THE TROUBLE WITH RATINGS

By Ramona Dzinkowski

With the global financial crises behind us, most investors are breathing a little easier these days. But should they?

Though the root causes of the global financial crises read like a classic whodunit, the role of credit rating agencies (CRAs) in the securities market meltdown has come under close scrutiny by numerous regulators and legal bodies around the world. In the United States, for example, the Financial Crisis Inquiry Commission (FCIC) set up by Congress concluded that the top CRAs were "key enablers of the financial meltdown." Similar reports from international groups, such as the Financial Stability Board (FSB), the U.K. Financial Services Authority (now the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)), and the European Commission, point to the weakness in the ratings process as a fundamental cause of the crises of 2008.

Out With the Agencies?

Since 2008, international regulators have been tasked with a multitude of objectives aimed at making investors feel more at ease, not the least of which is to recommend a better system for rating securities that will eliminate the potential conflict of interest between the issuers and agencies. At the same time, they are taking measures to possibly eliminate investor reliance on rating agencies. The "Code of Conduct Fundamentals for Credit Rating Agencies" of the International Organization of Securities Commissions (IOSCO) is just one example (www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf).

At the crux of the matter is the issuer-pay model, which the vast majority of CRAs use. Under this model, the agency receives compensation from issuers for rating their securities, and the issuers generally make their credit ratings publicly available for free. (Moody's Investors Service, Standard & Poor's (S&P), and Fitch Ratings accounted for approximately 97% of all ratings in the U.S. in 2011.) According to many observers, this poses a conflict of interest by creating an incentive on the part of the agencies to issue favorable ratings or delay possible downgrades.

In its December 2012 "Report to Congress on Assigned Credit Ratings," the U.S. Securities & Exchange Commission (SEC) (more specifically, the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives) reviewed a series of potential options around how the CRAs get paid and by whom and, perhaps more important, the potential for a new model whereby the SEC acts as the intermediary between the issuer and the agency. In other words, securities issuers in the U.S. no longer will be able to select their own rating agency, known more precisely as a Nationally Recognized Statistical Ratings Organization (NRSRO). To wit:

"Section 939F also provides that, after submission of the report to Congress containing the findings of the study, the Commission shall, by rule, as the Commission determines is necessary or appropriate in the public interest or for the protection of investors, establish a system for the assignment of NRSROs to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product from selecting the NRSRO that will determine the initial credit ratings and monitor such credit ratings."

The possible outcome of such a system has been the subject of much debate. For some, removing the choice of agency is a simple step in solving the conflict-of-interest problem. For others, however, this is seen as a much more complicated issue, an affront to the free enterprise system as we know it, and a possible violation of both the First and Fifth Amendments of the U.S. Constitution.

Meanwhile, the SEC is a long way down the road toward removing requirements and references to CRAs in their rules in an effort to eliminate the reliance on external ratings. According to the SEC report, "Reducing reliance on credit ratings could mitigate conflicts of interest to the extent that it causes investors to use factors other than credit ratings to make investment decisions. If credit ratings are no longer used in statutes and regulations to confer benefits or relief, the incentive to obtain credit ratings that meet these requirements should be eliminated."

For many, this solution presents a certain intellectual dilemma. On the one hand, Congress has taken measures to minimize the reliance on rating agencies by requiring the SEC to remove reference to them in Commission rules. On the other hand, Congress proposes to increase the agencies' perceived or "endorsed" credibility by having the SEC (a Credit Rating Agency Board, more specifically) independently assign agencies to rate new issues.

Also, there's the lingering question as to how the CRA Board will make these assignments, given the annual SEC review of the rating agencies. Would the best agency win all the time—resulting in a preferred agency with better compliance or accuracy being assigned a greater number of new issues on average? Would this ultimately lead to improved performance among all agencies, or would it simply increase the market power of one over the other in an already monopolistic industry? In addition, can a handful of CRA Board members and staff handle the sheer quantity of new, complex financial products every year, potentially thousands? In 2011, for example, 286,698 asset-backed securities were subject to U.S. credit ratings.

