Ratings Reform: Blasting the Business Model

The current credit rating system is biased and broken – and regulation hasn't helped. Let's fix this problem by eliminating the issuer-pay conflict of interest inherent in ratings.

By Joe Pimbley

"Everybody talks about the weather, but nobody does anything about it." I'm not sure there's any wisdom in this humor of Mark Twain, but it's a thought that suits my proposal to fix the credit rating agencies.

The credit ratings that rating agencies publish are immensely important to all bond markets. Unfortunately, such ratings do not represent third-party, unbiased assessments of default risk as they purport to do. The financial industry talks a great deal about this problem, but, imitating Twain without the humor, nobody does anything (effective) about it.

Value of Credit Ratings

First let me say I admire greatly the stated mission of the rating agencies. I've worked with and for many of these agencies during my decades in the financial world. Credit analysis is supremely challenging and I've been fortunate to know and collaborate with numerous excellent rating analysts.

From an inside view, rating agencies and their rating processes are impressive. They have "learning cultures" for all qualitative and quantitative aspects of credit risk. Analysts of diverse skills execute the rating methodology for each bond and bring their recommendation to a formal committee of experienced senior colleagues, where a lively and healthy debate often ensues.

More important is the value this rating process *should* add to the investment world. In an ideal scenario, the expert, disinterested, unbiased opinions of rating agency professionals are critical data points to investment managers supporting buy/sell decisions and surveillance. (See our discussion of the benefits and challenges of credit ratings in this GARP-Maxwell video.)

The "Rating Shopping" Dilemma

The problem with credit ratings is that the assigned ratings are not "unbiased." The issuer of the bond pays for the rating. It is therefore in the interest of the bond issuer to hire the rating agency (or agencies) who will provide the highest rating.

This is not a hypothetical concern, it's real! The industry label for the practice is "rating shopping." As an analogy, when a borrower needs a loan to buy a house, she selects the bank with the easiest lending terms (low mortgage rate, high loan-to-value, minimal upfront costs, *et cetera*). Shopping for a rating differs little from shopping for a loan.

Rating agency executives will say they compete on quality of service, the strength of their brand, and ancillary research offerings rather than on the stringency of their rating assignments. But the recent admissions and legal settlements of two large rating agencies with the U.S. Department of Justice contradict this story. (See the settlement announcements for the first agency and the second agency.)

In the original business model of the rating agencies, the bond *investors* – not the bond *issuers* – paid for ratings. By mutual agreement, issuers began paying the rating agencies circa 1970 due to the "free rider" problem of ratings becoming widely (and freely) distributed beyond the investors who'd paid for them. The bond issuers had no aversion to "free" dissemination of ratings, since the existence of ratings helped sell the bonds.

Past Attempts to Fix Credit Ratings

One universal lesson of the global financial crisis of 2007 is that credit ratings of structured finance products were defective and that rating agency incentives to lower analytical standards and win business were a leading cause. As a result, the Dodd-Frank Act of 2010 gave the Securities and Exchange Commission (SEC) new and expanded responsibilities and powers for supervision of the rating agencies.

In this new regulatory scheme, the agencies must: (1) post publicly the rating methodologies for every type of rating they issue; (2) create and

document procedures and controls for applying these methodologies rigorously; (3) implement independent internal review of their methodologies and models; and (4) collect and analyze data regarding the performance of ratings on a continuing basis to demonstrate accuracy. There are also numerous personnel, compliance, conflict-of-interest, and other restrictions and requirements.

Rating agency regulation prior to 2010 took the form of "Nationally Recognized Statistical Rating Organization" (NRSRO) status. A would-be rating agency in the U.S. needed to convince the SEC that it had the necessary skilled people, methods, organizational structure, capital, history and paying clients to qualify as "a rating agency."

In theory, this creation of NRSRO status prevented the issuance of "ratings" that were lacking serious analysis. In practice, the SEC review created a barrier to entry that aided existing rating agencies. This barrier grew considerably taller with the passage of the Dodd-Frank Act.

Some or all of these safeguards may seem helpful, but they're not. The problem is that all employees of a rating agency have a strong incentive to "win deals," and they can do so while staying within the confines of any regulation.

To win deals, the rating agency shows the bond issuer that it will give a favorable rating. The agency easily creates and implements its methodology to give this favorable rating for the simple reason that judgment, being critically important to all credit analysis, is a necessary ingredient of rating methodologies. Even model-based methods have great latitude for judgment.

Judgment is necessary and good when the goal is to find a "true result." But it is this same judgment that enables rating analysts and managers to compete for business with favorable ratings by choosing methods, parameters and techniques that fit a *desired*, rather than *true*, result.

In fact, the regulations themselves are *counterproductive*. To the public and investors, the presence of regulation implies there exists strong supervision, such that rating agencies cannot bias their ratings. That implication is false.

The judgment inherent in credit analysis enables bias in the ratings. Further, the abundant regulation gives the rating agencies an immediate excuse for any future problems: “We did precisely what the regulators asked, and we showed them everything we did!”

Best (and Unavoidable) Solution for Credit Ratings

It is the conflict of interest of the bond issuer paying for the credit rating that sits at the heart of the rating agency dilemma. Rating agency insiders I know agree completely with this observation. Privately, and sometimes publicly, they will say that the business model doesn’t work without the issuer as the paying client. Stated more bluntly, investors want the ratings but don’t want to pay for the ratings.

Whether it’s friendly to the rating agency business model or not, my opinion is that the unavoidable solution is to prohibit the bond issuers or any affiliates (such as the bankers) from paying for the bond ratings. Going back to the 1930s, the spirit of SEC regulation is that issuers of public bonds must disclose full, complete and accurate financial and operating information – including conflicts of interest and risk factors.

Of course, having the issuer pay for the “independent” bond rating is a tremendous conflict of interest. Beyond simply disclosing this conflict of interest, the SEC should prohibit both the inclusion of ratings within the offering documents and the issuer’s payment for the ratings.

As they do now, issuers may provide data and information to rating agencies to enable determinations of credit ratings. But, in line with the “fair disclosure” of Regulation FD, the public should receive all such data and information concurrently. I suggest we begin this new rating paradigm with structured finance bonds, since this sector is the epicenter of “rating shopping” behavior. It is possible that some rating agencies will earn sufficient revenue by billing investors directly. (Investment funds do pay fees now to rating agencies for data feeds of ratings.)

It is also entirely possible that the market will develop new methods for assessing risk of structured finance bonds that do not use traditional ratings. As the rating agencies themselves say (see the penultimate paragraph of

Triple-A Failure, April 2008), investors should do their own research and "not rely on ratings."

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