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Reforming Credit Ratings Agencies: More Competition, Less Regulation or Both? A Proposal for Moving Forward

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I. INTRODUCTION

While the root causes of various financial crises during the past two decades have differed, there have been recurrent questions regarding the possible role played by the Credit Ratings Agencies ("CRAs"). Among the concerns that have been raised are: the highly concentrated nature of the credit rating industry, with the leading three CRAs (viz., Moody's, S&P, and Fitch) accounting for the bulk of the global rating services market; their oligopolistic interdependent and possibly tacit collusive behavior, suggesting lack of effective competition; limited diversity and choice among "globalized" rating agencies; and regulatory and other barriers to entry that entrench the incumbent CRAs. In addition, the failure of the CRAs to properly rate sovereign debt during the Asian financial crisis or, more recently, corporate debt in the case of the Lehman Bros. bankruptcy, and other lapses point to major errors committed by the CRAs.

These errors have led to increased calls for reform and change—such as promoting greater competition, and/or revising the regulations governing CRAs, or even creating new bodies that could perform the function of CRAs—though these calls tend to wane when the financial crisis is over and economic recovery starts taking place. However, it is precisely during the post-crisis period—such as now—that stocktaking and assessment of CRAs should take place, and alternative policies and instruments be explored.

In the ensuing discussion, some of these issues are discussed briefly and a proposal is offered for dealing with the concerns that have been raised. Cognizant of the systemic impact that changes to the current process of credit ratings could have on financial markets, any new approach will need to be put adopted after extensive discussions, consultations, and cooperation with relevant participants in both the private and public sectors. The resulting proposals for change may also have to be gradually phased in.

II. IMPORTANCE OF CRAs

Essentially, CRAs provide information on the creditworthiness of debt issuers and play a critical role in the lending and borrowing process. They evaluate and rate corporate and sovereign debt issues. Asymmetry of information between the lender (who generally has less information about the borrower) and the borrower (who may have incentives for not disclosing all its liabilities/financial obligations) is a major gap in lending relationships. Lenders and investors need information as to whether the borrower has the ability and willingness to pay. While specialist lenders can gather data and information, and develop their own assessments,

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this would be costly, especially for the smaller non-specialist lenders. The ratings provided by CRAs reduce the inherent problems of asymmetric information.

However, what makes the lenders and investors trust the rating of the CRA? Analysts, and indeed the industry itself, have strongly argued that this is importantly based on CRAs' reputation and credibility. Since building reputation and credibility takes time, it poses as a barrier to entry which, together with other factors, have resulted in a highly concentrated industry structure, with the potential for anticompetitive behavior.

III. HIGH CONCENTRATION AS A CONCERN

A report by the Bank for International Settlements ("BIS"), published in 2000, mentions about 150 agencies worldwide. This includes a relatively large number of specialized smaller firms. However, only three U.S. based firms—Moody's, Standard & Poor's, ("S&P") and Fitch—are the principal "global" rating agencies, and tend to dominate the industry.

There are additional credit rating firms outside the United States, but these three U.S. firms have substantial presence in Europe through branch offices, and have significant presence and provide extensive ratings in other continents as well.

IV. DOES THE FEWNESS OF CRAs MATTER AND/OR ADVERSELY IMPACT ON BUSINESS CONDUCT AND PERFORMANCE?

Explanations that have been offered as to why there are such few firms have not been entirely satisfactory. Outside the United States this may be the case because of the relative small size and under-developed nature of the bond market. But rating firms are relatively few in the United States as well, where the securities market is well developed, large, and has been growing.

It is indeed somewhat puzzling that there are a large number of firms that offer assessments about stocks and the associated risk and investment potential, but few firms do so with respect to debt. Analysts have wondered whether this is because there are regulations requiring the offer, sale, and purchase of such securities. Due to prudential regulation requirements, various institutional investors such as pension funds, banks, et al., are required to hold financial products that are rated—which creates a built-in demand for the services of CRAs.

As the industry has developed, the practice of an "issuers-pay" model for ratings has evolved and gained wide acceptance as against an "investors-pay" model that previously existed. Typically, debt issuers will solicit and pay for having at least two ratings in order to provide investors' confidence on their creditworthiness. There are also some CRAs that conduct unsolicited ratings based on publicly available information (mainly relating to sovereign debt) but these account for a small percentage of the total.

The CRAs themselves strongly argue that it takes time to build experience and reputation in these markets and that this can be a significant barrier to entry. It apparently took the third ranking CRA (Fitch) over a decade to establish itself.

V. CAN INSTRUMENTS OF COMPETITION LAW AND POLICY BE APPLIED TO INCREASE COMPETITION?

Both the fewness of firms in the industry and the industry's entry barriers have raised questions relating to the possible use of market power to engage in anticompetitive practices such

as collusive behavior, monopolization, or abuse of market dominance. Should there be tangible evidence of CRAs engaging in fixing fees charged to issuers, allocating markets and/or customers, or abusing their dominant position in the market, then CRAs would certainly run afoul of most competition laws. The United States and the European Union both have a strong record of competition law enforcement that would pose as significant deterrent to such business conduct.

