ARTICLE

CONCERNS ON THE ROLE OF CREDIT RATING AGENCIES IN THE EVOLVING FINANCIAL REGIME: A POLICY PERSPECTIVE

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The smooth functioning of global financial markets depends, in part, upon reliable assessments of investment risks by investors. Credit Rating Agencies (CRAs) play a significant role in boosting investor confidence in these markets. CRAs issue opinions on the future creditworthiness of a particular company, security or obligation as of a given date. These opinions of CRAs give investors and lenders a better understanding of the risks they could face when dealing with a particular entity or in a particular product. Accordingly, CRAs can affect issuers' access to capital, influence the structure of financial transactions, and determine the types of investors in a company.

This article discusses the role of CRAs in the Enron case and current sub-prime crisis and raises various regulatory issues thrown up by these episodes. It further attempts to bring together policy responses of regulators to the issues raised through the above episodes. It also looks at the CRA scenario in India and submits certain issues for further debate. This article is anchored on a Consultation paper by International Organization of Securities Commission (IOSCO), relating to role of CRAs, released in March, 2008

CRAs and the Enron case

CRAs came under a lot of criticism for their late action in identifying problems in the working of Enron and accordingly rating its debt. All agencies approved by Securities and Exchange Commission (SEC) gave Enron an investment grade rating on its debt up until five days before the company filed for bankruptcy. The Testimony of Chairman of Congress, Joe Lieberman before the Governmental Affairs Committee hearings on the collapse of Enron and the implications for Enron employees, investors, and the American economy as a whole, of March 2002, highlights the concerns arising out of the Enron episode in the following words:

"The credit raters hold the key to capital and liquidity, the lifeblood of corporate America and of our capitalist economy. The rating affects a company's ability to borrow money; it affects whether a pension fund or a money market fund can invest in a company's bonds; and it affects stock price. The difference between a good rating and a poor rating can be the difference between success and failure, prosperity and bad fortune. The government - through hundreds of laws and regulations - requires corporate bonds to be rated if they're to be considered appropriate investments for many institutional investors - and, by the way, 95% of corporate bonds are held by institutional investors. Most of these laws and regulations involve banks and securities...

Along with this power, comes special access and special protections. The credit raters, for example, are allowed to look at a company's inside information when making assessments and they are exempted from liability when they participate in securities offerings - two benefits that give them more information than other analysts working within the system....

It seems reasonable to me that power of this magnitude should go hand in hand with some accountability. And yet, once the SEC anoints the credit-rating, they are left alone. So, I think it's appropriate, as we try to learn the lessons of Enron, to ask if the agencies should have some

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sense of accountability, some oversight, from the SEC perhaps, to ensure they properly perform their function as watchdogs."

On October 8, 2002, the staff of the Senate Committee on Governmental Affairs issued a report (the "Staff Report") entitled 'Financial Oversight of Enron: The SEC and Private-Sector Watchdogs,' which contained among other things, the results of the Committee staff's investigation into the actions of the three SEC recognized CRAs (viz. Moody's Investors Service, Standard & Poor's, and Fitch Ratings) in the years prior to Enron's collapse. The Staff Report concluded that, in the case of Enron, the credit rating agencies failed to use their legally-sanctioned power and access to the public's benefit, instead displaying a lack of diligence in their coverage and assessment of Enron. The Staff Report found that the credit rating agencies did not ask sufficiently probing questions in formulating their ratings, and in many cases merely accepted at face value what they were told by Enron officials. Further, the rating agencies apparently ignored or glossed over warning signs, and despite their mission to make long-term credit assessments, failed to sufficiently consider factors affecting the long-term health of Enron, particularly accounting irregularities and overly complex financing structures.

CRAs and the sub-prime crisis

In the recent sub-prime crisis in the US, overseas credit rating agencies viz. Moody's and S & P have come under increasing fire for their covert collusion in favorably rating junk Collateralised debt obligations (CDOs) in the sub-prime mortgage business. The impact of CRA ratings on investors was greater because many investors and market participants effectively outsourced their own valuations and risk analyses of collateralized products to the CRAs. Questions have been raised as to whether these credit ratings were based on incorrect information and faulty or dated models.

