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*John Thirlwell**

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The Credit Rating Age (Part II)

"The Call for Control"

From humble origins the credit rating agencies have evolved as global power brokers and de-facto intermediaries in debt and derivative markets. Their might, their perceived failings on a number of high profile cases, and their potential exposure to greed and conflicts of interests have sparked a lively debate on how best to ensure that they remain focused on their primary default prediction service, with minimum distraction from their own commercial goals or outside pressures from issuers, investors, intermediaries and governments alike.

Further to an analysis of the agencies' seemingly unstoppable ascent (see: RBC CM Open Forum Notes, Volume 8) this note examines recent proposals for a reform of the rating agency business, with particular regard to the frequent calls for a dedicated regulatory framework. Closer inspection reveals that more competition, more transparency and the unbundling of the core rating service from non-rating activities would be more effective means to preserve the agencies' integrity and reputation and to enhance their contribution to financial markets than more regulation:

- A key element of reform would be the removal of the regulatory restrictions which act as barriers to entry for new or smaller agencies, in particular the current system of NRSRO recognition in the USA.
- To widen the gene pool of agencies, the key criterion for any regulatory eligibility test should be one of "market recognition", whether that market is defined by geography, industry sector or product.
- Whilst it would be preferable for issuer fees to be prohibited, at the very least income sources, including those relating to ratings on securitised products, should be made transparent to the ratings' users.
- Transparency should extend to identifying whether a rating has been solicited and the nature of any rating triggers within instruments which are rated.
- The conflict of interest deriving from the provision of ancillary services must also be removed by their being unbundled.
- Regulators must learn to curb what has become their habitual use of ratings effectively as a proxy for prudential standards in the debt and securities markets.
- The nature of the rating agencies' activities argues for some form of oversight, short of their direct regulation. A respected third party agency could provide independent assessments of performance.

Ultimately, though, any attempt to tame the 'leviathan' depends on the active support of the markets themselves. They must accept their duty to perform their own due diligence instead of simply following the agencies and their ratings.

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

Introduction

The performance and dominance of the current oligopoly of credit rating agencies – Fitch, Moody's and Standard & Poor's (S&P) – has generated a range of concerns. Recent high-profile rating 'failures', such as Enron, WorldCom and Parmalat, have been the catalyst for these concerns to be articulated by regulators, users and others.[1]

This Note[2] will examine the proposals for reform of the credit rating agencies and the rating process, and consider how far they meet the aims of any reform of the system, which should be to improve the quality and timeliness of ratings and ensure adequate investor protection within markets which are fair, efficient and transparent.

Competition

The question of performance, which lies at the root of the problem, would probably be less prominent if there were real competition. Ratings quality might well improve with wider choice, based on performance. Instead, markets rely today on the oligopoly which has developed, principally through merger and acquisition rather than organic growth. This development has been endorsed by a plethora of regulatory actions in financial markets and by the absence of action from the normally zealous anti-trust and competition authorities.

The big three agencies might argue that rating is a complex task, which only those with the biggest resources can adequately perform. But firms such as Egan-Jones have shown that other models are just as effective. What the market needs is a greater number of agencies, possibly operating under limited licences to reflect their expertise, which can respond to market developments in a timely fashion. The deep analysis the larger agencies claim to undertake has been slow to react to events and not been especially effective.

NRSRO status

Increasing competition by reducing barriers to entry would be a first and important step to establishing a system appropriate for markets at the beginning of the twenty-first century. Fundamental to that lies the existence of NRSRO designation in the USA. NRSRO status, in its present form, confirms the present oligopoly. It is an anti-competitive barrier to entry, which also acts as an unduly narrow filter for those wishing to access the markets and must be replaced.

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[1] See Appendix for details of the principal initiatives currently being undertaken.
[2] See also: RBC Capital Markets Open Forum Notes, Vol 8, *Credit Rating Agencies – The New Emperors and Their Clothes* (30 April 2004)

When the Basel Committee reviewed the eligibility criteria used by G-10 countries and others in relation to credit rating agencies[1], a common theme was that agencies should demonstrate credibility with international or domestic market participants and objectivity. The UK, even more basically, simply stated their criterion as "market recognition", which it determined by a survey of banks and other market participants. This should be the basis for recognition – assuming, of course, that regulatory recognition is necessary at all.

