Curtis C. Verschoor, CMA, Editor

Credit Rating Agency Performance Needs Improvement

The continued poor performance of the credit rating agencies in providing adequate assurance of the creditworthiness of debt instruments requires stronger action from regulatory bodies.

Recent developments indicate the need for greater and more effective oversight of credit rating agencies (CRAs). In the fallout from the financial crisis of 2008-2009, a debate arose regarding the culpability of CRAs in creating or contributing to the crisis (see the January 2012 column, "Credit Ratings Should Be Improved, Not Discarded"). Several years later, their performance and reliability are still being called into question. Much of the cause of their poor performance may be because they have operated for many years without either adequate governmental or self-regulation.

Strengthening the oversight of CRAs has proceeded more rapidly in Europe. In May 2012, the European Commission (EC) published four technical standards developed by the European Securities and Markets Authority (ESMA). The standards address how the ESMA will assess credit rating methodologies and the information CRAs have to submit to the ESMA in specific time intervals in order to supervise compliance. According to the European Union (EU) release, the four standards "will ensure a level playing field, transparency, and adequate protection of investors across the Union and contribute to the creation of a single rulebook for financial services." In October 2012, the EC published rules enabling the ESMA to impose fines on CRAs. The regulatory document includes a list of infringements that may trigger fines.

In the United States, regulation of CRAs has rested with the Securities & Exchange Commission (SEC) and has proceeded much more slowly. A few years after Congress passed the Sarbanes-Oxley Act of 2002, it enacted the Credit Rating Agency Reform Act of 2006, which gave the SEC authority to implement rules for registration, recordkeeping, financial reporting, and oversight of CRAs. The overall strategy for dealing with CRAs has been to reduce investor reliance on credit ratings rather than improve the quality and reliability of the ratings themselves.

The adopting release for CRA rules under the Dodd-Frank Act of 2010 included a requirement for each federal agency to review how its existing regulations rely on credit ratings as an assessment of creditworthiness. At the conclusion of the review, each agency was required to replace those references with alternative standards. Pursuant to this mandate, in July 2011 the SEC adopted final rules eliminating most of the previously required credit rating information in public offerings of debt securities using short-form or shelf registrations.

Some of the rationale for reducing reliance on credit ratings is contained in the cost/benefit analysis section of the SEC's July adopting release, which states that issuers of debt securities "will benefit from not having to incur the associated costs of obtaining a credit rating to the extent that they decide not to obtain a credit rating for other uses. As a result, these rules could lessen the bargaining power rating agencies have with issuers, potentially lowering the cost of obtaining ratings." Saving money for securities issuers rather than protecting investors is contrary to the basic mission of the SEC.

The adopting release further notes, "The removal of a provision in our forms requiring the use of a credit rating to establish eligibility for a type of registration generally

reserved for widely followed issuers obviates a market externality that may have constituted a barrier to entry to potential competitors seeking to develop alternative methods of communicating creditworthiness to investors… [and therefore] may increase competition in the financial services sector." These stated benefits seem limited, obscure, and problematic.

It has been suggested that development of CRA regulations that would benefit investors the most would occur if the SEC mandated professionalizing the entire practice of issuing credit ratings. A white paper published in April 2009 by the Council of Institutional Investors advocated the formation of a Credit Agency Oversight Board (www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf). With considerable input from the financial services industry, the SEC should set specific "generally accepted" standards for the process of performing the analysis necessary to express a credit opinion and how that opinion should be expressed. This is similar to the guidance that the SEC and Public Company Accounting Oversight Board provide for independent audit firms.

Other reminders also have been offered. In a newsletter discussing CRAs, the law firm Skadden, Arps, Slate, Meagher & Flom notes that Dodd-Frank requires the SEC to prescribe ethical governance standards having adequate controls for CRAs that ensure quality and provide assurance that the controls are effective (www.skadden.com/newsletters/FSR_Credit_Rating_Agencies.pdf). Dodd-Frank also provides for sanctions when such standards aren't followed. And Gretchen Morgenson wrote in *The New York Times* that the SEC should also begin to enforce the Dodd-Frank requirement that CRAs be subject to the same liability exposure as other experts, such as lawyers and independent auditors (www.nytimes.com/2011/03/06/business/06gret.html?_r=0).

The tendency of the SEC to take the side of securities issuers rather than investors is further illustrated in an SEC staff report issued in September 2012 in accordance with a Dodd-Frank requirement to study the benefits of credit rating standardization. Citing the reasoning of commentators, the report recommends that the Commission not take further action at this time to:

(1) standardize credit rating terminology so that all credit rating agencies issue credit ratings using identical terms;

(2) standardize the market stress conditions under which ratings are evaluated;

(3) require a direct quantitative correspondence between credit ratings and a range of default probabilities and loss expectations; and

(4) standardize credit rating terminology across asset classes so that named ratings correspond to a standard range of default probabilities and expected losses.