Further, while in theory the largest CRAs could be in a "conflict of interest position" whereby borrowers willing to pay higher fees would obtain a higher rating, there have been no substantiated cases that this has occurred. The reputational damage that such behavior would cause would be irreparable, and provide competitive advantage to other rating firms.

There are of course other complexities entailed in trying to construct a case against CRAs' possible anticompetitive behavior, but these largely fail. To mention a few: (i) high concentration and inter-dependent or parallel behavior does not constitute a violation of competition law; (ii) circumstantial evidence needs to be complemented with other "plus" factors/evidence; (iii) the relevant market needs to be delineated—which could prove difficult given the plethora of financial data and publications that can be accessed by investors to gauge creditworthiness; (iv) competition between CRAs is based not only on price but also on quality, accuracy, and timeliness of the relevant information, among other such determinants; and (v) while CRAs have committed errors in their ratings, these do not constitute infractions of competition law—though they may arise due to low level of intensity of competition and choice of rating agencies.

In addition to the forgoing, there is variation in the ratings conducted by the CRAs. While there is similarity in the ratings of the largest (first tier) corporations and countries, this is not the case with medium and small firms, and across regions. And, regarding global concentration, among the leading three CRAs, one of them may be more present in Latin America while the other in Asia.

In summary, in the literature on CRAs, concerns regarding the state of competition have been raised, but at this stage these are primarily conjectures and do not provide a basis for investigating the industry. If, indeed, a significant anticompetitive arrangement or conduct is unearthed, existing competition laws in most jurisdictions provide a sufficient arsenal of instruments to deal with it.

VI. ARE REGULATORY PRACTICES THE CULPRIT?

Meeting mandatory regulatory requirements usually imposes costs that can serve as a barrier to entry. However, the industry is in large part still self-regulated. The International Organization of Security Commissions ("IOSC") has a set of voluntary principles or conduct rules for the CRAs to adopt (which were strengthened after the financial crises). These basically spell out requirements with respect to public disclosure, avoidance of conflicts of interest, integrity of the rating process, and the like. The IOSC, however, has no enforcement mechanism.

In the United States, the SEC has an oversight role by its process of recognizing and designating certain CRAs as Nationally Recognized Statistical Rating Organizations ("NRSROs") whose ratings can be used for regulatory compliance purposes. The Credit Rating Act of 2006 also gave it powers to conduct on-site inspections and to take actions if there are violations.

Essentially the enhancements required greater industry transparency and gave SEC powers for dealing with conflicts of interest and abusive practices.

EU regulations have similarities with those of the United States. They require the CRAs operating in the European Union to be in full compliance of the IOSCO Code in their codes of conduct. EU regulation is also based on some directives that deal with market abuse ("MAD") and a directive on the capital requirements ("CRD") that firms have to meet to be recognized as CRAs or ECAIs ("External Credit Assessment Institutions").

It has been argued that the SEC criterion for recognizing NRSROs was not sufficiently transparent and that the time lag for gaining accreditation was too long, increasing the costs of entry. Nevertheless, the number of recognized firms, albeit slowly and by a small number, has increased since the SEC introduced the NRSRO requirements

While the regulatory requirements on firms do not seem to have increased significantly; nor can it be said they have substantially increased compliance costs, the regulatory *use* of ratings has expanded via several channels. Demand for ratings has increased as the securities market has expanded. Pension and other institutions regularly require ratings for investment decisions. Holders of commercial paper such as money market funds use NRSRO ratings as benchmarks to establishing standards and, indeed, even the U.S. government increased its reliance on CRA ratings in giving out loans under the latest financial crisis. There has also been an increased demand for ratings under the rules of the Basel Committee on Banking and Supervision ("BCBS") ,which attempts to align capital requirements to the bank's risk of economic loss. Banks also use ratings assigned by recognized CRAs in determining credit risk weights for their institutional credit exposures.

It is puzzling, therefore, that in spite of both higher demand and little evidence that there are higher costs of entry due to regulation, the number of firms has not significantly increased. In fact, some analysts argue that this is because reputation (which takes time to build) is critical for gaining acceptance. The additional demand for rating services has merely entrenched the dominant position of existing firms. All in all, it is clear that there may be no easy solution to foster more competition and instill competitive behavior through changes in regulations. Moreover, it is important to minimize interventionist policies that could reduce innovation and efficiency in financial markets.

VII. A PROPOSAL FOR CHANGE: THE NEED TO TREAD EASY AND ADOPT A MEASURED PACE.

There is no dearth of reform measures that have been suggested with respect to CRAs. Except for the recommendation that calls for more competition, these proposals have generally tended to work on existing structures. The proposals suggested below have potential for changing the existing structure. They would address the issues identified above: 1) the need to inject competition, 2) the need to address the "problem" that, in order to be effective, there is a need for any new CRA to establish a reputation quickly, and 3) the need to minimize any interventionist regulatory policy that could impinge negatively on innovation and efficiency in the financial sector.

