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Ratings agencies

Of all the dogs that failed to bark when the financial crisis loomed, credit rating agencies (CRAs) were the most notorious. Nicholas Kochan reports on the measures being introduced by global financial centres and regulators to improve their reliability and transparency.

Tight regulation for credit ratings agencies (CRAs) is now being demanded by every sector of the financial community, from the largest investors to lawyers and regulators.

Critics of the agencies - pre-eminently Moody's, Standard and Poor's, and Fitch - whose key role is to produce a rating that indicates the quality of a financial instrument or entity, say the weaknesses of their analysis have been clear for some time. Many are frustrated that it has taken a financial crisis in which securities given AAA status have turned out to be valueless to spur regulators into action.

"Their quantitative models appeared to have a Mensa-like IQ of at least 160, but their common sense rating was closer to 60, resembling an idiot savant with a full command of the mathematics, but no idea of how to apply it," says Bill Gross, founder of Pimco, the world's biggest bond investor.

He says that he comes "not to bury the rating services, but to dismiss them. To tell the truth, they can't really die - they serve a necessary and even productive purpose when properly managed and more tightly regulated".

The agencies maintain that their models were accepted over a period of a decade of financial and market expansion. They also say that they required banks issuing securities to formulate contracts that included investor protection and credit enhancement features, like the over-collateralisation of Credit Derivative Obligations (CDOs). It took the tsunami of an unprecedented economic crisis to sweep away the legal protections.

However legitimate this defence may be, the critics are showing no signs of reducing the pressure for significant reform. The European Union and the United States have already drafted legislation they hope will make rating a more transparent and accountable process. If the first attempt fails, they seem prepared to go further.

Flaws in the ratings system

For the regulators, one of the key problems comes from the conflicts of interest endemic in the ratings system - for example, from the way the agency is paid to conduct its examination of a company or a stock. Under the current system the company pays the agency. Critics say this puts irresistible pressure on the agency to deliver a higher rather than lower score.

" CRAs hope that financial institutions, for whom they provide ratings, will provide repeat business," says Lista Cannon, a partner in the law firm Fulbright and Jaworski. "CRAs have also sought to obtain highly lucrative consultancy work from clients. As a result, CRAs are under pressure to provide high ratings, while clients have been able, effectively, to 'shop around' for favourable ratings. For example, reports suggest that financial institutions have pressured CRAs to provide high ratings for what are now known to have been failing complex financial instruments."

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The system of inflating ratings to benefit the banks selling the instruments is explained by Frank Partnoy, Professor of Law and Finance at the University of San Diego and the author of the seminal work *Infectious Greed* .

He argues that "the product the agencies were selling was not their own expertise. They were selling an inflated rating methodology that enabled buyers to purchase riskier high-yielding assets. The banks controlled the inputs and told the agencies what they needed to get a deal done. As a result the agencies could fill in the blanks and make money. By the time a rating agency understood the bells and whistles of these models, the banks doing the CDO deals would hire him or her at a significantly higher salary."

There is also growing concern about the limited number of leading agencies - the result, say critics, is an inefficient "oligopolistic" market where competition is highly restricted.

Potential conflicts of interest often arise where a leading agency is providing several services to one client, effectively compromising its ability to provide independent ratings for each separate arm of the business. Consequently, the CRAs' ability to provide neutral ratings may be compromised. Financial institutions have connived in building this oligarchy by limiting their investing to instruments rated by one of the top three CRAs.

"The market for ratings would be more transparent if there were more established agencies. Instead we have a very few CRAs of any repute and those few are immensely powerful," says Peter Hahn, professor of finance at the Cass Business School and an adviser to the Britain's Financial Services Authority.

There have been worries about the transparency and competence of ratings agencies for the past 20 years, but such has been their power that critics have been reluctant to speak out. The CRAs, say their critics, failed, at a sovereign level, to spot the Asian crisis in the early 1990s, and at a corporate level the Enron crisis in the mid-1990s and the dotcom bubble in late 1990s.

And in the last decade they have been collecting very large fees for rating and advising corporates and countries as banks sold investing institutions large amounts of at best opaque paper instruments. Indeed, just before the 2008 crash, Standard & Poor's published guidance on how non-performing loan CDOs are rated, entitled: "Distressed Debt CDOs: Spinning Straw into Gold."