To give some background, loan originators were found guilty of packaging sub-prime mortgages as securitizations, and marketing them as CDOs on the secondary mortgage market. The slackness of the Rating agencies in appropriately warning the financial world of this malpractice through a fair and transparent assessment has been questioned. There have been news reports alleging adoption of lenient rating standards by the rating agencies for the mortgage-backed securities segment. These reports point out that this happened mostly on account of the rating fees being twice as high for the mortgage-backed bonds as for the corporate bonds, which provided huge temptation for the rating standards to be relaxed and the non-development of appropriate rating techniques for relatively recently innovated mortgage-backed bonds.

The regulatory response

It is well recognised that since ratings are intended to provide investors with an informed and objective opinion expressed by a professional rating agency after analyzing factors like business and financial prospects, management quality and corporate governance practices etc. CRAs need to be regulated intensely. In view of the critical role played by CRAs in the modern financial architecture, policymakers have recently focused on some shortcomings arising from concerns about conflicts of interest in their operation, transparency, accountability and barriers to entry and lack of competition among the CRAs.

Various regulatory issues surrounding the working of CRAs, as highlighted in the preceding paras have been raised by the IOSCO, the United States Securities and Exchange Commission (SEC), the European Commission Committee of European Securities Regulations (CESR), and by the United States Congress and Senate.

Some of these concerns have been highlighted by IOSCO in its consultation paper on CRAs (March 2008) as follows:

1. **CRA transparency and market perceptions:**

   - Many CRAs do not publish verifiable and easily comparable historical performance data regarding their ratings. While the IOSCO CRA Code of Conduct encourages CRAs to publish historical performance data, there are complaints that this data is not readily comparable.

   - Investors fail to recognize the limitations on CRA rating methodologies for structured finance securities. These methodologies rely on models, which, like most financial analytical tools, make certain assumptions which may not prove to be correct under all circumstances. Arguably, this has happened recently with the subprime market turmoil and there have been suggestions that CRAs have been slow to modify either their methodologies or the assumptions used by their methodologies despite rapid market changes.

   - Some CRAs do not adequately disclose the assumptions they used when rating these structured finance products. A further concern is that some investors may take too much comfort in CRA historical performance statistics for structured finance securities.

2. **Independence of operations and Conflicts of interest:**

   - There is conflict of interests which contaminates the rating in a scenario where the rating agency is paid by the rated entity. A frequent claim in the aftermath of the subprime market turmoil is that this conflict of interest is even more acute where structured finance transactions are being rated, given the volume of deals and corresponding rating business attributable to particular financial institutions.

   - An additional concern is that CRAs are doing more than rating structured finance securities, namely: advising issuers on how to design the trust structures, thus giving rise to a conflicts of interests situation.

3. **CRA competition:**

In the United States, there are only 9 CRAs designated by the SEC as Nationally Recognized Statistical Rating Organization (NRSROs). In the early 1980s, there were 7 NRSROs, but, due to mergers, this number dropped to three during the 1990s. Recently, the SEC, arguably as a result of political pressure and/or concern about concentration in the industry, added to this number, first with Dominion Bond Rating Service (a Canadian CRA) in 2003, and A.M. Best in 2005. In 2007, the SEC added two Japanese rating agencies, Japan Credit Rating Agency, Ltd. and Ratings and Investment Information, Inc. and a Philadelphia area based firm Egan-Jones Rating Company (EJR). However, some data indicates that the largest three CRAs (Moody's Investor Services, Standard & Poor's, Inc. and Fitch, Inc.) collectively comprise approximately 85 percent of the CRA market.

With the mandate of the United States Congress the SEC issued a "Report on the role and function of credit rating agencies in the operation of the Securities Markets " in January, 2003. The report addressed several issues pertaining to the current role and functioning of CRAs including the information flow in the credit-rating process, barriers to entry artificially created by the NRSRO[2] designation in the United States and conflicts of interest or abusive practices.

Consideration of the issues related to CRAs by the United States Congress eventually culminated in the Credit Rating Agency Reform Act which was signed into law in early September 2006. This amended the Securities Exchange Act of 1934 to redefine an NRSRO as any CRA that has been in business for at least three consecutive years and is registered under the Act. It also prescribed procedural requirements for mandatory NRSRO registration and certification. It granted the SEC exclusive enforcement authority over any NRSRO and authorized the SEC: (i) to take action against an NRSRO that issued credit ratings in contravention of procedures, criteria and methodologies included in its registration application; and (ii) to censure, limit, suspend or revoke the registration of an NRSRO for violations of the Act.

