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WHY SHOULD RATINGS BE IMPORTANT TO YOU?

Credit ratings agencies played a pivotal role in the U.S. housing and global financial crises of 2007 and 2008.[1] As investors learned that some portion of the structured securities (e.g., Residential Mortgage Backed Securities or RMBS) they held included mortgages that were riskier than their ratings indicated, large portions of the credit markets dried up. This lead to widespread pain, the demise of a major issuer (Bear Stearns), and deep concerns about the viability of other players, including government-sponsored enterprises. The credit ratings agencies who issued optimistic ratings on these securities have been widely implicated in the resulting problems. Regulators and other Industry experts have placed considerable attention on the overall institutional role played by the ratings agencies in the financial system and want to determine what, if anything, can be done to improve the ratings system.

[1] A credit rating agency is a firm that assigns credit ratings for certain types of tradable debt obligations, as well as, in some cases the issuers themselves. Companies such as insurance providers are also given ratings. Securities issuers include companies, special purpose entities, state and local governments, nonprofit organizations, and national governments. A credit rating takes into consideration the issuer's credit worthiness (i.e., its ability to pay back the security purchaser or lender), which in turn affects the coupon or interest rate applied to the particular security being issued.

In this brief, we address several crucial issues regarding credit ratings and the agencies that produce them:

- Critical challenges to the credit rating system that may have contributed to the continuing liquidity crisis, including security complexity, cross-market consistency, disclosure adequacy, over reliance on ratings, the agencies' institutional status, and potential conflicts;
- Limitations on ratings agencies' and institutional investors' capacity to address these new issues, as well as potential for improvements; and
- Implications for markets, including the attractiveness of distressed securities funds and the ongoing likelihood that structured securities, particularly RMBS and RMBS-based CDOs, will remain distinct investments.

BACKGROUND

The credit rating industry was inaugurated by John Moody in 1909, when his firm began assessing credit risks, using a distinct methodology to determine the ability of corporate bond issuers to meet their financial obligations. The industry grew to include the four major U.S. ratings agencies (the eponymous Moody's, Standard & Poor's, A.M. Best, and Fitch Ratings), along with a number of foreign firms, all of which provide ratings for an increasingly wide range of securities' types and insurance companies.

Initially, subscribers paid the ratings agencies for research and ratings reports on the creditworthiness of issuers of debt securities. However, such information is hard to restrict to subscribers, so in the 1970s, the agencies began charging the companies who issue fixed-income securities.

To simplify and create some consistency among the groups, the agencies developed ratings systems that essentially assigned grades to individual securities and insurance companies. These are the familiar letter or letter and star ratings. TIAA, an insurance company, can receive the highest possible ratings — AAA or equivalent — from the four major ratings agencies.[2] These grades are accompanied by detailed credit reports prepared by the rating agencies' experienced analysts.

CHALLENGES

Security transparency. The structured security market has grown rapidly and with it the need for securities ratings. From 2002 to 2006, ratings agency revenue coming from structured securities ratings increased 27% per year and is now more than half of total revenue.[3] Other ratings markets, such as corporate bonds, municipals, and nonprofits, have their own idiosyncrasies and complexities, but it is clear that structured securities, in which thousands of individual mortgages, or even parts of mortgages, may be packaged into one RMBS, create degrees and types of complexity that are different, even new, compared to more traditional types of securities. Structured security analysis is primarily model driven (as opposed to corporate and ABS securities, which use qualitative, as well as quantitative analysis). In turn, models are dependent on data and the history of RMBS and many other types of structured securities is relatively short. Extrapolating performance based on a history that may not include a full market cycle runs the risk of not understanding the worst that could happen to these securities. Combined with the explosion of issuance, it is possible that the ratings agencies have encountered understandable challenges in fully analyzing all types of structured securities.

