The Problem with Rating Agencies

On December 4, 2008 the Securities and Exchange Commission (SEC) approved a series of measures to improve the transparency and accountability of rating agencies. The importance of this pronouncement is of significance to the global community since the major ratings agencies all have a US base and are therefore required to comply with these regulations.

These proposals were issued for responses within 45 days. Amongst the changes was the following:

"(the rules) would prohibit an (agency) from issuing a credit rating with respect to an obligor or security where the (agency) or an affiliate of the (agency) made recommendations to the obligor or the issuer, underwriter, or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security."

The structure of the industry has always been a cause for concern to many of us. Ratings are paid for by the company that is rated, therefore ratings agencies actually go about selling ratings. If a company receives a rating that they consider inappropriate then there must be a tendency for them to wish to surrender their ratings. This has been exacerbated by the Basel Accord where banks lending to firms that are unrated receive a lower

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capital charge than those lending to firms with poor credit ratings. The surrender of the rating results in a lower capital charge for the bank and also therefore a lower interest charge to the firm.

The ratings agencies also have significant businesses involved with the provision of various consultancy style services. In credit risk Moody's KMV is one of the market leading credit risk products, whereas Fitch owns Algorithmics, Opvantage and Fitch First, all risk products. The combination of these with consultancy arms means that the ratings agencies are providing ratings to financial institutions where they have also provided guidance on the risk management techniques that they should employ.

We do not at this stage believe that such activities will be expressly prohibited by the SEC. However, we do remain concerned that the provision of such services does create the perception of bias in ratings subsequently provided. Indeed more than one of the ratings agencies has stated that they will reward firms that have appropriate risk management systems with higher ratings.
The situation parallels the potion that previously existed with the accountancy

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practices where there had been concern at such firms providing consultancy services to those firms to which they provide external audit services. This resulted initially in an effective prohibition of the provision of such services, although these rules have now been relaxed.

The industry has a difficult conundrum to deal with. The market needs ratings agencies that are independent and also needs them look at issues from a series of different perspectives. Anything that creates a potential for bias within such a system is to be abhorred, yet both the ways that the ratings are paid for and the provision of additional services provides the perception that such bias might potentially exist. The alternative is rather draconian and would require a central levy to fund the provision of ratings by quasi-governmental agencies that cannot provide any other services. We have real concerns whether such an agency would either be effective or sufficiently accountable.

We would also welcome the development of a new ratings competitor with a non-US perspective to form some level of balance to the existing market participants.

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Whether any real progress in these areas will occur is subject to doubt, but the natural imbalance in the industry will remain a cause for concern. What we do expect is for the ratings agencies to continue to come under greater scrutiny and for them to reduce the number and range of services offered to clients that they rate. Our concern is that this might undermine the profitability of the ratings agencies potentially resulting in one of the firm becoming a pure consultancy play and giving up the ratings business altogether. This once again would be the law of unintended consequences applying.