Reforming the Credit-Rating Process

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The downgrading (and warnings of potential downgradings) of an unprecedented amount of asset-backed securities and collateralized debt obligations (CDOs) in July have raised concerns among investors about the ability of rating agencies to assess the credit quality of these instruments. Even though the affected securities represented a small share of these markets, the action surprised investors and led them to wonder why ratings had not been cut earlier, since the problems in the U.S. subprime-mortgage market had been apparent for some time. Rating agencies have also been criticized for putting themselves in conflict-of-interest situations. These concerns have been accompanied by calls in a number of countries for greater public scrutiny of rating agencies and for more transparency in the rating process. In October, the G-7 indicated its support for the Financial Stability Forum’s plans to study the role, methodologies, and use of rating agencies in structured-finance markets.

Various proposals have been put forward internationally to enhance the ratings process, especially in the area of structured products. This report provides a brief overview and discusses the merits of each one.

Increased Regulation of Rating Agencies

Citing past high-profile rating mistakes, conflicts of interest inherent in the rating business, and the oligopolistic nature of the industry, some observers have suggested that rating agencies should be regulated more closely. The major rating agencies operating in the United States are currently regulated by the U.S. Securities and Exchange Commission (SEC), which introduced a new regulatory framework for rating agencies in June. To make the case for increased regulation, it must be demonstrated that there has been a market failure that is not likely to be corrected by market forces alone, and that more government regulation represents a viable, cost-effective solution.

Rating agencies have been criticized for the conflicts of interest inherent in their business: They receive a significant portion of their revenues from the issuers that they rate, even though the same ratings are provided as a service to investors purchasing the securities in question; they provide advice to issuers before securities are issued that helps them qualify in advance for desired ratings; and they publish unsolicited ratings that could, potentially at least, pressure issuers to pay them fees.

Rating agencies acknowledge these inherent conflicts of interest and argue that they have a wide

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1. In September 2006, the U.S. Congress passed the Credit Rating Agency Reform Act of 2006, which provides new recognition standards and introduces more formal oversight of rating agencies. However, the SEC is prohibited under the Act from regulating the substance of credit ratings or the process by which ratings are determined. The SEC introduced a new set of rules to implement the Act in June 2007 and is currently in the process of redesignating rating agencies under the new rules. It is therefore too soon to assess the effectiveness of the new regulatory regime. Outside of the United States, there is little oversight of the major rating agencies. The European Commission has so far taken a “wait and see” attitude towards the rating industry. However, the recent market turbulence has resulted in calls from some European governments for more formal oversight of rating agencies, and the European Commission has asked the Committee of European Securities Regulators (CESR) to review the rating process surrounding structured products.
range of mechanisms in place to manage them. For example, they have a highly diversified client base, which does not leave them overly dependent on any one client or sector. In addition, they make their rating criteria and opinions public, which promotes a better understanding among investors of the rationale behind published ratings. Agencies also maintain a separation between the analytical and commercial activities associated with any given rating to foster the independence of their ratings. The compensation of their analysts is not dependent on the fees related to the ratings they assign, plus committees review and approve the ratings proposed by the analysts. More generally, they claim that the need to preserve their reputation is an incentive for them to try and provide fair, objective, and independent ratings—a claim supported by Covitz and Harrison (2003).

While rating agencies have experienced some controversial failures, they have also shown an ability and willingness to learn from their mistakes, and they are regularly refining their rating processes. It is not clear that regulators have any comparative advantage in overseeing the rating process, since they are further removed from the entities being rated than the agencies. Regulators may not be in the best position to evaluate the methods used by rating agencies to assess financial instruments. Venturing into this territory would expose them to the risk of being held publicly accountable for the mistakes of rating agencies. It could also stifle innovation in the rating industry, as well as the development of financial markets more generally, since regulators would have difficulty keeping abreast of the flow of new products that are regularly being developed in financial markets. It is also not clear who would be best placed to regulate the rating process, since rating agencies have significant cross-border activities and rate products that trade in more than one jurisdiction.

