

by Max Albert

Time for a *Change?*

The September 26th visit by the ratings agencies to Capitol Hill had a familiar ring to it. Five years earlier they made a similar trek to Washington, in the wake of the Enron bankruptcy.

In between these very public appearances, the ratings agencies endured a chorus of complaints from issuers that they remain too conservative, from investors that they are too close to borrowers and from underwriters that they are too expensive.

It's an unenviable position yet one they've become accustomed to occupying in credit crunch post-mortems. This time, though, Joe Public is feeling the pain, resulting in amplified criticism which has the potential to be more damaging – especially during the run-up to a presidential election. The September hearings gave voice to a slew of criticisms of their business model, and provided the distinguished members of the Senate banking committee a chance to demonstrate their flair for colorful similes.

"That is like a movie studio paying a critic to review a movie, and then using a quote from his review in the commercials," huffed Kentucky senator Jim Bunning. "It seems to me that credit rating agencies are playing both coach and referee," offered New Jersey's senator Robert Menendez.

The senators ended their hearing by declaring that the raft of reforms to the agencies' business over the last several years needed more time to take root. But not before New York's Chuck Schumer, a senator whose constituency and campaign contributions suggest a familiarity with the ways of Wall Street, offered up the following suggestion.

"I think we should consider the potential benefits of an investor-funded ratings agency model. We should discuss whether we should promote the entry of serious, viable, investor-funded ratings agencies to compete against the ratings agencies that are purely paid by issuers, or to provide incentives for today's ratings agencies to go back to their roots and have investors pay for the ratings."

Schumer brought out into the open a debate that has simmered since Enron went under — whether the revolution in credit ratings since the 1970s needs to be reassessed.

But the possible effects of a wholesale reform have not been widely explored, even though they could be far-reaching. So we shall attempt to do that here.

Hardwired to financial markets

There is one very obvious sticking point when it comes to a wholesale reform of the ratings agencies: their role is virtually hardwired into the financial markets. They have been around for almost a century. In fact it was federal and state banking regulators who, from 1931, issued rules on permitted securities holdings for various investment institutions that implicitly demanded they obtain a rating from an outside entity.

The credit crunch has spawned another round of calls for overhauling ratings agencies. But what might the consequences be of ending their unique role?



Turning something on its head might not always be a good idea

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Their designation as Nationally Recognized Statistical Rating Organizations (NRSRO) dates back to 1973, and their role as gatekeepers to the credit markets was further entrenched by the 2006 Credit Rating Agency Reform Act.

What's more, their ratings are now enshrined as the backstop for capital adequacy analysis under the Basel II rules. Banks can apply to assess their holdings according to their own ratings-based approach, with regulators assessing the robustness of this framework — the advanced approach. Or they can

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simply map the risk-weighting they attach to securities to the agencies' classifications. These rules are already largely being followed in Europe, and should be adopted by U.S. banks next year.

The credit crunch is not likely to convince legislators and banking and securities regulators that banks can do without regulation. There has already been a run on one bank, the UK's Northern Rock, while another in the U.S., Countrywide, looked to be precariously close for a while, too. Meanwhile, the multi-billion dollar write-downs at financial institutions like Citigroup, Merrill Lynch and UBS were on securities that carried the highest ratings from the agencies. That doesn't engender a great deal of confidence in self-assessment.

But there's the rub. Banking regulators in the U.S. rely on the agencies' output in their role as NRSROs to carry out their duties, as well. Removing the NRSRO status would mean regulators would have to build up their own analytical capabilities, in some instances from scratch, so that they would be able either to perform analysis on banks' portfolios directly, or to monitor the performance of the agencies on which banks depend. Where they cannot avail themselves of an SEC-blessed gauge of asset quality (or “steal” ratings, as one unhappy former bank analyst puts it), they will need to come up with their own measures. Regulators do not now have the staff, the infrastructure or the expertise to assess the quality of banks' structured finance exposure. Nor, at present, do they have the financial resources to do so.

There's another, more technical issue that could also throw up a road block to reform: references to ratings and NRSROs crop up eight times in Federal statutes and 60 times in additions to the code of Federal regulations up to 2002. Removing these would be difficult. Even Alex Pollock, a resident fellow at the regulation-hostile Washington policy think tank American Enterprise Institute, suggests that rewriting this corpus would be so time-consuming as to be impractical. The knock-on effects would be huge as regulations regarding money-market accounts, broker-dealers, even institutions participating in student aid programs, all rely on NRSRO ratings.

One solution might be to submit the agencies' models to

the same surveillance as the banks' internal ratings-based approaches. This would minimize the work that regulators need to do and provide some kind of uniformity between banks. But it would explicitly subject the agencies to regulation, something they have constantly opposed.

Let the market decide?

How about just throwing out the use of ratings entirely, substituting them with credit spreads? That would put the markets in charge of providing a more timely assessment of the risk attached to particular issues. But using credit spreads has some obvious pitfalls that the structured credit market turmoil of 2007 highlights all too well. As AEI's Pollock says: “What's the meaning of a market price when there is no market?” In times of stress, fear-induced illiquidity usually creates a severe disconnect between the price of a security and its longer-term value, or creditworthiness in the case of bonds. That's as true of equities as it is of CDOs.

