# REGULATION AND REGISTRATION REQUIREMENTS FOR CREDIT RATING AGENCIES: A NEED FOR INCREASED COMPETITION

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*This paper was prepared for Financial Executives International (FEI) and submitted by FEI's then-President Colleen S. Cunningham to the U.S. Senate Committee on Banking, Housing and Urban Affairs in support of her testimony in that committee's hearing entitled "Assessing the Current Oversight and Operation of Credit Rating Agencies" on March 7, 2006.*

## Executive Summary

Credit rating agencies (CRAs) today provide a variety of analytic, data, and consulting services, the most important of which are analysis and credit ratings of corporate, government, and other debt securities. CRAs play an important role in U.S. and world financial markets. There are more than 100 CRAs operating worldwide, but only five are designated as Nationally Recognized Statistical Rating Organizations (NRSROs) by the Securities and Exchange Commission (SEC). Yet guidelines for mutual funds and numerous other government and institutional investment portfolios as well as broker-dealer capital requirements are based on credit ratings from NRSROs. Because of the SEC's unexplained failure to designate more NRSROs and to explain the designation criteria more clearly, the incumbent NRSROs are enjoying an unfair competitive advantage with the benefit of regulatory protection and continue to build barriers to the entry of new competitors. A new system of registration rather than designation would bring needed competition to the currently restricted credit rating market. At the same time, the interests of issuers, investors, and rating-agency competitors would be better protected by increased SEC regulatory oversight.

## Importance of Credit Rating Agencies

*How Credit Ratings are Prepared.* A credit rating is a comparative grade of an obligor's general creditworthiness or creditworthiness with respect to a particular debt security or other financial obligation. Usually the rating is accompanied by a detailed written analysis. Rated obligors include industrial companies (such as manufacturers, retailers, and service companies), utilities, financial institutions, sovereign nations, and special-purpose vehicles created for mortgage-backed and other asset-backed securities. CRAs assign two types of ratings: one to the debt issuer and the other to the issuer's specific debt obligations. Ratings distinguish between senior and junior, or subordinated, debt obligations — the latter carrying a lower rating.

A credit analysis for an industrial company is based on business risk and financial risk. Business risk factors include industry characteristics and the rated company's competitive position. Examples of industry characteristics are macroeconomic factors, growth potential, cyclicality, risk of obsolescence, and number of competitors. Factors relevant

to a company's competitive position are market share, pricing, product mix, product quality, product differentiation, image, service, customer satisfaction, distribution capabilities, self-sufficiency, and cost structure relative to competitors. Financial risk factors include rate of revenue growth, profitability, capital structure, adequacy of cash flow to meet debt-service obligations, off-balance-sheet financial obligations, and financial flexibility (ability to sell assets or turn to other sources for financial support). A higher amount of debt relative to equity in a company's capital structure generally means a higher risk that the company will not be able to meet its debt-service obligations under adverse conditions. Some types of companies, however, are believed to have higher debt capacity than others for reasons such as stability of cash flow and ready marketability of assets. For example, a long-established producer of commodity chemicals with a track record of steadily growing revenues, earnings, and cash flow can justify a higher ratio of debt to equity than a high-risk, start-up technology company can.

Other types of entities such as financial institutions and sovereign nations have their own particular credit risk factors — such as the balance of payments, the ability to collect taxes, and other macroeconomic factors for a sovereign nation — but the basic principles of credit analysis remain the same. Debt essentially can be repaid from two sources: cash flow and the liquidation of assets. The credit rating process is a systematic way of analyzing and grading those factors.

CRA analysts generally meet with a company's management to review key factors that have an impact on the rating, including operating and financial plans and management policies. Such meetings help analysts develop their qualitative assessments. A lead analyst is generally responsible for conduct of the rating process. A rating decision is normally made by a rating committee based upon the lead analyst's recommendation. The issuer is notified of the rating decision and the major considerations supporting it. The issuer can appeal before the rating is published.

Credit ratings are inherently judgmental. Two CRAs may grade a given company differently. A credit rating and its underlying analysis is more nuanced than an opinion from an auditing firm stating whether or not a company's financial statements are in accordance with Generally Accepted Accounting Principles and whether or not management's assessment of the company's internal controls is fairly stated.