Where public authorities may have a role to play is in continuing to press rating agencies to adhere to the provisions of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO Code) so that investors have confidence that conflicts of interest are well managed. Four rating agencies have provided the Committee of European Securities Regulators (CESR) with self-assessments of their adherence to the IOSCO Code. In general, the CESR concluded that the rating agencies’ own codes of conduct comply, to a large extent, with the Code.2

Making Investors, rather than Issuers, Pay for Credit Ratings

For most of their history, rating agencies made money by charging investors subscription fees; they did not charge the issuers of securities. This changed in the 1970s, when agencies began charging fees to debt issuers to rate the credit quality of their securities. As credit ratings became more widely used, they were leaking into the public domain and becoming public goods with all of the attendant free-rider issues. Today, ratings are available free of charge on rating-agency websites. Furthermore, issuers have incentives to be rated because credit ratings facilitate their access to markets. Rating structured products now accounts for as much as 45 per cent of the revenues earned by some rating agencies. Given the apparent conflicts of interest associated with rating agencies being paid by the issuers of securities they rate, some commentators have suggested that the agencies should revert to the practice of having investors, instead of issuers, pay for credit ratings. This may no longer be possible or practical, however, now that credit ratings are public goods. The quality of ratings could decline over time if rating agencies were not able to fund an appropriate level of supporting research. There would also be less public scrutiny of ratings if fewer investors had direct access to them, which might weaken the pressure on rating agencies to produce high-quality ratings.3

Improving Competition in the Credit-Ratings Industry

Moody’s and Standard & Poor’s have dominated the credit-ratings industry for many decades. They enjoy healthy profit margins, because there are

2. IOSCO (2007) reviewed the implementation of its Code by a broader set of rating agencies. It found that those recognized by the U.S Securities and Exchange Commission (SEC) have adopted codes of conduct that largely follow the provisions of the IOSCO Code with few variations, but that additional efforts are needed to promote adherence among some other rating agencies. IOSCO is also reviewing the Code to see if it needs to be revised.
significant barriers to entering the industry. A key barrier is reputation, since investor faith in the quality of credit ratings can be earned only over time through a proven track record of ratings that are reliable indicators of credit risk. Economies of scale in the ratings business reinforce reputation as a natural barrier to entry. Rating a wide range of instruments and entities helps rating agencies signal their reputations to investors. References to specific rating agencies in a large number of laws and government regulations may have inadvertently added to the barriers to entering the industry.

Increased competition in the rating industry would give investors access to a broader set of views on the credit quality of their investments and would help keep agency fees at an appropriate level. There are, however, few practical suggestions about how to do this. Some, like Pollock (2005), have suggested eliminating SEC designation of rating agencies as a way to ensure that public authorities do not inadvertently contribute to entrance barriers. But the new regulatory framework introduced by the SEC in June now provides clearer criteria for rating agencies to achieve SEC designation status, which may foster more competition.4 In addition, designation/recognition by public authorities can help rating agencies reduce the high cost of building a reputation, thus promoting more competition in the industry.

Of broader interest is the reference to rating agencies and ratings in other laws and regulations, and the risk that this may encourage market participants to rely on ratings as a summary statistic of risk. The Bank of England commented in its October 2007 Financial Stability Report that there is a risk that banks may come to rely heavily on ratings, particularly for structured products. Under Basel II, banks are required to use the ratings published by the rating agencies to determine capital charges for structured products, where such ratings exist. The Bank of England expressed some concern that this regulatory requirement may result in some banks using external ratings as their only input when assessing structured products, and recommended that this potential overreliance be addressed by banks and their regulators.

Injecting More Transparency into the Rating Process

While rating agencies have a strong track record in rating financial instruments, history is replete with examples of high-profile debt restructurings and defaults that the agencies failed to anticipate in a timely manner. Some recent examples include Indonesia and Thailand in the mid-to-late 1990s and Enron and WorldCom a few years ago. The Committee on the Global Financial System (CGFS 2005) suggests that credit ratings of structured products are more fragile than those of other securities. This is consistent with data presented in a recent Moody’s report, which is summarized in Charts 1 through 4. They indicate that credit ratings of structured products are generally more stable than those of corporate securities, mainly because they have a lower probability of being upgraded. But when a downgrade occurs, credit ratings of structured products are more likely to fall several notches. The latter may reflect the greater uncertainty in assessing the credit risk of structured products and the higher leverage embedded in some of those products.

The different behaviour of credit ratings for structured products has led to calls for more transparency in the process for rating those securities. These include the IMF’s proposal in various Global Financial Stability Reports that a separate rating scale be used for structured products and the CESR’s suggestion that rating agencies be encouraged to provide more meaningful information on the analysis underpinning rating decisions. The Bank of England has also put forward some ideas on how the information content of ratings could be improved. (See Box 6 in its October 2007 Financial Stability Report.) They include thoughts on how rating agencies could provide more information on the risks associated with structured products and a

3. Public scrutiny of rating agencies is also reinforced by academic research into the usefulness of credit ratings. Numerous academic studies over several decades have generally found that rating actions lagged movements in market prices. Ammer and Clinton (2004) found that rating downgrades have a larger impact on the prices of structured products than on those of traditional “plain-vanilla” instruments. By contrast, the market impact of rating upgrades is insignificant for both types of instruments.

