The Evolution of Credit Rating Agencies

Jerome S. Fons
August 24, 2011
Canadian Investment Review
Risk Management Conference

CRA Industry Timeline

- 1841: Commercial credit bureaus
- 1868: Poor’s Manuals
- 1909: *Moody’s Analyses of Railroad Investments*
- 1970: Issuers charged for ratings
- 1975: US SEC creates NRSRO designation
- 2001-2004: Enron, WorldCom and Parmalat
- 2006: Credit Rating Agency Reform Act
- 2007: Subprime/CDO/SIV debacle
- 2010: Dodd-Frank
Current NRSROs

<table>
<thead>
<tr>
<th>Name</th>
<th>Year Started</th>
<th># of Analysts</th>
<th>2010 Revenue (Ratings only)</th>
<th>Business Model (Pays for ratings)</th>
<th>NRSRO Granted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moody's Investors Service</td>
<td>1909</td>
<td>1250</td>
<td>$1.8 Billion</td>
<td>Issuer</td>
<td>1975</td>
</tr>
<tr>
<td>Standard &amp; Poor’s</td>
<td>1916</td>
<td>1300</td>
<td>$1.9 Billion</td>
<td>Issuer</td>
<td>1975</td>
</tr>
<tr>
<td>Fitch Ratings</td>
<td>1924</td>
<td>1120</td>
<td>$680 Million</td>
<td>Issuer</td>
<td>1975</td>
</tr>
<tr>
<td>Dominion Bond Rating Service</td>
<td>1976</td>
<td>150</td>
<td>Private</td>
<td>Issuer</td>
<td>2003</td>
</tr>
<tr>
<td>AM Best</td>
<td>1906</td>
<td>135</td>
<td>Private</td>
<td>Issuer &amp; Subscriber</td>
<td>2005</td>
</tr>
<tr>
<td>Kroll Bond Ratings</td>
<td>1984</td>
<td>23</td>
<td>Private</td>
<td>Issuer &amp; Subscriber</td>
<td>2008</td>
</tr>
<tr>
<td>Egan-Jones Ratings</td>
<td>1994</td>
<td>20</td>
<td>Private</td>
<td>Subscriber</td>
<td>2007</td>
</tr>
<tr>
<td>Realpoint (Morningstar)</td>
<td>2001</td>
<td>25</td>
<td>Private</td>
<td>Issuer &amp; Subscriber</td>
<td>2008</td>
</tr>
<tr>
<td>Japan Credit Rating Agency</td>
<td>1983</td>
<td>75</td>
<td>Private</td>
<td>Issuer</td>
<td>2007</td>
</tr>
<tr>
<td>Japan Rating and Investment Info.</td>
<td>1986</td>
<td>81</td>
<td>Not disclosed</td>
<td>Issuer</td>
<td>2007</td>
</tr>
</tbody>
</table>

Source: Author’s calculations.

Major Industry Themes

- Excessive reliance on ratings
- Conflicts of interest and rating shopping
- Lack of accountability
- Limited competition
Excessive Reliance

- Ratings in Regulation
  - Protecting investors and policyholders (SEC, NAIC)
  - Protecting taxpayers (OCC, FDIC, FED, ERISA)
- Ratings in Investment Guidelines
  - Refer to minimum rating levels
  - Often name individual CRAs
- Ratings as Performance Benchmarks
  - Bond indices based on rating categories
  - Only select CRAs used for these
- Ratings used to Monitor Borrower Behavior
  - “Rating triggers” in financial contracts (loans, swaps)

CRA establishes a reputation for reliability

- Users increasingly rely on its ratings
- As use increases, ratings become self-fulfilling
- CRA forebears in order to prevent crisis
- Rating accuracy falls
- Reputation is damaged
**Excessive Reliance**

<table>
<thead>
<tr>
<th>Distress Date</th>
<th>Moody's</th>
<th>S&amp;P</th>
<th>Fitch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bear Stearns</td>
<td>A2</td>
<td>A</td>
<td>A+</td>
</tr>
<tr>
<td>Fannie Mae</td>
<td>Aaa</td>
<td>--</td>
<td>AAA</td>
</tr>
<tr>
<td>Freddie Mac</td>
<td>Aaa</td>
<td>--</td>
<td>AAA</td>
</tr>
<tr>
<td>Lehman</td>
<td>A2</td>
<td>A</td>
<td>A+</td>
</tr>
<tr>
<td>AIG</td>
<td>A2</td>
<td>A</td>
<td>A+</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>A2</td>
<td>A</td>
<td>A+</td>
</tr>
<tr>
<td>WaMu</td>
<td>A2</td>
<td>A</td>
<td>A+</td>
</tr>
<tr>
<td>Wachovia Bank</td>
<td>AA-</td>
<td>BB-</td>
<td>BB-</td>
</tr>
<tr>
<td>Fortis Finance</td>
<td>AA-</td>
<td>BB-</td>
<td>BB-</td>
</tr>
<tr>
<td>Dexia</td>
<td>AA-</td>
<td>AA</td>
<td>AA-</td>
</tr>
<tr>
<td>Citigroup</td>
<td>AA-</td>
<td>A</td>
<td>A+</td>
</tr>
</tbody>
</table>