Consistency. Ratings agencies have long argued that the ratings scales they employ are consistent across assets and markets. In 2006, Moody's stated "The need for a unified rating system is also reflected in the growing importance of modern portfolio management techniques, which require consistent quantitative inputs across a wide range of financial instruments, and the increased use of specific rating thresholds in financial market regulation, which are applied uniformly without regard to the bond market sector."[4] In a similar pronouncement in 2001, Standard & Poor's stated their "approach, in both policy and practice, is intended to provide a consistent framework for risk assessment that builds reasonable ratings consistency within and across sectors and geographies."[5]

[2] Ratings are for TIAA as an insurance company and do not apply to the performance and safety of the variable investment accounts. A++ A.M. Best Co. (as of 6/07), AAA Fitch (as of 5/07), Aaa Moody's Investors Service (as of 5/07), AAA Standard & Poor's (as of 7/07).

[3] Moody's Corporation, Investor Presentation (March 2007), available at http://library.corporate-ir.net/library/12/123/123831/items/236937/MCO%20March%20Long%20FINAL.pdf

[4] Nomura Securities, *Bond Rating Confusion*, June 29, 2006.

[5] Ibid.

The consistency challenge has become evident in light of recent events as the number and size of the downgrades and defaults of AAA-rated structured securities (e.g., RMBS) have far outpaced those of the more traditional AAA-rated corporate bonds and ABS.[6] Questions have also been raised about the comparability of certain types of company, bond, and structured securities ratings, where risks to one may not be comparable to risks of the others.

The most important distinctions are derived from the dynamic nature of company investments (investments can be made, altered, or discontinued) versus the more static nature of structured securities (pools of securities that are not actively managed). The key distinction is that structured securities start out unseasoned and become seasoned over time. In other words, unlike a corporate bond that can be analyzed in light of the entire company's performance, past, present, and future , the performance of a structured security (e.g., RMBS) depends on the performance of the individual securities it contains. The security is not tied to a real individual entity. One implication is that structured securities tend toward either default or AAA performance, as empirical data determines consistent cash flow as experience is gained with the consistency of the cash flows. Another implication is that ratings revisions might need to be a built-in part of the ratings process for structured securities.

In general, it may be heroic to argue that the same criteria and ratings can apply to all types of fixed-income securities and companies.

Disclosure. As a result of the increase in the number of downgrades and defaults for securities and companies with initially high ratings, investors and oversight organizations have raised questions about the extent to which the ratings agencies sufficiently disclose the analysis and information on which a rating is based.[7]

6 Mason, Joseph R., and Joshua Rosner, "*Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions*." Social Science Research Network. May 14, 2007.

7 Ibid.

Potential over reliance on ratings and ratings agencies. In theory and, for the most part, in practice, credit ratings help to increase market efficiency, lower spreads, and encourage users of risk capital who might otherwise be shut out altogether: small governments, startup companies, hospitals and universities. They also encourage suppliers of risk capital, who might not have the capacity to do their own analyses, to invest. And therein lies the rub. Many of the largest institutions do their own credit analyses of securities they might wish to purchase and use agency ratings as a check. Smaller lenders may rely almost exclusively on agency ratings.

This might not seem to be a problem. Industry analysts in equities can be influential, for example, but do not directly affect cash flows. Bond ratings, in contrast, do determine cash flows in the form of the coupon rate on a bond, for example. The assumption is that fixed-income ratings are substantially accurate in grouping securities and companies with comparable credit risks. But if they are not, then the cash flows on a security can be significantly affected.

Public authority vs. private opinion. This challenge is embodied in law and regulation that treats ratings agencies as public authorities in some respects, and as private entities in other respects. On the one hand, the major ratings agencies have been deemed by the SEC to be Nationally Recognized Statistical Ratings Organizations whose ratings may be used by financial firms for certain regulatory purposes. For example, laws or policies restrict some institutional investments to investment-grade securities. In this way, bond ratings agencies exercise a grant of public regulatory authority (cf., FINRA). On the other hand, the courts have consistently ruled that a rating is an opinion rather than a determination and therefore protected by freedom of speech.

This dual approach to the ratings agency role is illustrated by the Credit Rating Agency Reform Act of 2006, which authorized the SEC to suspend or revoke the status of an agency that does not have the capacity to provide ratings with integrity.[8] Defining rating agency capacity is a qualitative, uncertain enterprise, one that is not attempted when it comes to equity security analysis.