The Rating Agencies Weigh In

Members of the rating agency community have similar concerns and question whether the CRA Board could possibly be as efficient as the current free market system. According to comments by Standard & Poor's Executive Vice President Patrick Milano in the company's response to the proposal, even if the CRA Board attempts to consider NRSROs' particular qualities and experience in making assignments, it isn't at all clear that it could do so effectively. "Among other things," Milano says, "the CRA Board would have to obtain, update, and apply a detailed

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understanding of each NRSRO's qualities in order to make that determination for each of the thousands of securities to be rated at any given time. By taking such decisions out of the hands of issuers and investors who have a superior understanding of each NRSRO's qualities and experience, the proposal runs the risk of depriving the market of the best available rating opinions." At the same time, Milano suggests, such a system will entice domestic companies to seek ratings in other markets. "Nor is it clear," he adds, "that the assignment body could make assignment decisions with respect to thousands of securities in a timely fashion—thus not delaying issuers' access to capital—and without additional cost to the market. Inefficiencies associated with the ratings assignment process could disadvantage U.S. markets by providing issuers with incentives to issue securities abroad."

For Moody's Investors Service President and Chief Operating Officer Michel Madelain, assigned credit ratings by an SEC-governed board won't necessarily eliminate bias in the choice of credit ratings of structured financial products. He recommends that, "if that is ultimately the model that the Commission chooses to adopt, [it] must adopt measures designed to prevent the government from influencing the NRSRO's ratings. Consequently, when considering an alternative business model, we believe the Commission should assess whether the new system simply transfers the ability to rating shop from one set of interested parties to another." Madelain suggests that, rather than establishing a system that picks winners and losers, "the Commission should encourage NRSROs, regardless of their business models, to compete against one another on the basis of the credibility, reliability, and independence of their analysis and opinions."

As for the broader investment community, eliminating the invisible hand of the capitalist system with respect to credit ratings in the U.S. resembles bygone days of a centrally planned society. According to Richard A. Dorfman, managing director and head of Securitization, and Christopher B. Killian, managing director, Securitization, at the Securities Industry and Financial Markets Association, "SIFMA struggles and fails to find an analog to this anywhere in the United States' capitalist economy." If the CRA Board, they continue, is allowed to "set the rules of the game, determine who is allowed to play, and decide how much the players are paid…they would direct and centrally control the market for initial credit ratings on structured finance products. This would represent a sea change in the United States government's relationship to financial markets, and business in general, representing a movement away from free markets and towards centralized command and control of the economy."

Other solutions are for the ratings agencies to avoid offering an opinion on complex products altogether rather than take on the risk of doing so. Chris Dalton, a former chief of S&P in Australia, says the bigger agencies—including S&P, Moody's, and Fitch—could withdraw from rating complex financial products and leave investors, money managers, and super funds to determine the risk of their own investments. (His warning came after the Federal Court in Australia found in November 2012 that S&P and investment bank ABN AMRO misled investors by improperly rating complex financial products as AAA.) Yet Dalton cautions that this would have the effect of causing greater delays, lead to higher costs, and possibly mean fewer viable financial products for investors. As he told *The Australian Financial Review*, "The credit ratings agencies, and S&P in particular, since the crisis have become much more circumspect in terms of how they go about their ratings, and I think this decision will continue to make them very wary of undertaking ratings of highly structured and complex securities."

Not There Yet

Despite international efforts to improve the quality of ratings and reduce conflict of interest, recent statements from international securities regulators suggest significant improvements are still a long way off.

Not unlike the European securities regulators, after the rating agencies failed to flag the instability of several major banks (credit default risk of instruments collateralized by subprime mortgages, to be clear), the SEC instituted a host of new regulations around the methods by which Moody's, Standard & Poor's, and Fitch, among others, establish their ratings of any given company. More specifically, under the 2010 Dodd-Frank Act, the SEC proposed new rules with respect to filing annual reports on internal controls, addressing conflicts of interest with respect to sales and marketing concerns, conducting "lookback" reviews to determine whether there was any company influence over ratings, disclosing information related to subsequent changes to credit ratings, requiring policies and procedures governing how a rating is determined, publishing rating methodologies, disclosing information around third-party due diligence reports for asset-backed securities, establishing standards for training credit rating analysts, and requiring consistent rating symbols and definitions.

