and create rating expectations on which it may be difficult for them to renege. The service is for the issuer, not the market. And remember also that their fees tend to be linked to the size of the deal they are advising on.

### *Unsolicited ratings*

Then, of course, there are unsolicited ratings. Initially, they were all the agencies offered. That began to change in the 1950's with the growth of the CP market. By 1996, the predatory possibilities of unsolicited ratings led the Department of Justice to launch a three-year inquiry into Moody's, prompted by their then dominant position in the market. The Department concluded that Moody's had not violated anti-trust laws. On the other hand, the mere 'threat' of unsolicited ratings can be a powerful argument for issuers to seek a 'friendly' (and paid) rather than risk a 'hostile' rating. Issuers are inevitably inclined to succumb to seeking a full rating, in which they have input, even if they have to pay a full fee.

The agencies' answer is, first, that unsolicited ratings benefit the market. That depends on their quality. S&P explicitly states that it relies exclusively on public information for such ratings and shows this through its 'pi' designation. At least this transparency makes it clear what the market is getting. Of course, the agencies' claim that unsolicited ratings are for the benefit of the market would be more convincing if they committed not to accept future fees from the issuers they target.

The real problem, though, is that free, unsolicited ratings, once the mainstay of the market, have become the means by which the agencies can use their financial and market muscle (generated from virtual monopoly cash-flows in the US) to defend their coverage and control of the major bond markets and to expand it to those which are new or developing. That extensive coverage effectively drives reluctant issuers into their arms and away from

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<sup>4</sup> Thomas McGuire, *Ratings in Regulation: A petition to the gorillas*, Moody's Investor Service (June 1995)

potential competitors. Hence, through unsolicited ratings the established agencies assert their dominant market position in a way that competition watchdogs in other markets could well qualify as abuse.

### *Financial strength*

The scale of that dominant position and the virtual monopoly which the major players enjoy can be seen in their results. Moody's 2003 figures reveal increases of 22% (2002: 28%) in revenues to \$1.46 bn and 26% (2002: 36%) in net income to \$0.364 bn, with operating margins now above 50%. These numbers are hardly evidence of fierce competition. The combined revenues of the three major agencies are now well over \$3bn and their growth path has been remarkably stable over the past few years. Some of the bulge-bracket players in the fixed income markets, which the agencies serve, would be very happy with those figures.

### *Market complicity*

But the markets have also been complicit. They know that it is mainly the issuers who pay the agencies, not they, the investors – which of course means that ratings are available at a fraction of their full costs. And they ought to be aware of the potential conflicts in agencies' practices, which are considerable. Those who are subscribers can at least have the benefit of reading the agencies' detailed reports. But the vast majority of investors, especially in the secondary markets, trade almost blindly off the back of the ratings. Is the market, in fact, a market in ratings, rather than bonds?

This might not matter so much if the market had a clearer idea of the agencies' assessment processes, which have become even more pseudo-scientific, now that a variety of 'watch' grades have been added to the mix. The reliance on ratings by the market and the regulators' ever more tacit support suggest an overly optimistic belief that ratings stem from an objective, empirical process. Even Sir Howard Davies, then Chairman of the FSA, admitted in an interview last year with the *Financial Times*, that regulators and investors took the opinions of the agencies as "a sort of shorthand for credit quality that regulators have sanctioned".

The National Economic Research Associates reported in November 2003<sup>5</sup> the results of a two year study into ratings of structured products, dealing especially with how underlying security, either rated by another agency or unrated, was dealt with. The results were at best inconclusive or ambiguous. As one commentator put it, bearing in mind the increased dependence by regulators on these ratings (including the new Basel Accord), "entire regulatory regimes might be based more on wishful thinking than on fact"<sup>6</sup>.

### *Who rates credit?*

Most worrying of all, the market has effectively outsourced its credit analysis to the rating agencies. Some may argue that there is insufficient corporate information and that the

<sup>5</sup> AS Carron, PJ Dhrymes, TN Beloreshki, *Credit Ratings for Structured Products – A Review of Analytical Methodologies, Credit Assessment Accuracy, and Issuer Selectivity among Credit Rating Agencies*, National Economic Research Associates (November 2003)

<sup>6</sup> Mark Adelson, *NERA Study of Structured Finance Ratings – Market Implications*, Nomura Fixed Income Research (6 November 2003)

agencies are helping to fill that gap. Another view might be that firms consider the cost of doing the job themselves, in a way they understand, far outweighs the risks they run of using agencies whose methods are a mystery to them, or is less than the possible benefits of competitive advantage. It points to a fundamental lack of investor awareness and discipline. And if there is no discipline, what incentive is there for rating agencies to do the job the market – not issuers – wants?