8 Ibid.

Potential conflicts. Ratings agencies rely on fees, as well as information supplied by the issuers that receive ratings. At least the appearance of conflict could arise when the issuers pay for ratings. And in the case of structured securities, the rating agencies provide feedback to issuers prior to publication so that an issuer can, if necessary, restructure the security before issuance in order to receive a higher rating. This can lead to “rating shopping” where issuers look to more than one agency for the “best” rating. Finally, the depth of rating agencies’ security analysis is determined as much by business forces (profit, revenues, expenses) as public policy objectives.[9] While these factors are unlikely to be at work in many if not most ratings decisions, whenever problems in ratings surface, it can affect investor perceptions and confidence.

In addition, some observers have suggested that the small number of ratings agencies result in barriers to entry due to market dominance, market coverage, reputation, and access to information. Does the current industry structure encourage complacency among the ratings agencies, or is there sufficient and growing competition among the agencies (U.S. and foreign) to produce improved ratings and ratings processes?

POTENTIAL CHANGES

These factors pose significant challenges for investors and ratings. A number of changes have been proposed by various public and private entities, all designed to improve ratings and ratings agencies. These include the following:

- **Develop explicitly separate ratings and documented ratings systems for different types of securities and companies.** This might range from simple signaling changes, such as scales that differ from letter grades, to more significant changes where various approaches to rating different types of securities are documented in detail and compared.[10]

- **Increase disclosure of assumptions, methods, data, and analyses that support ratings recommendations.** While some of this may be considered to be proprietary by the ratings agencies, the quasi-public authority nature of the agencies might justify or require additional disclosure.[11]

- **Require the ratings agencies to publish ratings on any securities they receive.** In the case of structured securities, such a change would curb the secret negotiations that go on between the agency and the issuer when the agency issues a draft rating that is not published, and would help to prevent agency shopping.

- **The SEC might consider auditing ratings methods and selected applications to ensure consistency and accuracy within types of ratings.** It might also consider requiring a greater portion of structured securities be exchange-traded rather than traded over the counter. Such changes would encourage greater consistency and transparency in these markets.

- **One other change that has been proposed would be to create a public or nonprofit entity to analyze and issue ratings. Such a move would have both advantages and disadvantages.** It has the potential to create a more arms-length relationship between raters and those being rated, thus possibly improving the perception and reality of objectivity. On the other hand, it might run the risk of seeming to be foolproof. There is a long history of regulatory agencies that end up being captured by the industry they regulate or simply lose effectiveness through lack of zeal and resources.

IMPLICATIONS FOR MARKETS

None of the preceding commentary supports a suggestion that ratings and ratings agencies should be ignored by investors. Instead, it suggests that investors should treat ratings as one of many pieces of information that can be used to evaluate fixed-income credit risks. For institutional investors, the capacity to do independent credit analysis is critical, whether it is done in house or by external investment advisors, and to assess the independence and depth of the investment process. And, as the market gains experience with the newer structured securities, some

9 See International Organization of Securities Commissions, IOSCO Report on the Activities of Credit Rating Agencies and IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies

10 Ibid.

11 Mason and Rosner, op. cit.

distressed securities could become attractive. Individual investors may not have the capacity to evaluate every security and therefore may wish to focus on mutual funds with long-term track records. And sorting through the ranks of the many new distressed securities funds may be more of a challenge than the ordinary individual investor deems as worthwhile.

The very nature of structured securities implies that the individual securities and their markets will never be as transparent as those for corporate bonds, for example. It also implies that it will take some time before the RMBS, RMBS-based CDO, and some other structured securities markets work through the difficulties they have faced with a lack of liquidity and limited new issuances. Investors would be wise to let these markets sort themselves out.

Recent events have trained considerable attention on the ratings agencies and the ratings process. This could encourage the agencies and the regulators to improve the approach to ratings generally and to the more complex securities in particular. It remains to be seen exactly which improvements will be adopted, but competition among the ratings agencies could spur needed developments.

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