Reforming Credit Rating Agencies

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Many readers will think that the last person whose opinion should be consulted on the issue of rating agency reform is a former rating agency employee. Maybe they're right but I did learn one thing from rating hundreds of complex securities. Contrary to what some may think, there are no easy solutions here. Unintended consequences are guaranteed. So here's my humble take on the current CRA reform proposals.

<u>What should be the goal of rating agency reform?</u>

In 2007, as S&P and Moody's were trying to decide how to rerate the entire structured finance debt market, I asked a shrewd fund manager what advice he would give to the management of a rating agency. He said they have to get the ratings right. No matter how hard it is, they have to focus on getting the ratings right.

There is an alternative school of thought. Instead of improving ratings, the reform agenda should be to be to eliminate their use. Since the rating agencies are hopelessly stupid or corrupt or both, just say no. End the market's addiction to credit ratings by eliminating the SEC designation Nationally Recognized Statistical Rating Organization (NRSRO). Go cold turkey and end the practice of using ratings to assess credit risk by governmental or regulatory entities.

These two competing goals, improve credit ratings and eliminate credit ratings, can be viewed from a larger perspective, a Minsky mindset. If stability breeds instability, then trust breeds disappointment, the greater the trust, the bigger the disappointment. The rating agencies were over-trusted until 2007.

But looking forward, as a bi-polar sufferer might do, isn't the best strategy to try to manage this fundamental aspect our identity by taking off the peaks and troughs of our swings in trust. In trading terms, if trust is the underlying commodity, we should manage our mood by selling an OTM call to fund a long OTM put and avoid capitulation here at the bottom of the trough in our trust.

The Financial Stability Act of 2010

How does the financial reform act being considered in the US Senate address the rating agency problem? Two significant amendments were passed on May 13, one from Senator Franken and one from Senators LeMieux and Cantwell. They are bolder (or perhaps more theatrical) than the previous provisions and almost perfectly reflect each of the two very different strategies: improve credit ratings and eliminate credit ratings. It's not so clear if the amendments work well together or with the other CRA provisions of the current financial reform bill.

Prior to those amendments, the existing provisions the bill sought to both improve and de-emphasize but not eliminate credit ratings. That's a good, sober approach that reflects the philosophy outlined by Assistant Treasury Secretary Barr (Financial Institutions) in his remarks before the Banking committee in August.

"Our legislative proposal directly addresses three primary problems in the role of credit rating agencies: lack of transparency, ratings shopping, and conflicts of interest. It also recognizes the problem of over reliance on credit ratings and calls for additional study on this matter as well as reducing the over reliance on ratings."

http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=89e91cf4-71e2-406d-a416-0e391f4f52b0&Witness_ID=44ad0f22-fecb-4c08-a980-3e49f791356c

The Franken amendment would attempt to improve ratings by addressing the conflict of interest issue. In Franken's amendment, a Rating Advisory Board would be appointed by the SEC to assign one qualified NRSO to rate each securitization. The criteria for assignment *could* have a random component assuring that all qualified agencies get to rate some transactions but the Credit Rating Agency Board is directed to consider "the effectiveness of the methodologies used by the qualified nationally recognized statistical rating organization." This seems to invite a contradiction of Secretary Barr's admonition that "the government should not be in the business of regulating or evaluating the methodologies themselves"

Here's a good description of Franken's amendment with some context.

http://www.theatlantic.com/business/archive/2010/05/franken-amendment-would-bring-real-rating-agency-reform/56346/

The LeMieux/Cantwell amendment cuts right through the problem of over reliance on credit ratings and ends Secretary Barr's time for additional study. It deletes all references to credit ratings from the Securities Exchange Act, the Investment Company Act of 1940 and the Federal Deposit Insurance Act. While not actually eliminating the NRSRO designation, Senator LeMieux describes his amendment as follows.

"My amendment writes these organizations out of law," Mr. LeMieux continued. "In a way, we're looking here and saying the astrology that we relied upon in the past didn't work. Let's have some new and better astrology."

http://www.nytimes.com/2010/05/14/business/14regulate.html?src=busln

I don't fault the Senator for the astrology remark. Credit ratings are predictions about the future. My question is, "Where is this *better* astrology?" His amendment seeks to eliminate but not replace credit ratings in regulation. If you try to replace something with nothing, you create a vacuum. Ironically, one of the unintended consequences here could play right into the hands of S&P and Moody's. If you undermine the significance of the NRSRO designation, you risk hurting the seven newly minted NRSROs more than the well-known brand names.