4. For example, the new criteria require a rating agency to be in business as a rating agency for at least three years, and it would need to provide certifications from at least ten institutional investors that they use the agency’s ratings.
suggestion that rating agencies adopt the same definitions for scoring credit risk.

**A separate rating scale for structured products**

A separate rating scale for structured products would emphasize that the ratings of those products behave differently from those of other financial instruments. This might make investors think twice before purchasing them. Of course, there is always a risk that investors may simply spend their time trying to map any new rating scale back to the conventional one used for other instruments. So, they would still need information about the characteristics of ratings for structured products.

Recent attempts by rating agencies to develop metrics to highlight the fragility of ratings for structured products (such as Fitch’s stability scores for structured products) are an encouraging sign that market forces are at work, and that the private sector will find an appropriate solution on its own. A possible role for governments and regulators could be to speed up the process by bringing stakeholders together to discuss possible solutions.
More meaningful disclosure of supporting information

A recent assessment of rating agencies conducted by the CESR (2006) noted that they have a tendency to provide investors with descriptions of rating methods that, for proprietary reasons, are quite general and not very precise or exhaustive. In particular, CESR noted that it is often difficult to understand how a rating agency arrived at a particular rating. This makes it hard for investors to compare the opinions of various rating agencies and to draw their own conclusions, especially for complex structured products.

While market forces should ultimately determine the kind of information (and the format) that would best suit investors, there is again a possible role for governments and regulators, who could help to facilitate an improvement in disclosure by arranging stakeholder discussions of this topic or by setting principles to guide the formulation of disclosure standards.5

Holding Rating Agencies Legally Liable for the Ratings They Publish

Partnoy (2006) notes that in the United States rating agencies have generally not been legally liable for the credit ratings they publish, because the latter are considered to be “opinions,” and are thus treated as free speech under the law. Some observers have suggested that rating agencies should be legally liable for the quality of their ratings, just as auditors are liable for the opinions they provide to investors and other stakeholders. It could be argued, however, that credit ratings require more judgment than auditor opinions.

Clearly, rating agencies must be held accountable for the quality of their credit ratings. While reputation is a barrier to entering the industry, it is also an inducement to continuous improvement in rating methods. Recent experience offers encouraging evidence that this is taking place. For example, rating agencies regularly revise their credit-assessment models in light of new information and as new analytic techniques are developed so that they can be seen by investors as being at the leading edge of credit-risk assessment. The crisis in the subprime-mortgage market will likely serve as a useful stress test that may well help to inform future rating decisions.6

Banning the Rating of Products for Which an Agency Has Provided Advice

Rating agencies are actively engaged in advising the issuers of securities about the credit quality of their securities before they are issued. This has led to concern about the conflict of interest of agencies that publish ratings on products for which they have provided advisory services. While rating agencies have always been ready to advise prospective issuers of securities, the concerns are magnified for structured products. Issuers of those products may have an opportunity to “game” rating agencies’ credit-assessment models. This is especially true for the newest products, where lack of data may limit the usefulness of those models.7

Banning rating agencies from all involvement in the development of structured products or requiring them to split their rating business from

5. In its new rules for rating agencies, the SEC requires them to publish performance-measurement statistics on ratings for short-, medium-, and long-term periods. An example of such statistics is the rating-transition matrices published by the rating agencies that were used to prepare Charts 1 through 4. However, the SEC indicated that it is not prepared to prescribe standard metrics at this time. It is also studying whether it would be appropriate to require rating agencies to furnish additional types of performance statistics to be disclosed as an alternative, or in addition, to rates on historical defaults and downgrades. Examples given included comparing a given credit rating to the market value of the rated security or to extreme declines in its market value after the rating.

6. It may also result in more official scrutiny of rating agencies. For example, the SEC has launched an inquiry into the behaviour of rating agencies in the market for subprime residential mortgage-backed securities, and the President’s Working Group on Financial Markets is examining the role of rating agencies in lending practices, how their ratings are used, and how securitization has changed the mortgage industry and related business practices.