Of course, it may well be that fear turns out to be right. And there may be a case for ratings to try to indicate leverage and volatility risk. But it would surely only make markets even more unstable in a crisis if a system was put in place that required all owners of assets to base their portfolio decisions more on potentially volatile short-term pricing than long-term credit or value judgments. There are, after all, plenty of banks, investment banks, hedge funds and structured credit vehicles that must currently wish, daily, they had never heard of market-to-market accounting.

But that's not all. Even in calmer times, credit markets still need a way to gauge the risk attached to a new bond, be it a plain-vanilla or an asset-backed deal. Ratings agencies do much of the initial leg work and box ticking that will always be re-

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quired. There are no doubt other ways to dole out this part of the process, but credit spreads alone cannot do that.

Credit spreads, then, are perhaps of more use in their role as an indicator of sentiment rather than as proxies for credit risk. But regulators could still be asked to enact a set of standards for debt holdings that moves beyond letter grades. There's no consensus on what these standards might be, and whether holders and traders would in any case lapse into some form of grading that differentiated between Good, Better and Best. If tranching for structured securities was to survive, it would, say several market observers, need to settle on a set of familiar, easily understood descriptions that corresponded to the familiar triple-A, single-A, triple-B, and so forth.

Is more better?

It's one of the basic tenets of the philosophy of capitalism that

more choice should foster better service. So increasing the number of ratings agencies ought to be a good thing that, along with subjecting them to closer monitoring from the SEC, was one of the goals of the 2006 Credit Rating Agency Reform Act — passed, belatedly, in response to concerns about the agencies' unusual regulatory position in the wake of the Enron and WorldCom scandals.

The act was designed to lower the barriers to entry for budding NRSROs, and there are now seven of them: Moody's, S&P, Fitch, A.M. Best, Dominion Bond Rating Service, and two Japanese agencies, Japan Credit Rating Agency and R&I. But more players doesn't necessarily mean better analysis. First, the number of new entrants providing ratings of structured securities is likely to lag the number of new providers of corporate ratings. The universe of securitized paper is much bigger, and rating it involves greater expense and investment, in personnel, legal expertise and in the necessary information technology.

The SEC was aware of these barriers, which is why it moved to compel agencies to accept the ratings of other agencies at face value when assessing the credit quality of underlying collateral in a securitization. Agencies frequently discount external ratings when they are unable to rate this collateral themselves, a process known as notching.

For the SEC to have banned notching would have amounted to the regulation of agency methodologies, and would have masked the very real differences between agencies' approaches, the larger agencies protested. But the SEC's decision did not create much of a dent in the position of the established agencies. The SEC's final rule allowed notching but forbade it if the commission could prove anticompetitive intent, a task that it acknowledged would be difficult.

But there is a broader issue with expanding the number of NRSROs: the ability to selectively pick ratings and agencies. In his testimony to the SEC Charles Morrison, who leads the

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money-market group at Fidelity, pointed out the stipulations of the 1940 Investment Company Act. It states that money-market funds require a rating in the two highest short-term categories from at least two NRSROs. Until recently, this meant a majority of the big three, but an expansion in their number allows for a manager to be selective in the ratings it picks.

Wider competition would bring the vexed issue of ratings shopping further out into the open. It is a common complaint from critics that agencies deliberately relax ratings criteria to attract issuer business, though there is never compelling evidence to back that up. The agencies rightly point out that even with the benefits of NRSRO status, definitive proof of laxity towards issuers would be suicidal for them.

But issuers do frequently pick and choose from the most favorable ratings, and a constant discounting of the most con-

servative voice would move the market standard downwards. Mark Adelson, of Adelson & Jacobs, a New York-based firm that specializes in structured finance, offers the example of requiring equity cushions in structured finance transactions. The voice calling for a 20% cushion, if not included in a transaction, is effectively silenced, while the agencies calling for merely 15%, or even 10%, come to constitute the market.

Could the agencies perform due diligence on each other? One popular reform movement, of which Adelson is a proponent, suggests the return of unsolicited ratings as a way of keeping rating shopping from dragging down the credit quality of ratings.

Unsolicited ratings, where agencies issue an indicative rating on securities rated by another agency without being paid by an issuer, are still a source of controversy. Many issuers regard them as a form of blackmail. Even some ratings agencies dislike them. As Barron Putnam, president of non-NRSRO LACE Financial, said in testimony to the SEC in 2002: “For a rating(s) company to use an unsolicited rating (no charge) to get a company to pay for a solicited rating is a form of extortion and the company should be charged with a criminal offense. If it is an NRSRO company, it should lose its NRSRO status.”

But LACE primarily rates financial institutions, for which there are a larger number of prospective competitors to the big three. Encouraging some competition between structured finance NRSROs looks like a decent option, assuming that nothing else about their regulation changes and that the issue of ratings shopping is addressed. The same oversight that applies to notching might be applied to unsolicited ratings, and where the SEC discerns anticompetitive intent it can act accordingly.