CRAs are important but not unique repositories of credit analysis expertise. Similar skills reside in commercial banks, investment banking firms, pension funds, mutual funds, insurance companies, hedge funds, and other government and private investment entities.

*Example of Rating Scales.* Credit rating agencies have multiple types of rating scales for different types of short- and long-term debt. Here, for example, are the long-term-obligation scales for the three largest CRAs:

| | Moody's | Standard & Poor's | Fitch |
|---|---|---|---|
| Highest credit quality | Aaa | AAA | AAA |
| Very high credit quality | Aa | AA | AA |
| High credit quality | A | A | A |
| Moderate risk | Baa | BBB | BBB |
| Speculative | Ba | BB | BB |
| Highly speculative | B | B | B |
| Possible default | Caa | CCC | CCC |
| Probable default | Ca | CC | CC |
| Imminent default | C | C | C |
| Defaulted | | D | D |

To further gradate the scales, the CRAs also use plusses and minuses, e.g., "BBB+" or "BBB-," and express their views of trends in issuers' creditworthiness by issuing ratings with a "favorable outlook," "stable outlook," or a "negative outlook."

*Investment Grade Ratings.* A rating that is "BBB-" or higher is generally considered to be "investment grade." The term was originally used for various regulatory bodies to define obligations eligible for investment by institutions such as banks, insurance companies, and savings and loan associations. Bonds with below-investment-grade ratings are often called "high yield" or "junk" bonds. A CRA's decision to downgrade a major corporation to junk status usually makes headline news. But high-yield or junk are not necessarily pejorative terms. A company may deliberately pursue a high-debt strategy that implies a below-investment-grade credit rating. For example, in 1993 Marriott Corporation split itself into two entities with different business strategies, capital structures, and investor appeals. Marriott International, the steady-revenue hotel service company, carries a "BBB+" rating while Host Marriott, the higher-debt real estate ownership company, carries a "BB-" rating.

*How Credit Ratings are Used.* Credit ratings are not a substitute for analysis by sophisticated investors, but many institutional portfolios have minimum credit rating guidelines. There is a significant relationship between a company's credit rating and the yield on its fixed-income debt, expressed as a "spread" over the U.S. Treasury or "risk free" rate — and a debate over whether the spread follows the credit rating or vice versa. Because of various market factors, spreads for different bonds at a given rating level can vary.

*Importance of Credit Ratings to Corporations.* Higher yield for the investor means higher borrowing cost for the corporation. Because credit ratings have such strong debt-pricing implications, corporations often structure their balance sheets and issuers of project or securitized debt (such as mortgage-backed or other asset-backed securities) often structure those financings to meet particular target credit ratings. For example, if institutional investors who typically invest in the project bonds of U.S. and Western European power plants are generally accustomed to seeing those bonds at the "BBB-" level, it behooves the project sponsors and their investment bankers to make sure the

equity contribution and other project and financing specifications will be sufficient to merit that rating. They sometimes do so with the help of preliminary rating analyses from CRAs. Very few corporations have the top "AAA" rating and often that is a matter of choice. A corporation may decide that a slightly lower rating such as "A" or "BBB" is consistent with ratings for its industry competitors and allows it to take on more debt to execute its business plan with a degree of risk it considers to be acceptable. When a corporation makes a strategic decision to try its best to maintain a rating such as "BBB," it tries to adhere to rating agency debt-service-coverage (ratio of free cash flow to debt service obligations) and balance-sheet (ratio of debt to equity) guidelines. Usually this means putting an upper limit on debt and hence on capital expenditures. Corporations also try to maintain good communication with CRA analysts covering them, for example letting them know of major events such as acquisitions ahead of time to avoid surprises.

## Role of Nationally Recognized Statistical Rating Organizations (NRSROs)

The guidelines for many government, mutual fund, and other institutional investment portfolios not only specify minimum credit ratings for their securities but also require that the ratings come from Nationally Recognized Statistical Rating Organizations (NRSROs). The Securities and Exchange Commission (SEC) originated NRSROs in 1975 in the course of developing a reliable way to grade securities used to satisfy broker-dealer capital requirements.