In addition to the two recent amendments, the original rating agency-related provisions of the bill are summarized here.

http://banking.senate.gov/public/_files/FinancialReformSummary231510FINAL.pdf

New Requirements and Oversight of Credit Rating Agencies

1) **New Office, New Focus at SEC:** Creates an Office of Credit Ratings at the SEC with its own compliance staff and the authority to fine agencies. The SEC is required to examine Nationally Recognized Statistical Ratings Organizations at least once a year and make key findings public.

2) **Disclosure:** Requires Nationally Recognized Statistical Ratings Organizations to disclose their methodologies, their use of third parties for due diligence efforts, and their ratings track record.

3) **Independent Information:** Requires agencies to consider information in their ratings that comes to their attention from a source other than the organizations being rated if they find it credible.

4) **Conflicts of Interest:** Prohibits compliance officers from working on ratings, methodologies, or sales.

5) **Liability:** Investors could bring private rights of action against ratings agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source.

6) **Right to Deregister:** Gives the SEC the authority to deregister an agency for providing bad ratings over time.

7) **Education:** Requires ratings analysts to pass qualifying exams and have continuing education.

8) **Reduce Reliance on Ratings:** Requires the GAO study and requires regulators to remove unnecessary references to NRSRO ratings in regulations.

Here's how I rate these provisions.

(1) AA

This one should have been included in the CRA Reform Act of 2006 but better late than never. There are three big questions in my mind.

a. What type of staff? Will it include some people with relevant experience either at rating agencies or at issuing or underwriting firms who have dealt with rating agencies?

b. Will the new focus at the SEC include the measurement of rating agency performance? The SEC needs to perform this critical task in-house, not wholly delegate it to the rating agencies themselves. Of course, this too has staffing implications.

c. How would fines be assessed? If properly targeted, fines could be a powerful tool to change incentives. For instance, the SEC could specify up front that financially painful fines will be levied for poor performance especially for an excess percentage of losses for ratings in the highest category.

(2) BB

Transparency is good except when it isn't. Rating agencies have been sharply criticized for revealing their methodology and thus allowing investment banks to "game" it. You cannot have it both ways. If a CRA has a transparent methodology, issuers or structuring bankers will use that knowledge to get better ratings. On balance I think transparency is good but issuers and underwriters will express strong opinions about anything that adversely affects them so investors and the SEC staff (see (1) above) need to voice their opinions about rating agency methodologies as well.

Regarding disclosure of rating agency track record, CRA's have always had staff publishing self-assessments. That's fine but it's very difficult to compare rating agency performance using their own idiosyncratic self-assessments. Surely the SEC needs to measure and publish comparative studies of rating agency performance (again see (1) above)

(3) CCC

Toothless. The information "considered" by the rater is irrelevant. It's the weight assigned to each piece of information that is critical. This is probably meant to help the plaintiff's bar in number (5) but I doubt it will.

(4) B

This is worth keeping in the bill but incredibly weak. Franken's amendment is definitely more effective at addressing the conflict of interest.

(5) B

OK but again weak. To avoid "knowing and reckless failures" the agencies will catalogue every conceivable risk in committee memos and thought pieces. I doubt this will affect actual rating decisions.

(6) A

Good but basically a nuclear option. The threat of deregistration is important but fines would be more helpful in practice to create incentives for better rating performance.

(7) BBB

Worth doing.

(8) AA

Good provision. Follows the main recommendation from Asst Treasury Sec Barr to the Senate Banking Committee in his testimony from August. LeMieux/Cantwell is a bridge to far.

Improvements

Actually the bill may give the SEC all the power it needs but, how will the SEC use its new power? As Arturo Cifuentes said In his testimony about CRA reform before Senator Levin's sub-committee on April 23,2010, the current CRA regulations are like a building code that prohibits tall buildings but does not define tall. I agree. The SEC needs to do three things.

(a) Define rating standards [but not methodology].

(b) Measure and publish rating performance.

(c) Impose fines for poor performance.

By way of example, there could be five simple categories: A for securities expected to loose under 0.1%, B for expected losses between 0.1% and 1%, C for expected losses from 1% to 5%, D for expected losses from 5% to 10% and F for securities expected losses between 10% and 20%.

As you can see, I would do away with AAA. The notion that an essentially riskless category exists should not be encouraged.

The fines would be heavy only for large-scale losses of securities with an A rating. Again, as an example, levy big fines for losses on A rated securities in excess of 10% for a given category and vintage or in excess of 1% across all categories and several years.

The fines help address the conflict of interest in the rating agency business. Rating agencies need restoration of the balance between rating performance against short term profitability. In the past, rating analysts expressing concerns about inflated ratings were seen only as threats to profitability. Fines do not guarantee accurate ratings but at least future rating agency employees who express concerns about inflated ratings have a chance of being seen as loyal employees working to ensure future profitability.