Does issuer-pays work?

Many commentators have always found it particularly vexing that issuers, not investors, pay for ratings. That gives the appearance of a conflict of interests: surely ratings agencies, to win business, must at times defer to their paymasters?

Instead, runs the argument, why not have a ratings-agency paid for by the investors who actually use the work? Indeed, there is no reason why investors couldn't do just that, despite the seeming government imprimatur of the current state of play via the NRSRO designation.

The ratings agencies have already proved there is a market for ratings research beyond the issuer-pays model. Moody's Investors Service posted revenue of \$82 million in last year's third quarter from research, including subscription income. That's just a fifth of the \$404 million of revenue from charging issuers for rating all manner of transactions. But it's a blossoming income stream, up 29% from the same period in 2006.

That is potentially good news and not just for proponents, like senator Schumer, of abandoning the issuer-pays model. It also shows that in times of stress, despite all the arguments leveled against them by their critics, ratings agencies' research is still in demand as an analytical tool.

But it is this business line that most exercises Glenn Reynolds, the co-founder and chief executive of credit research firm

CreditSights, since it competes with independent buy-side research providers that do not have the franchise of an NRSRO.

Investors might be wary of paying for ratings for several reasons. First, the benefits aren't always that clear: other market participants might benefit from this work without paying for it. Proponents of this view believe it is better to keep the issuer-pays model, and use their cash to fund supplemental, in-house research.

Then there is the question of how to pay for it. Senator Schumer's suggestion, which mirrors a proposal from AEI, would involve users collectively funding a private agency whose ratings would be available only to its owners.

The specifics of such an action are vague, not the least of which is who would coordinate the effort. Such an agency would present a formidable competitor to the existing NRSROs, even if it were able to keep its ratings private. If investors balked, Congress might give the SEC the power to impose a compulsory levy, although this would make the agency a quasi-government body.

Does cacophony sound good?

And let's circle back to that question of conflict of interests. The Schumer-style model wouldn't eliminate them; rather it would simply transfer the potential for asserting undue pressure on the raters from the issuers to the investors.

Perhaps the answer is to provide scope for both the issuer-pays and investor-pays business models to thrive. The two might balance out each other's potential conflicts and, again assuming the game of ratings shopping can be curtailed, could foster more dynamic competition.

Ratings that did not carry the benefits, and the implicit regulatory license, of NRSRO designation, would revert to their status in the 1920s, when John Moody was expanding his eponymous ratings agency. To do so would leave ratings as just one component of a cacophony of credit research, which the agencies say is as it should be.

Moody's points out that it is the only ratings agency to welcome unequivocally the end of NRSRO status, a recognition that the head start that it enjoys would last several years into a free-for-all for providing ratings. As Joanne Rose, S&P's global head of structured finance, recently said: "What we provide to the market is a mutually agreeable convergence point. Individual investors and issuers may not completely agree with our opinions, but they agree that these opinions are a good place to start the discussion."

But it deserves mentioning that the agencies operating under the current system already do disagree about ratings. It may not be as often as some may like. But it does happen. After Moody's and S&P blessed 2006's constant proportion debt

obligations (CPDOs) with triple-A ratings, both Fitch and Dominion Bond Rating Service begged to differ. DBRS' opinion was that "using assumptions derived solely from recent experience in a benign credit market is difficult to justify." Those who snapped up these CPDOs when credit spreads were so tight cannot complain that at least a couple of ratings agencies tried to warn them off.

A quick fix or a change in culture?

That's just one example, and it's unlikely to stop the calls to restructure or reform the agencies. Eric Mindich, the founder of hedge fund Eton Park and an advisor to the White House, has called for a break-up of the ratings agencies that goes beyond their existing operational separation of ratings and advisory work. Focused on addressing the short-term market crisis of confidence in ratings reliability, the Mindich proposal also calls for better disclosure of agency conflicts and remuneration. "I do not think that the market can discipline ratings agencies sufficiently," he said in September.

But there's no reason why the structured credit market as a whole shouldn't undergo a round of self-examination, too. The central case for maintaining the ratings status quo is that their work should not be taken as an absolute stamp of reliability, nor used as the sole source for analysis.

As Anthony Thompson, head of CDO research at Deutsche Bank, said at a recent ASF seminar: "We tend, in structured credit, not to come up with our own view of a company or a structure's rating, unlike in the corporate bond market. We rely too much on third parties to do the work for us."

That's all the more powerful coming from a sell-side analyst. Thompson freely admitted it's a generalization, of course — and plenty of participants will take issue with it. But it is hardly without merit, as recent losses and write-downs prove. But the implication is that to catch up with their corporate bond brethren, structured finance professionals on all sides need to beef up, or at least dust off, their own analytical skills. That costs money, the last thing investors or banks want when returns are low and business slow.

However, it's more preferable to being caught out again the next time a bull market in credit leads to excessive, even exclusive, reliance on ratings. Perhaps the agencies do need a shake-up, perhaps not. But market participants ought by now to have learned that they shouldn't peg the fortunes of their business too closely to them. ▼



Pick a ratings agency, any ratings agency

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