7. While rating agencies have always interacted with issuers before a new instrument is rated and issued, issuers of structured products have more scope to adjust the terms and conditions of their products to achieve a desired credit rating in advance; for example, by varying the degree of over-collateralization for each tranche.
their consulting activities seems excessive. Rating agencies have useful expertise and insights to offer, which should result in better products for investors. In addition, since the transparency of the rating process continues to improve, there may not be any further tangible benefits from imposing such a separation.

Instead, one could envision a regime in which a rating agency is either: allowed to rate the products for which it has provided advisory services, but only under the condition that it fully discloses its involvement in the development of the product; or barred from rating products for which it has provided advice prior to issuance (while being free to rate other products for which its competitors provided advice). Here in Canada, recent market developments may lead investors to increasingly follow the international practice of requiring structured products to be rated by two or more rating agencies.

**Market-Based Credit Ratings**

There is also an issue of whether credit ratings should be replaced by market-based measures of credit risk. Moody’s has already done much of the work needed to generate market-based ratings. It publishes “Market Implied Ratings,” or MIRs, designed to reflect the credit-rating equivalent of the market price of credit for various instruments over time. The main advantage of such a metric is that it would incorporate all available information into a rating, including the ratings of other rating agencies. Moreover, it could be designed to be very timely. The main disadvantage is that these measures may be misleading, since market prices can be distorted by fads or bubbles. For example, many asset-backed securities traded at spreads that did not reflect their inherent liquidity risks prior to the recent market turbulence. Thus, prudence would suggest that MIRs not be exclusively relied upon in managing credit risk.

**Conclusion**

Investors have had a long-standing need for specialists who can advise them on the credit quality of their investments. Most find it cost-effective to delegate this task to rating agencies that can benefit from economies of scale in assessing the credit risk of a wide range of issuers and financial instruments. The advantages of this approach have become increasingly pronounced with the emergence of structured products, since proper assessment of the credit risk of these products requires sophisticated tools and modelling skills.

The difficulties that structured products have faced in the recent market turbulence have renewed concerns about rating agencies and their role in financial markets. Rating agencies have benefited handsomely from the rapid growth in those markets. While their ratings are generally consistent with actual default experience, rating agencies have had some notable failures. They also continue to have some well-recognized conflicts of interest that need to be managed. Moreover, ratings are playing an increasingly important role in financial markets as financial instruments become more complex and difficult for investors to understand. And ratings play important roles in public sector activities more generally.

Some natural self-correcting market forces are at work, which should ensure that rating agencies continue to improve their processes. Although reputation is a natural barrier to entering the rating industry, it is also an inducement to continuous improvement in rating methods. The recent turbulence in structured-finance markets will, no doubt, be a useful stress test to help calibrate analytic tools in the future and may lead investors to demand increased transparency in those markets so that they can better manage their exposure to credit risk. Moreover, the role of rating agencies in developing new structured products may increase their exposure to legal risk, making them more legally accountable for the quality of the ratings they produce.

Nevertheless, there are some further steps that could be taken to reinforce market discipline in the rating industry. For example, the rating process would benefit from greater transparency, so that investors are better able to critically assess ratings. The best solutions are likely to emerge through an active dialogue between rating agencies and their stakeholders; regulators are unlikely to have any comparative advantage in imposing solutions. They could possibly play a useful role, however, in setting or supporting some minimum principles of disclosure, which could be the basis of a dialogue between investors and issuers, and could possibly lead to an agreement on industry-led best practices or a code of conduct. Initiatives such as the CESR’s assessment of rating
agency compliance with the IOSCO Code could be a useful means of maintaining public pressure on the rating agencies to continue to enhance the management of conflicts of interest in their industry. The role that rating agencies and ratings play in various laws and regulations and public sector activities could possibly be re-examined. Formally recognizing specific rating agencies may have inadvertently reinforced barriers to entering the rating industry. It may also have encouraged some investors to rely heavily on credit ratings inappropriately as a summary statistic of risk.

In the end though, investors need to accept responsibility for managing credit risk in their portfolios. While complex instruments such as structured products enhance the benefits to be gained from relying on credit ratings, investors should not lose sight of the fact that one can delegate tasks but not accountability. Suggestions such as rating structured products on a different rating scale could be helpful, in that this may encourage investors to think twice before investing in such complex instruments. Nevertheless, investors still need to understand the products they invest in, so that they can critically review the credit opinions provided by the rating agencies.

References