Market recognition

Market recognition depends on what is meant by a market. It can certainly be national and the new Basel Capital Accord could encourage this, although the use of 'market share' as a criterion for market acceptance in the proposed EU Capital Requirements Directive patently works against new entrants[2]. Whilst Moody's and S&P have been accused of exporting an American approach, which does not recognise local characteristics, national agencies have also fallen short, possibly by being too close to their home markets. Ratings of Japanese construction companies and Swedish banks in the early nineties are good examples. National, or even regional, agencies are not the whole answer. A market, and related agencies, can also be product (e.g. high yield, ABS or project finance) or sector specific. CESR, for instance, has asked whether sufficient attention is given by agencies to SMEs.[3]

Competition must be encouraged, so that all agencies which are recognised and used by the market operate on a level playing field. That means the markets also must open their processes to new or specialist agencies and not rely, through habit, on the big three.

Conflicts – who pays?

All observers note the huge dependence of the 'big three' agencies on issuers for their fees - approximately 90% of revenue. The agencies themselves recognise this obvious potential conflict, which they counter on the basis that no particular issuer constitutes any significant proportion of the CRA's overall revenue.[4] Maybe, but the principle remains, and could be even more significant in the case of specialist agencies. A former senior executive of

[1] Basel Committee on Banking Supervision, Working Paper No 3, *Credit Ratings and Complementary Sources of Credit Quality Information*, Table 4 (August 2000)
[2] European Commission, *Proposal for new capital requirements regime for credit institutions and investment firms* (July 2004), Annex VI, Part 2, 9
[3] European Commission, *Call to CESR for technical advice on possible measures concerning credit rating agencies* (28 July 2004), 3.4 ["CESR"]
[4] IOSCO, *Report on the Activities of Credit Rating Agencies* (September 2003), p 11

Moody's once admitted that the practice "puts bargaining leverage in the hands of the issuers who sign the cheque."[1]

In their response to the SEC, Egan-Jones simply proposed that issuer compensation should be prohibited – which is, of course, how Egan-Jones operates. Sadly, it is unlikely that the SEC and others will go that far, but it would certainly remove the conflict.

It would also fundamentally alter the business model of the large agencies, back to the model of 30 years ago. If that meant higher fees to subscribers for rating information, users would evaluate more closely the true benefit of the agencies' work to them. Ratings quality would become the critical factor, as it is for those firms selling genuinely independent research.

The likely fallback is for agencies to have to disclose the nature of compensation arrangements, including any fees deriving from consultancy, as IOSCO has recently proposed. [2] If so, that should also apply to those agencies which are predominantly subscriber funded, often the new or small, specialist agencies which need to be encouraged to increase competition. The potential risk of undue influence is real and must be tackled, wherever it occurs.

Rating triggers provide another opportunity for undue influence. Transparency regarding triggers would provide investors with useful information against which to judge rating decisions.

Conflicts – ancillary and advisory services

Another significant concern lies in the somewhat pernicious development by the agencies of commercial services, such as ratings guidance or other consultancy advice. There is an obvious conflict when the advice comes from the agency which will almost certainly be asked to provide the actual rating when the time comes. Chinese walls do not solve the problem, are difficult to police and can easily be breached. IOSCO recommends that they

[1] Thomas McGuire, *Ratings in Regulation: A petition to the gorillas*, Moody's Investor Services (June 1995)
[2] IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies* (October 2004), 2.8, "The CRA should disclose the general nature of its compensation arrangements [and] . . . the proportion non-rating fees constitute against the fees . . . for rating services."

should separate their ratings business and analysts from any other business, "including consultancy businesses, that may present a conflict of interest."[1] This does not go far enough. It neither demands unbundling, nor does it appear to prevent ratings guidance offered from within the ratings business.

Accountancy firms lost the argument that their consultancy services were unconnected with their audit services and are now unbundled. Sarbanes-Oxley has dealt with conflicts of analysts' interests in investment banks.[2] Rating agencies are no purer, or less powerful, than the major accountancy firms or investment banks.