At the level of IOSCO, the technical committee of the IOSCO issued three reports in September 2003: (i) Report on the Activities of Credit Rating Agencies; (ii) Statement of Principles Regarding the Activities of Credit Rating Agencies; and (iii) Report on Analysis of Conflict of Interest. These reports highlighted the important role CRAs play in financial markets, and aimed at ensuring greater reliability for their ratings.

In December 2004, the IOSCO published its Code of Conduct Fundamentals for Credit Rating Agencies (the IOSCO Code) which aimed at developing "governance rules" for CRAs to ensure: (i) quality and integrity of the rating process; (ii) independence of the process and avoidance of conflict of interests; and (iii) greater transparency in the methodology of ratings and adequate treatment of confidential information. However, the IOSCO Code did not address the issue of enforcement of the Code, recommending that CRAs adopt these rules voluntarily.

In the European Union, the Enron breakdown prompted discussions on CRA reliability. In response to a call by Commission for Advice, the Committee of European Securities Regulators (CESR) released in March 2005 'CESR's' Technical Advice to the European Commission on possible Measures Concerning Credit Rating Agencies. In its advise, the CESR advocated the adoption of IOSCO's code of conduct by CRAs.

IOSCO in its consultation paper of March 2008 laid down some important recommendations as follows :

- A CRA should take steps that are designed to ensure that the decision-making process for reviewing and potentially downgrading a current rating of a structured finance product is conducted in an objective manner.
- CRAs should establish an independent function responsible for periodically reviewing both the methodologies-and-models and the changes to the methodologies-and-models used in the rating process.
- CRAs should adopt reasonable measures to ensure that the information they use is of sufficient quality to support a credible rating.

[2] In the United States CRAs are designated by the SEC as Nationally Recognized Statistical Rating Organization (NRSROs).

- Where a CRA rates a structured finance product, it should provide investors and/or subscribers (depending on the CRA's business model) with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product can understand the basis for the CRA's rating.

Position in India

At present, the rating agencies in India are governed by the Securities Exchange Board of India (Credit Rating Agencies) Regulations, 1999, which came into effect from July 7, 1999. SEBI regulations concern rating of securities by CRAs. Among other things, the CRAs are subject to the Code of Conduct, enshrined in the Third Schedule of the Regulations, requiring the CRAs, inter alia, to observe highest standards of integrity and fairness in dealing with the clients, to disclose to the clients any possible sources of conflict of interest, to avoid any conflict of interest of any member of its rating committee participating in the rating analysis and that of its clients, not to indulge in unfair competition, to maintain an arm's length relationship between its credit rating and other activities, etc. SEBI also has powers under the Regulations to inspect and investigate the books of accounts and records of the CRAs.

Policy debate

Enhanced role of CRAs and regulatory framework

The role of CRAs has become more important with the revision by the Basel Committee on Banking Supervision (BCBS) of capital standards for banks culminating in Basel II. Under the Standardized Approach to credit risk, Basel II establishes credit risk weights for each supervisory category which rely on "external credit assessments". Moreover, credit ratings are also used for assessing risks in some of the other rules of Basel II.

In the context of implementation of the Basel II framework in India, from March 2008, for the capital adequacy regime of the banks, the Standardised Approach has been adopted for determining the capital charge for the credit risk inherent in the operations of banks. This allows the use of borrower ratings issued by rating agencies to determine asset risk weights.

Also, RBI has mandated compulsory rating and a minimum level of rating of Commercial papers (CPs) issued by the entities who are eligible participants in the CP market.

Thus, in the above context of the enhanced role of CRAs, and in the backdrop of the US subprime crisis, the regulatory framework for CRAs in India, may need to be revisited to take a larger view of their role in the financial markets.

Conflicts of interests

Most of the CRAs are not only doing their core rating business but have also diversified into investment and risk management services offering advise to their clients on investment decisions, structuring new products etc. When such ancillary services are offered to the same clients as those it is rating, there are likely to be conflicts of interests wherein the agency may become lax in the rating process in the interest of developing the market for its allied services. The IOSCO's code of conduct for CRAs suggests that:

"The CRA should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses that may present a conflict of interest. The CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise."

The regulatory framework for rating agencies in India may need to explicitly address the conflict of interest grappling these entities, on the above lines.