Yet, until recently, these arbiters of financial strength were allowed a free hand. As one commentator observed: "Regulators have traditionally designated the leading CRAs as the only acceptable ratings providers in certain markets. As a result, critics consider that the market structure for CRAs has been fundamentally flawed."

In the United States President Obama started the clampdown on the agencies just over a year ago, when reforms were included in the Financial Regulatory Reform Bill, which subsequently became the Wall Street Reform and Consumer Protection Act (dubbed the Dodd-Frank Act after the parliamentarians who promoted it).

The legislation seeks to tackle conflicts of interests and create increased transparency by subjecting an analyst's past work to increased scrutiny where they are hired by a customer, and by requiring CRAs to disclose their fees, ratings history and provide detailed methodologies. Finally, it bans CRAs from offering consultancy work to ratings clients. The most important institutional provision is the

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creation by the SEC of an Office of Credit Ratings (OCR) to "provide oversight over Nationally Recognised Statistical Ratings Organisations (NRSROs) and enhanced regulation of such entities".

The act does acknowledge the importance of the CRAs. Ratings, it says, are a matter of national interest and, in the debt market, agencies are critical "gatekeepers" central to capital formation, investor confidence, and the efficient performance of the US economy. But it does not mince its words in highlighting the fact that "conflicts of interest and inaccuracies during the recent financial crisis contributed significantly to the mismanagement of risks by financial institutions and investors which in turn adversely impacted the health of the United States economy". These factors, it argues, make it essential to increase agencies' accountability and transparency.

While the American government has sought to provide new oversight of the CRAs, others have sought to bring them more directly to book. New York attorney general Andrew Cuomo is reported to have handed out subpoenas to leading CRAs (in addition to leading financial institutions) as part of his criminal investigation into practices in the run-up to the financial crisis. California's attorney-general has taken out a court order requiring one of the leading CRAs to "explain why it gave its highest rating to risky and toxic" mortgage-backed securities.

Fastest and most decisive of all has been the European Union; in November 2009 the European Parliament and Council approved the Credit Rating Agencies Regulation, which took effect immediately across the whole EU. British r egulations passed at the same time put the Financial Services Authority in charge of CRA regulation. This power was transferred at end of last year (2010) to a common European regulatory body, the European Securities and Market Authority. "The path towards the better supervision of credit rating agencies at European level is now open,' said Jean-Paul Gauzes, the MEP responsible for leading the regulation. "Our objective is to enable the European Securities and Markets Authority to exercise its powers as soon as it is operational'.

ESMA is the body responsible for enforcing regulations which include the establishment of a registration and certification system for CRAs: EU issuers may only use those established in the EU and registered under the CRA Regulation, non-EU CRAs certified by the EU authorities, or non-EU CRAs endorsed by registered CRAs.

There are also restrictions on conflicts of interest. CRAs may not provide advisory or consultancy services to issuers to whom they provide ratings services, and they must also ensure that employee compensation arrangements are linked to the quality of the rating and review process - and not to the ratings provided.

Ratings must be clear and justified, which means CRAs must differentiate rating categories for structured finance instruments or justify each structured finance rating with a comprehensive report. They must only provide ratings for financial instruments based on sufficient quality information and must implement an internal function to review the quality of ratings. They are also required to make greater disclosure to regulators, including an annual transparency report.

The EU has also proposed amendments to the Capital Requirements Directive (CRD 2), which may also impact on the role of CRAs as they seek to clarify the assessment of a company's overall capital. They also introduce restrictive lending measures on companies with large exposures, improve the risk management of securitisation, upgrade disclosure standards of a company's accounts and impose higher capital requirements for re-securitisation. CRD 2 must be implemented by the start of 2011.

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Financial regulators will continue to target the activities of the CRAs. In the US, legislative committees will maintain their probing of the agencies' role in rating high-profile, extremely complex but ultimately flawed financial instruments. CRAs will face increased regulatory scrutiny and will need to ensure that procedures are in place to justify in more detail the ratings provided. CRAs will also need to work hard to re-establish their reputation and independence.