Source: Bloomberg, agency web sites.

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**Conflicts of Interest**

- CRAs are paid by issuers
  - Issuers want high and stable ratings
- Reputation Risk is not sufficient to offset conflict
  - No clear definition of rating quality
  - Rating quality is difficult to assess
- In some areas issuers can “shop” rating agencies
  - CRAs compete by lowering standards
- Sometimes there is no appetite for the truth
  - Sovereign debt crisis
Conflicts of Interest

- Investor/Subscriber Pays Model
  - Fewer conflicts, but not eliminated
  - Can’t support large staff of well-paid analysts
  - Goes against “public good” nature of ratings

- Government Sponsored Agency
  - Supported by a tax on transactions
  - May not be seen as independent

- Mutual Rating Organization
  - Funded and operated on behalf of members
  - Difficult to organize natural competitors

Conflicts of Interest

- An accurate rating system best separates *ex ante* defaulters from non-defaulters

- Stable Ratings vs Accurate Ratings
  - Can’t have it both ways
    - Want to be all things to all people
  - Stability encourages reliance on ratings
  - Many fund managers like stable ratings
    - Easier target to “beat”
    - Some believe that fundamental credit risk moves slowly
Lack of Accountability

- Ratings are protected by the First Amendment
  - *Jefferson County School District No. R-1 v. Moody’s Investors Service, Inc.*, 175 F.3d 848 (10th Cir. 1999)
- SEC Rule 436(g) (1982)
  - Excludes any NRSRO whose security rating is disclosed in a registration statement from civil liability under Section 11 of the Securities Act of 1933.
  - Exempts an NRSRO from liability as an expert, but still subject to liability under the antifraud provisions of the federal securities laws.
- Federal preemption:
  - Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings. (CRARA 2006)

Dodd-Frank Response

- Tighter Supervision
  - SEC has new enforcement powers
  - Places greater responsibility on internal compliance officers
  - Independent directors
- Increased Disclosure
  - Reliance on third parties and due diligence
  - Assumptions and data used to support ratings
- Increased Accountability
  - Eliminates Reg FD exemption
  - Lowers standard for private rights of action
  - Subject to expert liability
- Al Franken scheme
- Remove statutory and regulatory use of ratings
The Uncertain Future

- What will replace NRSRO ratings in regulations and guidelines?
- Alternative “standards of credit-worthiness”
  - Market indicators
    - Bond prices/bond spreads (vs “default-free” benchmark)
    - Credit default swap spreads
    - Equity price based measures
    - Highly volatile
    - Potentially circular
  - Fundamental accounting ratios
    - Minimum thresholds
    - Who sets and adjusts these?

Limited Competition

- Despite the risk from rating shopping, new competition can improve the CRA industry by:
  - Raising standards
  - Lowering costs
    - Industry margins among the highest in the S&P 500
  - Providing investors with new choices
- “Chicken & egg” phenomenon
  - NRSRO required to have 3-year history
  - Statistically significant record takes years to build
  - Investment costs for full-service, global CRA are high
  - Reputation takes time to establish
Solving the Problem

- What can you do?
  - Remove references to CRAs by name in investment guidelines
    - Expand the list to include all NRSROs
  - Conduct own due diligence of CRAs
    - Independent from adverse influence
    - Qualifications of staff
    - Rating objectives and performance
    - Beyond the rating
      - Transparency/usefulness of ratings research
      - Research/analysis hard to find?
      - Research/analysis costly to obtain?

Solving the Problem

- What can you do? (cont’d)
  - Demand clear standards of rating quality
    - Rating objectives to meet your needs
    - Consistent definitions and reporting
  - Rely less on ratings and more on supporting analysis
    - Pre-sale reports and other research
    - Follow-up monitoring reports
  - Ask for ratings from KBRA