Credit Ratings: Investors in a Bind

Credit rating agencies defend their business model

BY JAMES HYMAS

Credit rating agencies (CRAs) made headlines in the past six months. Pages of invective 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 pays" has been widely criticized as being an inherent conflict of interest.

Along these lines, Willem Buiter, 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 learn 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, but 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 communication of ratings from those who have paid for the service to those who have not. In the 1970s, the advent of inexpensive photocopying 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; when 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 conception 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 issuance 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 defence to charges of unacceptable conflict of interest will also be familiar to advisors.

OTHER INFLUENCES

CRAs are providing advice only and are doing so at no cost to those being advised. Their value to the issuer paying them for a rating lies in their reputation with the investors who will rely on those ratings, to a greater or lesser extent, to assist them with the decision regarding whether or not to buy the securities offered. Should a CRA become notoriously poor in its evaluation of credit risk – and a rating that is too low can be as damaging, in terms of lost opportunity, as a rating that is too high – then a particular CRA's rating on a bond will become unimportant to investors, irrelevant to the success of an underwriter and, therefore, not paid for by the issuer.

The issue of CRA reputation is not trivial. In a U.S. Federal Reserve paper, released in 2003, authors Daniel M. Covitz and Paul Harrison concluded: "The findings strongly indicate that ratings changes do not appear to be importantly influenced by rating agency conflicts of interest but, rather, suggest that rating agencies are motivated primarily by reputation-related incentives." (The authors intend to update this paper in the next year or two. It will be interesting to determine whether their conclusion survives the subprime train wreck!)

PAY FOR ADVICE

Fortunately, anybody who has a serious problem with the "issuer pay" model has an easy alternative. There are many subscription-based firms who will be happy to provide advice on creditworthiness for a fee.

A great deal of opprobrium directed towards the CRAs is due to a misperception of their objective. They seek to measure credit risk and ignore other elements of risk of importance to investors, such as market risk and liquidity risk – these latter two elements are left to investors and their advisors to evaluate and incorporate into investment strategy. Most investors are familiar with some elements of market risk and understand that a GE Capital bond maturing in 30 years may fluctuate more in response to interest rate movements than their commercial paper. However, it became clear in the early stages of the subprime crisis that other elements of such risk were misunderstood; many investors expected – or purported to expect – that two similar bonds with the same credit rating should always trade at similar prices. When subprime became a four-letter word, many investors found otherwise.

In many ways, the CRAs are the victims of their own success; success that may be measured and is regularly communicated to the investing community via "transition analyses." A transition analysis compares the credit rating of issues on a given starting date to a particular end-date. Most dramatically, of course, investors are concerned with how much warning they were given before the "D" (Default) rating was assigned, but it is also necessary to understand how stable the ratings are. For example, what is the probability that an issue rated "A" on any given date will be no worse than BBB three years later? It is very difficult to look at the extended track record of any of the major CRAs and not to be impressed.

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

Seduced by a long period of overall stability and by the CRAs' impressive accuracy in providing their advice, regulators have incorporated ratings into legislation. Credit ratings are used in the *Income Tax Act* (Section 204) to determine whether a debt obligation may be deemed a "qualified investment" and, more insidiously, in the implementation of 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 due to capital considerations, 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 disproportionate effect on the markets. 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 [CRA]s 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 constituency demanding a rating from free-market investors interested in a conservative opinion to regulated investors looking for an inflated one."

INVESTOR ACCOUNTABILITY

Individuals, too, have made mistakes – some investors assign far too much credence to officially blessed ratings, forgetting that the investor, and only the investor, will bear the cost of any unfortunate mistakes. A potential solution was propounded 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." Sage advice, but there is a problem with applying it.

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A conservative investor will certainly wish to check the work of CRAs and come to some independent view of the quality of their advice, rather than blindly accepting it. But is this possible? In Canada, National Policy 51-201 makes a specific exception from disclosure standards for the CRAs. To paraphrase the regulatory response to a request for explanation: Communications to CRAs would generally be in the "necessary course of business," provided that the information is disclosed for the purpose of assisting the agency to formulate a credit rating and the agency's ratings are or will be publicly available. In other words, issuers may disclose material non-public information to CRAs in the "necessary course of business," but not to you or me if this information is considered sensitive.

How, then, is an investor – or a subscription service employed by an investor – to check a credit rating? We do what we can; we all have our restricted lists based on our degree of comfort with publicly disclosed information relative to the credit rating; but regulators have ensured that we can never be sure that our analysis is based on all the facts available to the CRAs.

It is clear, therefore, that investors as a class cannot be chastised by the powers that be for over-reliance on credit ratings; while credit ratings are a form of advice, it is regulators who have given this advice the force of law. It may seem paradoxical, but to improve credit analysis, information available to the CRAs must be restricted to what is available to equity analysts, to the public, and to the subscription-based, non-regulatorially blessed agencies – all of whom must currently labour, and invest, with disclosure that is guaranteed to be second-class.

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