However, the regulation and legislation so far passed in the UK and EU has failed to provide an alternative to the "issuer-pay" model by which CRAs are remunerated by the debt issuer. At EU level, discussions on CRD 2 to move towards an "investor-pay" model foundered. Moreover, the regulators have not yet addressed the stranglehold on the market of the leading CRAs. Lista Cannon, of law firm Fulbright and Jaworski, says the "leading CRAs will continue to dominate the financial markets and global financial institutions will keep referring to ratings provided by a restricted number of CRAs".

The Commission is consulting on further policy issues. These include an examination of the possible options concerning overreliance, sovereign debt ratings, competition, civil liability and conflicts of interest.

On the question of civil liberty, the United States has already gone further than the European Union. According to Helen Parry, a former UK regulator and academic in the financial field, "the issue of civil liability has already been addressed in the US through the Dodd-Frank legislation, which provides for a private right of action against an agency which commits a securities law violation based on its failure to conduct appropriate due diligence with regard to its ratings.

Under Dodd-Frank, there are also provisions for mitigating conflicts of interest by means of a system whereby the selection of the credit rating agency could be undertaken by an independent agency, particularly in the case of structured finance products."

However, European legislation has a better chance of bringing the ratings agencies to book than new American regulations, says Piero Cinquegrana, an analyst at the Centre for European Policy Studies.

In his opinion, " CRAs need closer supervision. While certainly burdensome and likely to raise barriers of entry, the European Commission's proposal seems to be the most sensible solution given the circumstances. Market discipline based on competition and transparency as envisioned in the US will lead to a weak surveillance regime, while leaving the regulatory licence intact."

One test of how serious the banks and other financial institutions are about significant change is their readiness to consider alternative ratings sources. Reports suggest that the Bank of England has recently proposed to undertake its own risk assessments for many classes of collateral, offering itself as an alternative to CRAs. As a neutral credit assessor, it could provide investors with a robust alternative for reliable, independent and high-quality ratings. The European Commission is also said to be considering the establishment of a European credit rating agency.

The best outcome for banks and other financial institutions is that consistent regulatory pressure will produce genuine reform within the CRA market, resulting in increasingly independent and reliable ratings and more stable markets.

If it does not, one alternative is for investors to do their own research rather than rely on the agencies. That would have the benefit, some argue, of forcing them to take full responsibility for their decisions. According to one lawyer, "i t is all very well blaming the agencies, but investors have

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a duty to understand what they are buying. They are as much at fault as the agencies in failing to do proper due diligence. This is a systemic issue. Agencies deserve to be bashed, but someone should also be pointing fingers at gullible investors."

The European Commission makes a similar point, pointing out that "t here are growing concerns that financial institutions and institutional investors may be relying too much on external ratings and do not carry out sufficient internal credit risk assessments, which may lead to volatile markets and instability of the financial system."

Professor Peter Hahn, of the Cass School of Business in London, also focuses on the buyers of information rather than the sellers. "The demand for the CRAs is the problem. It is cheaper for investors to buy the approval of a rating agency than to set up their own econometric facility. It also passes the buck to a third party if something goes wrong," he says.

Rating agencies are putting a brave face on the swathe of measures, regulations and laws coming their way. Fitch, for example, says that it "believes the market will gain confidence from globally consistent rules for credit rating agencies that foster transparency, disclosure of ratings and methodologies and management of conflicts of interest".

The reality is that reputational damage done by past failures now ensures that the CRAs have little power to resist regulatory change. In fact, the evidence of the last year is that they have supported the efforts of regulators, and indeed in some instances worked with them to ensure a workable system. Yesterday's arrogance has been replaced by a spirit of collaboration with the financial authorities.

The challenge now is for regulators to impose a more rational and reliable system on CRAs, so that investors can trust in their outcomes. This requires a much more comprehensive revision of their practices and outcomes than is presently envisaged on either side of the Atlantic.

The fact that the CRAs are cautious, perhaps over-cautious at the moment, is an indication of how chastened they have become as a result of their failures. But that does not mean that they are any more likely to spot, let alone prevent, the next bubble.