*How NRSROs are Designated.* Currently, a CRA achieves NRSRO status be requesting a staff no-action letter from the SEC stating that the SEC will not recommend enforcement action against parties that use that CRA's credit ratings for the purpose of calculations under the SEC net capital rule for broker-dealers. The SEC's criteria for an NRSRO include that it be "widely accepted in the United States as an issuer of credible and reliable ratings." The notion of national recognition was designed to help ensure that the credit ratings used under SEC rules are credible and the marketplace can reasonably rely on them. Before issuing a no-action letter, the SEC conducts an assessment of a CRA's operational capacity and ratings process, including the CRA's organizational structure, financial resources, size and quality of staff, rating procedures, independence from rated companies, and internal procedures to prevent the misuse of nonpublic information.

*Growing Importance of NRSROs.* Since NRSROs were created in 1975, the importance of the NRSRO stamp of approval has grown far more than anticipated. Today, laws, charters, and by-laws often specify minimum credit ratings from NRSROs for securities in pension funds, mutual funds, and other portfolios. State and local governments are usually required by law to invest in securities with specified ratings from NRSROs. Mutual fund managers, to whom investor have entrusted over $8 trillion, typically rely at least to some degree on ratings from NRSROs. Many of them incorporate NRSRO ratings criteria into shareholder disclosures regarding their funds' investment policies and strategies. Rule 2a-7 under the Investment Act of 1940 limits money fund investments to securities in NRSROs' two highest short-term rating categories unless, in the unusual case of unrated securities, a fund's board can determine that those securities are of comparable quality. Loan agreements often require borrowers to maintain certain ratings

from NRSROs; failure to do so can trigger higher interest rates, new bondholder rights, or even default.

## The Current Duopoly

According to the Basel Committee on Banking Supervision, the international association of bank regulatory agencies, there are more than 100 CRAs in operation worldwide today, but there are just five that hold NRSROs status: A.M. Best Co. Inc.; Dominion Bond Rating Service Limited; Fitch Inc.; owned by Fimalac SA of Paris; Moody's Investors Service Inc.; and the Standard & Poor's Division of the McGraw Hill Cos. Inc. A.M. Best, designated in March 2005, specializes in the insurance industry and Dominion, designated in January 2003 is concerned mostly with Canadian securities. Fitch has grown through consolidation in recent years, having purchased Duff & Phelps, Inc., Thomson Bank Watch, and IBCA, but it still does not have the market power of either Moody's or Standard & Poor's. Therefore, Moody's and Standard & Poor's are considered to be a duopoly. Some would define them as a "shared monopoly" or "partner monopoly" because many issuers require at least two ratings from NRSROs, so the gains of one partner do not reduce the gains of the other.

Despite numerous applications for NRSRO status from other CRAs, the SEC has designated only A.M. Best and Dominion in recent years and has appeared reluctant to designate others. Aside from "nationally recognized," the SEC has not made the designation criteria clear. For example, Egan-Jones Ratings Company, a corporate credit rating agency based in Haverford, PA, has been trying since 1994 to gain NRSRO designation. The firm has paid for a survey to assess national recognition and requested meetings with the SEC. However, despite two fact-finding missions by the SEC, the firm has neither been approved nor been told the reasons it does not qualify. Meanwhile, with the growth of debt issuance worldwide and the continued benefit of regulatory protection, the incumbent NRSROs have grown exponentially in recent years.

## Advantages of Current System

The two leading NRSROs, Moody's and Standard & Poor's, have built formidable depth of staff, experience, and expertise in rating debt issues worldwide — and Fitch is a growing rival. In virtually every industry the leading NRSROs offer breadth of coverage and comparison of ratings and analyses across numerous borrowers. The large number of issues they rate allows them to publish robust statistics showing the number of defaults by issuers in each rating category over decades, helping to validate their rating decisions. The NRSRO leaders offer substantial published material on the rating process and rating criteria as well as comparative industry studies and individual issuer analyses. Some of that information is available only to paying subscribers, but much of it, including issuers' credit ratings, is available at no charge on the NRSROs' websites.

## Problems with Current System

Problems with the current system include weaknesses in the SEC's NRSRO designation process, lack of competition resulting from the NRSROs' protected status, conflicts of interests, anticompetitive practices, lack of transparency, lack of oversight, and lack of accountability.

*NRSRO Designation Process.* Because of the SEC's unexplained historical reluctance to designate new NRSROs and its failure to make designation criteria clear, a "chicken and egg" conundrum has emerged. A CRA must be nationally recognized to be designated an NRSRO, but it is difficult to become nationally recognized without such designation.