Late in 2012, SEC staff published a summary report of their examinations of each NRSRO for the period of August 1, 2010, through September 30, 2011. According to the report, "2012 Summary Report of Commission Staff's Examination of Each Nationally Recognized Statistical Ratings Agency," there were numerous instances where the rating agencies didn't do their jobs. After reviewing the documentation of ratings activity for a selected number of issuers, the report concluded that each of the larger agencies and two of the smaller ones didn't appear to follow their established methodologies and certain policies and procedures in determining certain credit ratings.

The SEC found that one of the larger agencies changed its method for calculating a key financial ratio in rating a specific asset-backed security, but it failed to disclose this change and the effect on the ratings and continued to incorrectly reference the previously used method in its published ratings reports. On a more troubling note, the SEC was "concerned" that the ratings may have been influenced by market share and business considerations in how the agency applied its methodology. The SEC also believes that another large CRA delayed downgrading a number of structured finance transactions in order to give the issuers the opportunity to avoid downgrades by restructuring their transactions in anticipation of regulatory action.

In the case of one smaller agency, SEC staff found that it allowed the issuer to improperly influence the substance of its ratings press release. Two weeks after the agency published its ratings and press release, the issuer petitioned for bankruptcy. These are but a few examples.

The Last Straw

If securities law isn't having the desired impact on the quality of ratings, perhaps monetary penalties will do the trick. Is a precedent-setting decision made by the Australian courts against Standard & Poor's the beginnings of a potential onslaught of legal actions and fines against agencies? The Australian case marked the first time ratings agencies have faced trial over their evaluation of complex derivative products. The ruling stated that both S&P and ABN AMRO had deceived 12 local Australian councils in the purchase of A$17 million of AAA-rated derivative products and that the ratings on these products were "misleading and deceptive and involved the publication of information on statements false in material particulars and otherwise involved negligent misrepresentations." S&P, which is owned by McGraw Hill Financial, plans to appeal.

In the U.S., rating agencies have often come in front of civil courts for a variety of alleged offenses, but to date they have largely escaped penalties on the basis of the First Amendment, which protects free speech. More recently, however, the U.S. Justice Department seemed to have another card up its sleeve.

In February 2013, U.S. Attorney General Eric Holder filed a civil suit against Standard & Poor's in a California court, seeking billions in damages for the agency's alleged role in misleading investors during the run-up to the financial crisis. In this case, the government's way around the First Amendment defense is to sue S&P under the Financial Institutions Reform, Recovery and Enforcement Act of 1989, which is seen to impose a lower burden of proof. If S&P is found guilty and forced to pay such a penalty, some suggest it could spell the end for S&P/McGraw Hill Financial. (At the time the legal actions were instituted, McGraw Hill Financial was still McGraw-Hill.) The impact of these allegations was immediate: McGraw-Hill's stock fell by 4% in a single day while the overall market remained relatively constant. Other agencies were painted with the same brush, as investors decided against sticking around to see what happens. Moody's also fell—by 3%.

Nevertheless, both companies' stock prices rose at the end of April when the surprise news of a confidential settlement came in with regard to a $638 million lawsuit filed by 14 plaintiffs led by Abu Dhabi Commercial Bank and King County, Wash. Analysts generally viewed the news as a positive sign since the settlement removes one of the bigger legal distractions both agencies faced and could lessen their risk of additional lawsuits.

The Road Forward

With respect to the possible Congressional solution to the conflict-of-interest problem, the SEC is still in the public information-gathering process and is expected to provide further recommendations sometime this year. Meanwhile, IOSCO is moving forward on its "supervisory colleges" proposal whereby international bodies will have a greater opportunity to further harmonize regulation of CRAs as well as heighten their international monitoring of them.

At the same time, the regulatory and legal noose continues to tighten in Europe. In January 2013, the European Parliament approved new rules on when and how credit rating agencies may rate state debts and private firms' financial solvency—allowing agencies to issue unsolicited sovereign debt ratings only on set dates and enabling private investors to sue them for negligence. According to Michel Barnier of the European Commission, "…the new rules will reduce the over-reliance on ratings by financial market participants, eradicate conflicts of interest, and establish a civil liability regime." **SF**

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