VIII. A ROLE FOR THE IMF?

The main thrust of the proposal is for the IMF to play a greater role in the credit rating process *as it relates to sovereign debt.* A weaker and a stronger modality for the IMF's role are put forward.

A. The Weaker Modality Form

T*he weaker modality form* would give the IMF an oversight role on CRAs world-wide and assess their performance. At the present time, there is an information gap for investors in that they have little solid information to form judgments on the performance of the larger CRAs, let alone the smaller ones. A report on CRAs worldwide, perhaps on an annual or bi-annual basis (with timely updates), applying clear and consistent assessments (or ratings) that could be globally compared across CRAs, would provide useful information to investors on their performance.

Several positive outcomes could ensue which would reduce the barriers to entry. Filling the information gap, i.e. lack of solid assessments of the CRAs themselves, could reduce the time needed for new entrants or facilitate existing smaller CRAs to establish reputation and credibility quickly. A "shout out" of clear and well analyzed credit rating reports by smaller firms, and noted as such in an IMF report, has the potential of changing market shares and market concentration by encouraging new entry, thereby facilitating smaller firms recognized in the report to grow and gain market share. It could also be a trigger for a re-emergence of investor-pay models, which has been suggested in the literature as being preferable to the user pay models that are currently the norm. In addition, the proposal would address the question that has been asked with respect to CRAs: Who is rating the rater?

An extension of this modality could be to include the suggestion in current literature for the establishment of a centralized clearing platform for credit ratings. It has been argued that there is a "free rider" problem in the theoretically preferred investor-pay models (because of photocopying etc.) which permits non-paying firms to freely obtain information on ratings, and that a clearing platform for ratings would solve this problem. In this model the issuer would be charged a flat fee for rating and the platform would choose one or more (to overcome the problem of shopping for ratings) CRAs to issue the rating. In this model as well, CRAs would continue to operate in the sovereign debt market and compete with the IMF. Such a platform could be housed in the IMF. The selection criteria for the CRAs and other details to provide the ratings would need to be worked out.

B. The Stronger Modality Form

A stronger modality would bring the IMF more directly into the rating process. This role would be limited to sovereign debt where the IMF has considerable expertise. It would inject competition in one of the markets in which CRAs operate. The CRAs would operate without the IMF exclusively in the corporate, state, and local government level ratings.

Much of the needed infrastructure for this new role is already in place at the IMF. The IMF does regular assessments that evaluate the economic and financial policies of the countries (Article IV Reports), and conducts in-depth surveillance of the financial sector ("FSAPs") in most of its member countries. It also undertakes an assessment of debt sustainability of external

and domestic debt ("DSAs") of the member countries. The ability of the country to meet its debt obligations under current policies (and alternate policies, as in the shock scenarios) is an integral part of the debt sustainability analysis ("DSA").

Some refinements and minor changes would be needed to the assessments to perform the role filled by CRAs. One of the benefits of the CRA rating is that it provides an easy metric to compare country risk. Such a metric will need to be developed by the IMF and the criteria made transparent.

This role would inject competition quickly in the sector, as there would be (hopefully) less of a need for the new entrant (the IMF) to establish reputation. Indeed, the competition could be mutually useful and trigger the need for sharper analysis and accountability at the IMF, and also by the CRAs.

The proposal is not without its own set of caveats. It is not clear that the members of the IMF would support this role in light of conflict of interest concerns. As well, the IMF may be thrust into forming some political assessments, as a credit rating in principle looks at both the ability and willingness of the country to meet its debt obligations. Pricing of the IMF rating would also be problematic.

C. Other Reforms Needed As Well

Ideally, other reforms not related to an IMF role would need to go hand-in-hand with this proposal:

- Reducing the regulatory role of credit ratings would be desirable in order to reduce the risk that credit ratings of existing firms become entrenched.
- The time taken to obtain recognition from the SEC as a NRSRO could be capped.
- It would be ideal if one could avoid interventionist measures such as introduction of state controlled CRAs, and instead instill more competition. Such an approach will ultimately reinforce self-regulation by the CRA industry and avoid the need for imposing any regulatory burden.

IX. CONCLUSION

The credit rating industry plays an integral and important role in the financial intermediation process. The securitization process is increasingly global and there is need for global oversight. This needs to be least interventionist from the perspective of not inhibiting innovation and efficiency. A market-driven framework underpinned by greater competition would be ideal. But entry into the sector is difficult given the time-period needed for building reputation and credibility to operate effectively in the market.

This proposal aims to inject competition by injecting a new player viz., the IMF, which has the expertise, reputation, and other advantages to perform this role quickly. There are many refinements that could be suggested but the main objective is to get serious discussion started, as the best time to reform to sector is when the markets are relatively calm.