Abuse of dominant position – unsolicited ratings

Unsolicited ratings, i.e. those ratings which are initiated by the agency, are a constant bone of contention. Companies see them as a predatory practice which is difficult to resist. It wasn't always so. In the early days, when investors not issuers were the agencies' main source of revenue, unsolicited ratings were all that was offered. They still remain an important means by which new entrants access a market. But, in a world where agencies depend on issuers for their revenue, they have become the means by which the major agencies can use their financial muscle to defend their coverage and control of major markets and expand into those which are new or developing.

The agencies claim that unsolicited ratings benefit the market. This would be more convincing if they undertook not to take fees for the rating or in the immediate future from the companies they had so blessed. As a minimum, agencies should disclose whether a rating is unsolicited[3] and be forbidden from sending fee schedules with the rating (likened by some to a 'protection racket').

Transparency is essential to clear up the perceptions and misconceptions surrounding this aspect of credit rating activity.

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[1] IOSCO, *Code of Conduct*, 2.1 and 2.5.

[2] Sarbanes-Oxley Act of 2002, sec 501.

[3] See the recent IOSCO, *Code of Conduct*, 3.8, "The CRA should disclose when its ratings are not initiated at the request of the issuer and whether the issuer participated in the rating process."

The rating process – opacity

Transparency would also throw light on the opacity surrounding the agencies' methodologies. Everybody would like disclosure, partly to ensure that similar issuers are treated equally. IOSCO wants documented procedures "subject to some form of validation based on historical experience".[1] The European Parliament[2] and AFTE/ACT/AFP have made similar proposals.

On the agencies' side, opinions range from Moody's, which believes that transparency would help the market's understanding of a rating, to Fitch, which does not. It is unclear, though, that what they revealed would meet expectations or what effect it might have on ratings quality.

The market also agrees that regulators should not attempt to prescribe agencies' process and methodologies[3] or create a situation where they become harmonised, whether intentionally or not. Any attempt to fix standards will further entrench the position of the large firms. Variety is the essential spice of competition.

Ratings and regulators

Fundamental to the growth and dominance of the big three agencies, though, are the regulators, who have effectively awarded agencies control over the access to and the costs of funds in bond markets and beyond. In the Basel Committee's review of credit rating agencies, there is a table of selected ratings-dependent regulation in the USA.[4] It starts in 1931 with the OCC and Federal Reserve examination rules. In 1936 banks are prohibited from purchasing "speculative securities". So it goes on, through regulations for insurers (1951), broker-dealers (1975), S&Ls (1989 and 1994), money market mutual funds (1991), even the Department of Transportation (1998).

The situation is acknowledged by the SEC, IOSCO and even the European Commission, which specifically noted that "the role of credit ratings is being reinforced by developments

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[1] IOSCO *Code of Conduct*, 3.4.

[2] European Parliament, Committee on Economic and Monetary Affairs, *Working Document (PE 333.059) on Rating Agencies* (Rapporteur: Giorgis Katiforis, MEP) (6 October 2003) ["EP"]

[3] Draft *Code of Standard Practices for Participants in the Credit Rating Process*, Association Française des Trésoriers d'Entreprise (AFTE), Association of Corporate Treasurers (ACT), Association for Finance Professionals (AFP) (April 2004), 1.5, 1.6

[4] Basel Committee on Banking Supervision, Working Paper No 3, *Credit Ratings and Complementary Sources of Credit Quality Information*, Appendix 1, Table 6 (August 2000)

in the Basel II banking legislation" and so recommends that CESR collaborates with its banking colleagues.[1] It goes on to seek views on whether "the further use of ratings in European legislation should be encouraged beyond these measures."[2]

Quite rightly. Whilst Basel will allow the most sophisticated banks to use their own internal credit ratings to estimate their capital requirement, the vast majority of banks around the world will find that their capital is assessed on the basis of external credit ratings. There will be considerable capital advantage in lending to an entity rated investment grade.[3] Regulators created the 'tyranny' of the investment grade and acknowledge the agencies' excessive power. Yet Basel will make the position even worse, not better.