The report states that it would be more efficient to focus on the rulemaking initiatives mandated under the Dodd-Frank Act. "In passing the Dodd-Frank Act, Congress noted that credit ratings applied to structured financial products proved inaccurate and contributed significantly to the mismanagement of risks by financial institutions and investors," said then SEC Chairman Mary L. Schapiro. "Our proposed rules are intended to strengthen the integrity and improve the transparency of credit ratings." Unfortunately, little progress has been made toward the release of final rules under the massive 519-page rule proposal issued in May 2011. Among others, public accounting firms objected to a requirement for disclosure concerning third-party due diligence reports for asset-backed securities, arguing that results of such "agreed-upon procedures" engagements are intended to be confidential.

One Dodd-Frank requirement for CRAs that has been implemented concerns examining how well each CRA complies with its own policies and procedures. The second annual SEC staff report issued in November 2012 contained a 16-page summary of "essential" findings, some that could later be considered "material

For guidance in applying the *IMA® Statement of Ethical Professional Practice* to your ethical dilemma, contact the IMA Ethics Helpline at (800) 245-1383 in the U.S. or Canada. In other countries, dial the AT&T USA Direct Access Number from www.usa.att.com/traveler/index.jsp, then the above number.

regulatory weaknesses" by the SEC as a whole. For example, the report notes that "one of the larger [CRAs] appears to have changed the method for calculating a key financial ratio in rating certain asset-backed securities, but failed for several months to publicly disclose the change and its effects on the ratings, and continued to incorrectly reference the previously used method in its published rating reports. It also failed to provide sufficient disclosure about the method used to calculate such ratio in its published rating methodology applicable to these securities." Such language certainly diminishes an investor's trust in the reliability of credit ratings and suggests that one of the causes of the financial crisis of 2008 is still present.

The SEC staff report also states that "it appears the [large CRA] did not consistently apply its rating methodology and failed to follow certain internal rating policies and procedures with respect to these securities, including the policy regarding the use of models, in assigning initial ratings to, and performing surveillance on, these asset-backed securities. The Staff found that this [CRA] appeared to have weak internal supervisory controls and lacked transparency over the process of rating these asset-backed securities. The Staff is also concerned that this [CRA] may have been influenced by market share and business considerations in its application of the methodology used to rate asset-backed securities." This is a very troubling report.

Issuance of final rules to implement the requirements of Dodd-Frank for CRAs mandates a majority vote of the SEC, so Schapiro's departure December 14, 2012, left the Commission in a deadlocked position with two members of each political party. This may make it difficult for the SEC to pass any final rules until a new commissioner is named and receives Senate confirmation.

Some observers believe that the proposed rules to implement the Dodd-Frank requirements don't go far enough.

Some observers believe that the proposed rules to implement the Dodd-Frank requirements don't go far enough. A 34-page comment letter on the proposed rules, dated August 8, 2011, and submitted by the Consumer Federation of America and the 250 groups represented by Americans for Financial Reform, states: "As currently drafted the proposed rules offer little hope of making significant progress on addressing the deep-rooted problems with credit ratings that were revealed by the financial crisis."

Further, CRAs soon may face increased legal proceedings and actions. An Australian court has become the first in the world to find a ratings agency liable for issuing AAA ratings on junk derivatives. This decision may pave the way for possible new claims in the U.S. and elsewhere. The court found that Standard & Poor's (S&P) was partially liable for A$30 million (US$31.3 million) in losses sustained by purchasers of a complex, structured, synthetic investment product known as a Constant Proportion Debt Obligation (CPDO), which it rated as virtually risk free at AAA. According to an article published November 17, 2012, by DLA Piper, "S&P was found to have used unjustified and unreasonably optimistic assumptions for some of its inputs for the modeling of the CPDOs' performance, which produced the AAA rating. Had they been eliminated or properly stress-tested, the modeled performance of the CPDOs would have changed from AAA to sub-investment grade (i.e., below BBB)" (www.mondaq.com/australia/x/206052/Financial+Services/credit+rating+agencies+liability).

The securities markets operate on the basis of trust that the information provided to investors is presented fairly. Without effective oversight of the agencies providing assurance of the creditworthiness of debt instruments, these markets won't be able to operate effectively. Professionalization of the CRA industry is the most efficient way to bring about this outcome. **SF**

Curtis C. Verschoor is the Emeritus Ledger & Quill Research Professor, School of Accountancy and MIS, and an honorary Senior Wicklander Research Fellow in the Institute for Business and Professional Ethics, both at DePaul University, Chicago. He was selected by Trust Across America as one of North America's Top Thought Leaders in Trustworthy Business Behavior–2012. His e-mail address is curtisverschoor@sbcglobal.net.