### *Rating performance*

It might be a reasonable approach if the agencies' performance was exemplary. Recent high profile cases, ranging from Swissair to WorldCom, suggest that it is not – and perhaps never will be. On the other hand, the agencies do have a duty of care. In its annual report of international capital markets, published in September 1999<sup>7</sup>, the IMF raised concerns about the accuracy and stability of ratings (following the significant and sudden downgrades which followed the Asian crisis of 1997) and suggested that agencies should devote more resources to the rating of emerging market countries if they were not to repeat the mistakes they had made in SE Asia. Indeed, the IMF suggested that the agencies had accelerated the outflow of capital from countries and so made a bad situation worse.

### *Rating sensitivities*

Partly because of their power in the markets, ratings (or more particularly downgrades) generate huge sensitivities.

In Germany, in December 2003, S&P found itself attacked on two fronts. First, under political and regulatory pressure, it announced a six month delay in publishing its 'post-2005' ratings for the German Landesbanks, i.e. after they lose their State support. Next, it was attacked in a report by two academics hired by German corporations such as ThyssenKrupp, Linde and Deutsche Post, which S&P had dramatically downgraded earlier in the year in the light of their pension deficits. The accusation was that S&P's approach was inappropriate for the German corporate system. Yet these same corporations had, of course, sought ratings from S&P when they needed them.

### *Ratings and politics*

Politicians have also entered the fray. European politicians have long complained about the agencies' power to damage economies or even to bring down governments. They have also pointed to the very different corporate financing structures which exist in Europe, with a different debt/equity mix and a relatively less significant or developed bond market than in the USA. They do not believe these are adequately reflected by the US agencies. A recent EMAC paper, which was tabled in the European Parliament, argued for the establishment of a European rating agency.<sup>8</sup> Similar concerns (following significant downgrades) have been heard in Japan, both at a national and corporate level.

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<sup>7</sup> International Monetary Fund, *International Capital Markets; Developments, Prospects and Key Policy Issues* (September 1999)

<sup>8</sup> European Parliament, Committee on Economic and Monetary Affairs, *Working Document (PE 333.059) on Rating Agencies* (Rapporteur: Giorgis Katiforis, MEP) (6 October 2003)

The US bias card is frequently played. To use Andrew Fight's phrase in his book *The Ratings Game*, are they, or especially is Moody's, "the McDonald's of the business", exporting the modus operandi it uses on its own turf?<sup>9</sup> He quotes Moody's as saying, "our objective for the future is to supply the global credit markets with the same independently created analyses that those domestic US financial markets have required since 1909". Fine if the accent is on "independently", but not if, inappropriately, it's on "same".

The market's view of Moody's independence was somewhat shaken in June 2002 when it withdrew its sovereign credit ratings for Iran because it "could be inconsistent" with US sanctions. The commercial significance was probably slight, but the perception that Moody's was not independent of government interference, or perhaps US commercial pressures, was not.

### ***Unregulated superpowers***

The rating agencies wield extraordinary power. Ironically, the regulators, who have in part helped to create this position, have also added their voices to the chorus of disapproval and the cry that "something must be done". Both the SEC and IOSCO are currently undertaking investigations of the agencies' role and seeking solutions. Yet their banking colleagues in Basel are poised to reinforce the status quo.

The agencies enjoy significant and still increasing power through the quasi-regulatory status, yet are essentially unregulated themselves. How can this be resolved, given also the supranational status of the major players?

### ***The way forward***

Apart from this, the issues to be tackled are many:

- How to encourage realistic and effective competition in the rating market.
- How to ensure that all corporations in all countries are given appropriately equal treatment, or all corporations in particular sectors.
- The agencies' use (and abuse?) of their dominant position. Perhaps unbundling of services could be the answer, as has happened to accountants/Microsoft?.
- As research providers the agencies enjoy the privileges of insiders. But whilst the problem of information asymmetry is constantly being tackled in the equity markets to assure equality of treatment for all market participants, regulators seem only to reinforce the rating agencies' privileged position.

A forthcoming note will evaluate the alternatives which are being proposed to tame the 'leviathan', whilst at the same time consider how to revitalise the credit rating industry's core contribution to financial markets.

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<sup>9</sup> Andrew Fight, *The Ratings Game*, John Wiley (2001)

**John Thirlwell**  
**+44 (0)20 8386 8019**  
**info@johnthirlwell.co.uk**

**RBC Capital Markets**  
**International Bonds**  
**Fixed Income Sales**  
+44(0)20 7895 9297

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