*Lack of Competition.* The incumbent NRSROs have less pricing pressure and less incentive to innovate than they would have in a more competitive environment. The longer they enjoy regulatory protection, the longer they will have to continue building barriers to the entry of new competitors through established client relationships, brand power, depth of expertise, and financial strength.

*Conflicts of Interests.* There are several inherent conflicts of interests in the current structure, regardless of the extent to which the current NRSROs are actually taking advantage of them:

- About 95 percent of NRSRO revenues come from the issuers they rate. Critics say they cannot be independent because they are paid by the companies they rate. The NRSROs reply that their reputations depend on strict neutrality and that individual rated companies do not have sufficient impacts on their bottom lines to sway their opinions.
- NRSROs sell ancillary consulting and data services in areas such as risk management, corporate governance, and corporate valuation to the issuers they are rating. A rated company could feel explicit or implicit pressure to buy consulting services to protect its rating.
- NRSROs staffs have access to inside information under an exemption from SEC Regulation FD (Full Disclosure). Analysts could inadvertently disclose inside information to their agencies' subscribers that was obtained from issuers with the benefit of that exemption.

*Alleged Anticompetitive Practices.* Although difficult to document and always subject to the other side of the story, the incumbent NRSROs have been alleged to take unfair advantage of their commanding market position in some instances. Whether or not the allegations are true, the current system offers at least potential for practices such as the following:

- refusing to rate a new debt issue unless the CRA is already engaged (and paid) to rate other existing issues

- issuing unsolicited ratings, which may be less accurate than they could be without the benefit of access to management or inside information, and then requesting payment from the issuers.
- downgrading issuers that refuse to pay for ratings.

*Lack of Transparency.* Despite extensive published material by the rating agencies such as guides to ratings approaches and comparative studies of ratings within industries, rating methodologies are not always transparent and widely understood. Some parties are concerned with the confidentiality and the degree of analysts' judgment in the rating process, although as explained above the credit analysis process cannot be completely formulaic and is necessarily judgmental.

*Lack of Oversight.* No outside party effectively supervises and regulates the leading NRSROs. The SEC subjects the NRSROs to few if any examinations and does not police them as it does broker-dealers, investment advisers, and mutual funds. There is no clear review policy for removing designation in the case of negligence. Under terms of no-action letters, NRSROs are required to report material changes that might affect their ability to meet any of the original designation criteria. They have a strong disincentive to report any such changes. Even if the SEC had the desire and the resources to supervise the NRSROs more closely, it questions its own legal authority to do so without clarification from Congress.

*Lack of Accountability.* The NRSROs have no legal or financial liability for the accuracy of their credit judgments. They have maintained under the First Amendment that they cannot be held liable for erroneous ratings absent a finding of malice. The NRSROs compare their status under the first amendment to that of a financial newspaper such as *The Wall Street Journal*.

## Criticism of Recent NRSRO Performance

The NRSROs have been criticized for their failure to detect and report problems with companies such as Enron, WorldCom, Global Crossing, and Parmalat soon enough to protect the majority of investors. For example, Moody's and Standard & Poor's did not downgrade Enron from investment-grade to junk status until four days before Enron declared bankruptcy in 2001. Pacific Gas & Electric was rated "A-" two weeks before defaulting in 2001. WorldCom was rated investment grade three months before it filed and Global Crossing was rated investment grade four months before it defaulted on its loans in 2002. AT&T Canada was rated investment grade in early February 2002 and defaulted in September 2002. Some say that CRAs, with their exemption from Regulation FD, should have been alerted to problems when Enron was shifting debt off its balance sheet — and indeed Egan-Jones, the aspiring NRSRO mentioned above, downgraded Enron to junk status more than a month before Moody's and S&P did. The NRSROs argue that they are not equipped to detect fraud because they rely on the veracity of audited financial statements and other data they receive from the corporations they rate. They cite a former Enron assistant treasurer who in a plea agreement on

federal criminal charges in October 2004 detailed his efforts to mislead the CRAs about Enron's cash flow.

## Proposed Solutions

Among the proposed solutions to the current problems cited above are to change the current designation system to a registration system, to require certain disclosures of NRSROs upon registration, to prohibit NRSROs from certain practices, and to empower the SEC to regulate the NRSROs.

