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The current and prospective role of credit rating firms

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There has been and remains tension in the ratings industry regarding the proper role of a rating firm. On the one hand, a large part of the financial community would prefer a relatively malleable group of rating firms, such that when a credit crisis arises, as is currently the case with Ambac, MBIA, MGIC and other monoline insurers, the market has time to adjust and hopefully work out a solution. State and federal regulators have been heavily involved in the search for solutions for stressed credits such as the monolines, Countrywide and Bear Stearns. On the other hand, an equally large part of the financial market wants ratings to reflect current and future credit quality accurately, such that the ever-changing capital markets have the opportunity to adjust. At the heart of the issue is whether the economy is best served by managed or timely and accurate ratings. Our view is that there is a natural bifurcation of the ratings industry.

In the early 1970s the traditional rating firms, such as Standard & Poor's, Moody's and Fitch, shifted their business practices from an investor-pay model to an issuer-pay model so that today over 90 per cent of the revenue from ratings is derived from issuers. Alternatively, Egan-Jones, which was recognised as a rating firm by the Securities and Exchange Commission (SEC) in December 2007, receives no compensation from issuers, but rather is supported entirely by institutional investors. The timeliness and accuracy of Egan-Jones's ratings were confirmed by studies conducted by the US Federal Reserve and a joint study by Stanford and Michigan Universities. Since Egan-Jones does not know the position of its clients, it can be called independent, whereas the issuer-supported rating firms can be confident in concluding that their principal source of revenues, the issuers, are seeking the highest possible ratings, which in turn usually results in the lowest possible funding costs.

The freeze in various credit markets is the natural outcome of a hopelessly flawed market structure. Given the fact that an issuer-supported rating firm has a natural tendency to please issuers to ensure the flow of future business, and that the freedom of speech defence protects against any rating mistakes, it is little wonder that we are experiencing the current market crisis. To its credit, Moody's attempted to tighten up credit standards in the commercial mortgage rating area, but found that its revenues and market share suffered. For most issuer-supported raters, it is far easier to track the actions of other issuer-supported raters than to take a hard line and become marginalised. In the case of mortgage and structured finance transactions, all the parties were paid if and only if the transaction was completed; long gone was the local bank examiner checking that proper underwriting standards were maintained. The solution to this miserable situation is not to pile a few more bricks onto fairly porous Chinese walls, which is the direction being suggested to the International Organisation of Securities Commissions. Rather, the better approach is to realise that just as Pavlov's dog started salivating at an indication of dinner, the issuer-supported rating firms must do what is reasonably within their power to support their paymasters. The slashing of ratings from AAA to D in a period of days, which was the case with Rhinebridge and other structured investment vehicles, is the natural outcome of an unbalanced incentive system.

The trick now is to rebuild trust in the assigned ratings. Assuming that the SEC and other regulators will not second-guess ratings assigned by rating firms, and assuming that the freedom of speech protection will remain for any ratings which in retrospect are viewed as off the mark, the best hope is for an alignment of interests. Investor interest and issuer interest will remain diametrically opposed, and therefore fiduciaries which rely on issuer-supported ratings will not be serving their beneficiaries particularly well. Prospectively, we expect more investors to align their investment policies to investor rather than issuer-supported ratings.

Egan-Jones has been asked by numerous clients to enhance its activities in the structured finance area and, as is always the case, will issue ratings from the perspective of investors. This focus has the benefit of highlighting market opportunities: the decline in assets has created opportunities for new-money investors because of the depressed asset values and rating pressure on old-money investors because of the likely portfolio losses. We are also working with various regulators and internal risk control groups to provide guidance on dealing with some various holdings.

In the meantime, significant work is required both to unfreeze markets and to reduce the probability of future problems. We are recommending the following reforms.

Credit market reform proposals

In 2006 Congress passed legislation reforming the process by which the SEC certifies companies as nationally recognised statistical rating organisations (NRSROs). The specific goal of that legislation was to improve competition by easing entry barriers and the early results are encouraging as additional companies are being certified as NRSROs. However, these are relatively small companies and the scope of the current credit debacle, where even high-quality loans are being rejected by the secondary market, has produced a consensus that process reforms are inadequate to address the serial failings of the major credit rating agencies to fulfil their mission of issuing timely and accurate debt ratings.

Disclosure by rating agencies

The publication of any debt rating, whether in written reports or on websites, should be accompanied by a prominent disclosure statement indicating how the entity which provided the rating has been compensated. For example, if a rating agency is paid by the issuer of the securities, a securities dealer, a securities broker or any other party being compensated from the proceeds of the sale of the debt obligations being rated, this fact should be disclosed. If the rating agency's report is paid for by investors or any other party, it should likewise be required to disclose the generic source of its compensation.

Disclosure by institutional money managers

Fiduciaries such as mutual funds, pension funds and investment advisers currently disclose the general risk profile of a particular fund in their annual or more frequent investor reports. If the fiduciaries invest in rated debt instruments, they should also be required to disclose whether those ratings were generated by rating firms compensated directly or indirectly from the sales proceeds of the debt issuance.

Elimination of SEC exemption

Rating agencies are exempt from the SEC's fair disclosure rules (Regulation FD), which can allow them special access to material non-public information from issuers of corporate debt. This is a form of information monopoly which puts the investing public at a disadvantage and contributes to the perception that rating agencies 'know better'. This special treatment should be ended in order to ensure the uniform release of credit information to all market participants.

Business model independence

Both Moody's and Standard & Poor's followed the 'investor pays' business model from their founding in the early 1900s until the 1970s, when the shift to the 'issuer pays' business model came to prominence. As part of its recent exposé of the industry, Barron's suggested that rating agencies "be encouraged to make their money from investor subscriptions rather than fees from issuers, to ensure more impartial ratings". One way to do this would be to phase in a requirement that any rating agency, in order to maintain its NRSRO designation, derive a given percentage of its annual revenues from investors rather than relying almost exclusively on issuers.

Financial regulatory requirements

Bank capital requirements, particularly after the recent adoption of the Basel II revisions, rely on NRSRO ratings

for purposes of prescribing appropriate capital levels. Assets with high-quality ratings are subject to lower capital requirements than lesser-rated and non-investment grade bonds. Financial regulatory bodies in the United States and abroad are increasingly concerned about the impact which inflated ratings may have on the banking system. Since most bond issues carry ratings from two agencies, an antidote would be to require that one of these ratings be from a company which was not compensated by the issuer of the bond.

Disclosure of 'forum shopping' for ratings

Assigning ratings to structured finance bonds differs from the process for corporate and municipal bonds. In the unsecured corporate and municipal markets, debt issuers are subject to being rated by all the rating agencies because financial information is publicly available to all parties. The structured finance market has been a 'rating by request' market, where the debt issuers invite some or all of the major rating agencies to preview the collateral pools so that the rating agencies can provide preliminary rating indications that can be used to size the bond classes and structure the bond transactions.

Historically, all the rating agencies have agreed to bow out of the rating process if they are not actually selected by the debt issuer to rate a securities transaction. This has encouraged the debt issuers to shop for the best ratings so they can optimise their securitisation proceeds. Given the lucrative nature of the rating business, rating agencies have had incentives to compete for rating assignments. This incentive could be neutralised by requiring issuances over a certain dollar threshold to disclose whether the issuer discussed a rating with any rating agency that did not issue a rating for the issue.

The above materials represent the recommendations of various academics, industry consultants, regulators and independent rating firms.