Credit rating agencies (CRAs) made headlines in the past six months. Pages of intricate blame the CRAs for losses on specific securities and even for the credit crisis in general. As a result, the CRAs have been placed in the uncomfortable position of having to defend not only their specific action, but their entire business model.

The CRAs earn revenue by charging the issuer for rating the issues (except when these ratings are unsolicited); these ratings are then released freely into the public domain. This practice of “issuer pay” has been widely criticized as being an inherent conflict of interest.

Along these lines, Willem Butler, international economist affiliated with the Centre for Economic Policy Research, states: “They are the only example of an industry where the appraiser is paid by the seller rather than the buyer, even though the buyer is likely to have the greatest information deficiency.”

Prior Models
Prior to the implementation of the “issuer pay” model, the CRAs were dependent upon subscription fees; in theory, the only way to lower the credit rating of a particular bond was to subscribe to the service. This model of doing business is essentially the same as any other newsletter or fixed-rate advisory service. The “issuer pay” model was adopted in the 1970s due to a number of factors:
- Explicit Free Riding
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- Increased demand for multiple ratings

Explicit free riding is the communification of ratings from those who have paid for the service to those who have not. In the 1970s, the advent of inexpensive photocopiers made the sharing of reports and summaries an easy task – the equivalent of pirating music on the Internet. This problem is found in virtually any knowledge-based industry. Without the first copy of a product has a very high cost relative to the second, there will always be a difference of opinion between consumers, who base their conclusion of value on the marginal cost of the second copy, and producers, who must pay for the first copy before selling the second. The “issuer pay” model addresses the problem by having the issuer pay for the first copy and allowing free circulation thereafter.

Implicit free riding is more insidious than the explicit version, as it occurs without any wrongdoing. The market price of securities will be set by large investors who subscribe to the services – but non-subscribers can trade at the same level. The CRAs (and their subscribers) are thus providing a free service to non-subscribers.

The third factor, increased demand for multiple ratings, arose from the Penn Central bankruptcy in June of 1970. This bankruptcy was a watershed moment for American capital markets, as the default on the commercial paper (CP) for the firm led to investor demand for backup bank lines of credit for issuers – now a standard requirement for CP issuers in the States – and also to investor demand for multiple ratings for debt instruments. Once the issuers started approaching the CRAs and asking to be rated, charging them for the privilege became the next logical step.

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The “issuer pay” model brings with it the same potential for conflicts of interest as it does at the advisor level, in which stockbrokers are compensated, in a lump sum or via trailer fees, by the issuer for distributing new issues of securities to retail clients. The defense to charges of unacceptable conflict of interest will also be familiar to advisors.

Other Influences
CRAs are providing advice and doing so at no cost to those being advised. Their value to the issuer paying them for a rating lies not in their reputation but in their evaluation of market risk. CRAs are inescapably involved in the credit rating process. A core requirement of market risk is to identify potential losses on specific securities. Credit agencies are involved in the process only in an advisory capacity, helping parties to estimate the probability and impact of losses. Credit agencies are involved in this process both directly (by creating a strong incentive for businesses to minimize their credit risk) and indirectly (by creating a strong incentive for businesses to minimize their credit risk).

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The CRAs’ success at long-term forecasting, however, has brought with it unrealistic and unattainable expectations on the part of both regulators and investors. The CRAs’ success at long-term forecasting, however, has brought with it unrealistic and unattainable expectations on the part of both regulators and investors. The CRAs’ success at long-term forecasting, however, has brought with it unrealistic and unattainable expectations on the part of both regulators and investors.

Reduced by a long period of overall stability and by the CRAs’ impressive accuracy in providing advice, regulators have incorporated ratings into legislation. Credit ratings are used in the “score card” of Basel II standards for the Basel II accords by the Office of the Superintendent of Financial Institutions. These considerations can lead to “crowded trades,” in which bond buyers, constrained either explicitly or implicitly by capital requirements, all have a very strong incentive to sell immediately upon a downgrade. A relatively small change in rating, or an anticipated change, can therefore have a disproportional effect on the market. More usually, an advisor will find that the mandate for a bond portfolio incorporates parameters based on credit ratings.

Dr. Joseph Mason, associate professor of economics at Drexel University in Philadelphia, remarked to a U.S. House of Representatives committee: “Giving [CRAs] more power actually reduces the value of their ratings by creating a strong incentive for grade inflation and making the meaning of ratings harder to discern. Regulated investors encourage [CRAs] to understate risk so that the menu of high-yielding securities available to them is larger. The regulatory use of ratings thus has changed the constitutionality demanding a rating from free-market investors interested in using the conservative opinion to regulated investors looking for an inflated one.”

Investor Accountability
Individuals, too, have made mistakes – some investors assign far too much credit to officially blessed ratings, forgetting that the investor, and only the investor, will bear the cost of any unfortunate mistakes. A potential solution was proposed by Mark Zelmer, director of the Bank of Canada’s Risk Office, in the bank’s December 2007 Financial System Review: “In the end, investors need to accept responsibility for managing credit risk in their portfolios. Investors should not lose sight of the fact that one can delegate tasks but not accountability.

Advisors do, however, need assurance that the information on which they rely is current and accurate.