*From Designation to Registration.* The SEC's current designation system for NRSROs should be changed to registration system. The meaning of "R" in NRSRO should be changed from "recognized" to "registered."

*Disclosure Requirements.* NRSROs should be required to make public disclosure of the following upon registration:

- Conflicts of interests
- Procedures and methodologies
- Performance measurement statistics, including a spread of ratings by industry and historical defaults by rating grade
- Procedures to prevent misuse of non-public information.

*Written Policies and Procedures.* NRSROs should be required on an ongoing basis to have written policies and procedures that address and manage conflicts of interest and prevent the misuse of non-public information

*Prohibited Practices.* The NRSROs should be prohibited from anti-competitive practices such as those described above and, in particular, from selling consulting services to the issuers they rate. This would be consistent with the Sarbanes-Oxley Act, which bars accounting firms from consulting for companies they audit. However, such prohibition should not apply to preliminary rating assessments, for example hiring a rating agency to analyze and explain the rating effect of taking on a certain amount of additional debt for a project or an acquisition.

*SEC Regulation.* The SEC should be empowered to regulate the newly defined NRSROs. Such regulation would include periodic inspection of records and requiring the NRSROs to follow the procedures and standards they disclosed during the registration process. This would not entail the heavy-handed regulation that the current NRSROs fear, for example second-guessing actual rating judgments. Even if the SEC wanted to second-guess the NRSROs' credit judgments, they would not have to resources to do so.

## Likely Results of a New System

If the proposed solutions were put in place, the likely results would include increased competition, greater variety of rating products, multiple pricing models, greater reliance

on disclosure, some routine administrative adjustments, possible re-examination by the SEC of NRSOs in relation to broker-dealer capital requirements, and an evolution rather than a revolution in the competitive landscape.

*Competition.* The solution to the problem of the incumbent NRSROs not being sufficiently accountable is more competition. Under a new registration rather than designation system, more firms, capital, and people would be attracted to the credit rating business. The market would include more niche providers that specialize in industries or geographic areas. Providers of closely related data-base, research, and analytic services would consider expanding their offerings to include credit ratings. Some large entities could consider rolling up smaller specialized firms to challenge the established NRSROs.

*Variety of Products.* There would be greater innovation and new product introduction. Issuers and investors would have more choices as an increased number of competitors offered different rating and analytical approaches. New competitors would most likely include firms that specialize in particular industries or geographic regions.

*Pricing.* The incumbent NRSROs would have less pricing power and there would be multiple pricing models for rating services. For example, some believe that having investors purchase ratings and analysis is a superior incentive structure.

*Disclosure.* To be competitive, NRSROs would have to disclose information that issuers and investors want such as policies, procedures, analytical approaches, analyst qualifications, number of issuers covered by each analyst. Issuers and investors would be able to make more informed choices based on those disclosures.

*Administrative Adjustments.* Regulators, issuers, and lawyers would have to do some paperwork. Language in prospectuses and various regulations would have to be changed from “recognized” or “designated” to “registered.”

*SEC Use of NRSRO Ratings.* The SEC probably would have to re-examine its regulation concerning the use of credit ratings from NRSROs for calculating broker-dealer capital requirements.

*Evolution Rather Than Revolution.* Some fear that the return to a completely open, market-driven ratings industry could unsettle bond ratings and possibly bond prices as regulators, investors, and issuers adjust to a new reality. This is unlikely for the following reasons: While the number of players will increase, today’s leading NRSROs will not shrink overnight. They will continue to benefit from their expertise, depth of coverage, brand power, and client relationships. Aspiring ratings firms will still have the challenge of gaining the acceptance of institutional investors and persuading those investors to add new ratings firms to their investment parameters. To do so, they will need to bring new types of products, information, analytical approaches, and specialized coverage to the table. Nonetheless, the entry of new competitors into the credit rating market will put additional pressure on incumbent NRSROs to justify and maintain their market shares and hold them more accountable for their rating performance.

In conclusion, this paper does not dispute the incumbent NRSROs' robust capabilities. Rather it argues that the incumbents have an unfair competitive advantage based on regulatory protection, and that a new system of registration rather than designation would open the field to more deserving competitors that also have strong credit analysis and rating skills — a tradition of competition firmly upheld in other industries by a century of antitrust law.