The regulators' habitual references back to ratings bloat their importance and distort the markets by encouraging artificial price cliffs, especially around so-called 'investment grade' level and the speculative grades below. Whenever regulators are tempted to use ratings as a proxy for prudential standards, they should question whether the standards are necessary and, if so, whether ratings are the only answer.

Public or private goods

Agencies have long resisted regulation on the grounds that they merely offer opinions on prospects of default, and not recommendations to buy or sell investments. This is far too disingenuous.

Ratings are central to the markets and central also to the regulatory process and to the political and socio-economic context in which it operates. In MEP Giorgis Katiforis's words, the agencies increasingly perform "a delegated government function"[4] and assume, even if involuntarily, "quasi-public responsibilities for the stability of the financial system"[5]. His conclusion is that they should be subject to some form of parliamentary accountability. Politicians, like regulators, must control.

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[1] CESR 1, Background
[2] CESR 3.5
[3] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards. A Revised Framework* (June 2004), paragraph 66
[4] EP D.II
[5] EP G (b)

The perception of agencies as public goods lies at the heart of efforts to regulate them. Regulation is a two-edged sword. It might level the playing field for newcomers, but it could also offer the major agencies the protection of "public good" status, for which they might well be prepared to pay. In a recent speech, Callum McCarthy, Chairman of the FSA, stated that the FSA was "sceptical about what and how much regulation can achieve".[1]

It must be preferable to reach a market-based solution, in which they are maintained as private goods, whilst acknowledging the benefits of some form of oversight. Even that might be avoided were it not for the regulators' dependence on ratings to perform some of their functions. Perhaps the agencies add more value to the regulators than to the markets.

Any oversight should be light and principles-based. It should encourage the development of new or growing agencies, recognising their lack of rating history and relative lack of resources. It should perhaps deal with harmonisation of ratings and their language and consider the introduction of public performance measures, which would therefore have a direct benefit to the market. This role could be performed by a respected third party authority such as IOSCO. If oversight merely leads to a significantly increased compliance burden (the message of the last ten or so years), and no harmonisation of international approaches, the additional overhead will become a further barrier to entry and the source of higher charges. And the quality of ratings will remain precisely where it is now.

Toxic waste

All of these issues and proposals, though, often seem like attempts to fight the last war. Markets and the ratings world have moved on. A couple of years ago, Howard Davies, then Chairman of the UK FSA, quoted an investment banker who referred to CDOs as being "the most toxic element of the financial markets today".[2] Toxic may be too strong, but there must be concern at the virtual market in credit which has grown up, in which the market trades ratings, not the issues they represent. Relationship banking appears more and more out-moded. For the agencies, this is increasingly the profitable business they are now in. It goes far beyond rating individual entities, the activity which prompted the original concerns.

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[1] Mansion House, 21 September 2004.

[2] AIRMIC Annual Lecture, London, 29 January 2002.

However, that should not deter reform of some of the more obvious potential abuses of the present system to create a better basis from which new issues and new markets can be tackled.

Conclusion

These reforms are key. Prohibiting issuer fees and/or unbundling commercial services would radically alter the agencies' current business model and refocus it on its traditional core. If subscribers had to pay more, perhaps some might decide they could do a better job themselves. The established agencies should also discontinue their practice of making their ratings available for free; instead, they should charge subscribers to both access to their research and their ratings, thus no longer 'dumping' their ratings and raising the barriers to entry for subscription-revenue based newcomers.

Oversight has its place, but the market also has a duty to perform its own due diligence and not blindly follow the agencies and accept their ratings without question. In any case, increased regulation or oversight will not improve the quality of agencies' performance, failures of which started the whole debate. But then, nor should it in sophisticated markets.

The real answer is to increase competition, reduce barriers to entry and so widen the gene pool of agencies. That way, the market will be better served and performance may improve. If increased competition brings problems of rating equivalence, let the market decide, rather than regulators.

Because, in the end, the buck stops with the markets. Do they truly wish to encourage the establishment and development of more agencies in whom they can have confidence and, through competition, improve performance, or are they going to be content, subject to some governance tinkering, to let things carry on much as before? They must be brave enough to reject inertia.

Other sources: *Responses to SEC Concept Release by Egan-Jones Rating Company, Fitch Ratings, Moody's Investors Service, Standard & Poor's.*

Appendix: Current Reform Initiatives on the Credit Rating Industry			
Organisation	**Document**	**Content**	**Timescale**
Securities and Exchange Commission (SEC)	Concept Release on rating agencies and the use of credit ratings under federal securities laws	Asks 56 questions covering: • NRSRO designation: its elimination and/or alternatives • NRSRO criteria for recognition: reducing potential regulatory barriers to entry • Examination and oversight of NRSROs: level an d need for ongoing oversight • Conflicts of interest and their management • Alleged anti-competitive, abusive and unfair practices • Information flow: need and means for improving quality of information available to users of credit ratings	Report written in January 2003 in response to directive within the Sarbanes-Oxley Act (2002). This formed the basis for the Concept Release, published 4 June 2003 for comment by 28 July 2003. The SEC is expected to publish its resulting thoughts and rule changes by Autumn 2004.
International Organization of Securities Commissions (IOSCO)	Code of Conduct Fundamentals for Credit Rating Agencies	Covers four key areas: • Quality and integrity of the rating process: agencies to issue opinions that help reduce asymmetry of information among market participants • Independence and conflicts of interest: rating decisions free from political or economic pressure or conflicts of interest; analyst and employee independence • Transparency and timeliness of ratings disclosure: publication of ratings methodologies and assumptions and statistics relating to historic default rates to enable comparisons between CRAs. • Handling of confidential ('inside') information	Issued October 2004, following publication of Report on CRAs (25 September 2003) and builds on 'Statement of Principles contained in that report. Fundamentals of a 'Code of Conduct for Credit Rating Agencies' due to be published by end-December 2004.
European Parliament (EP)/Economic and Monetary Affairs Committee (EMAC)	EP Resolution on the role and methods of rating agencies, following an own-initiative report from EMAC (Rapporteur: MEP Katiforis)	Calls for: • Cost-benefit analysis of establishing a European Registration Scheme for rating agencies, on the basis of well-specified criteria • Close contact and co-operation with IOSCO, US authorities, Financial Stability Forum • Specialist agencies to be treated on a level playing field with other agencies by regulatory authorities; promotion of agencies which have greater regard for SMEs • Voluntary industry body to determine best practice, encourage training and provide disputes resolution forum for issuers and investors • Transparency of methods, models and fees; publicising of unsolicited ratings; annual reporting by agencies, including their financing • Disclosure of rating triggers in loan agreements • Regulation of process but not content of ratings	EP Resolution adopted 10 February 2004, following a report by MEP Katiforis, calling on the EC to submit by 31 July 2005 its assessment of the need for appropriate legislative proposals.
Association Française des Trésoreries d'Entreprise (AFTE)/Association of Corporate Treasurers (ACT)/Association for Financial Professionals (AFP)	Code of Standard Practices for Participants in the Credit Rating Process	Regulatory recommendations: • Credibility and reliability: no prescription of agencies' methodology • Transparency in the agency recognition process • Improved oversight • Inside information flows: prevent selective disclosure Rating agency Code of Practice: • Improve transparency of rating process: public disclosure of methodology • Conflicts of interest and Chinese walls • Disclosure of unsolicited ratings • Improved communication with issuers and market Issuer Code of Practice • Improved communication with agencies and timely response to agency requests • Annual review with agencies: minimum information standards • No pre-emptive action to challenge or counter the release of ratings	Following a member survey by the AFP in November 2002, the AFTE, ACT and AFP published a joint Exposure Draft in April 2004 for comment by 30 June 2004.
Committee of European Securities Regulators (CESR)	Technical Advice to the European Commission (EC) on possible measures concerning credit rating agencies	Core issues identified by EC: • Barriers to entry • Potential conflicts of interests: unsolicited ratings; payment for ratings; ancillary services • Transparency of rating agencies' methodologies • Regulation and rating of rating agencies	Issued November 2004, following call by EC (July 2004) to consider the activities of credit rating agencies and the EP Resolution of 10 February 2004 (see above).

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

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