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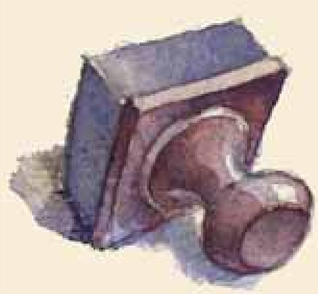
Do the Credit Rating Agencies Deserve to Exist?

The proverb says it's no use locking the barn door after the horse is gone. But even if the door to the credit rating agencies can't be closed, should these institutions be disenfranchised, as many critics argue? Do the rating agencies elevate or add to risk? Is the charge credible that these institutions have never been ahead of the curve in predicting the bursting of an economic or financial bubble? Should the U.S. Securities and Exchange Commission and similar international agencies disassociate from the agencies in the evaluation of risk? Or are effective reforms possible?



Fourteen distinguished experts rate the raters.

Yes, but eliminate their conflicts and have them report to the SEC.

MAURICE R. GREENBERG
Chairman and CEO, C. V. Starr and Company

The rating agencies are an integral component of the financial market. Done properly, their evaluations of credit risk are essential to many market participants who lack the resources or skill to make an independent evaluation.

The problem lies in the method whereby rating agencies are paid for their services which has changed adversely over the years. Once rating services sold their ratings to the purchasers of securities and were viewed as independent evaluators of risk. As securities became more complex, investment banks wanted to know in advance what would be the rating of the security before bringing it to the market. The rating agencies became engaged in the structuring of the securities and demanded to be paid for their efforts.

Investment banks soon learned to play one rating agency against another and only pay for the highest two ratings they would receive. The rating agencies, in order to maximize their own income, became co-originators of securities rather than the independent arbiter that was their original role. The rating agencies became reluctant to downgrade securities they helped to create. If institutions want or need the ratings supplied by the rating agencies, then they should pay for them.

The rating agencies must at all times be independent of the investment banks and originators of securities. If they are publicly owned, individual corporate investors should be limited to 5 percent of the outstanding common stock to avoid an appearance of conflict of interest.

In light of the important role they play in the functioning of the securities market, all of the ratings agencies should be subject to a self-regulatory body which would ultimately report to the Securities and Exchange Commission as do the self-regulatory bodies for the securities markets.

They should be taken over by a public regulatory agency.

HEINER FLASSBECK
Director, Division on Globalization and Development Strategies, UNCTAD, Geneva

Credit rating agencies should solve information problems and increase transparency. Indeed, they have played the opposite role and made the market even more opaque. As in all former crises, agencies were too optimistic. This is the systemic problem.

Rating agencies normally respond that their ratings include disclaimers that clarify that they are paid by the companies they rate and that ratings are only opinions and not accurate predictions of the risk of a given instrument. The problem is that rating agencies play an ambiguous role in the current regulatory environment as it renders rating decisions important in establishing what assets can be held by certain types of financial intermediaries.

A fundamental reform of crediting rating agencies and of their role in rating complex financial instruments is an indispensable step towards increasing transparency of the whole financial system. There is no private solution to this matter any more. What is needed is the establishment of a public regulatory agency which takes over the role of credit rating agencies. Thus, just as the Food and Drug Administration has to certify the safety of a given pharmaceutical product, such a non-partisan agency would certify that an AAA asset has indeed minimal probability of default and can be used by risk-averse investors like pension funds.

Given this, the main question today is whether this should be a national or supranational agency? If it is a national agency, should assets rated as AAA in a given country be considered as AAA in other countries? How would such an agency deal with political sensibility linked to rating sovereign bonds? While these are important issues, it is worth noting that three agencies (one in the European Union, one in the United States, and one in Asia) would cover the majority of the world's financial assets and this would be the case even if these agencies were not allowed to supervise the rating of sovereign issuers.

Only if they become less opaque.

ROBERT E. LITAN

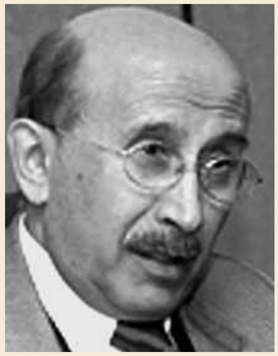
Vice President for Research and Policy at the Kauffman Foundation and Senior Fellow, Brookings Institution

There is no question that the credit ratings agencies deserve much of the blame for the subprime lending fiasco and its current, unbelievable aftermath (although, to be fair, there is so much blame to go around). It is not easy, however, to figure out what policymakers should now do with them.

There is mounting support, for example, for removing the legal requirements that ratings be used—by money market funds, insurance companies, pension funds, and the like. Even were this done, however, there will continue to be a demand by both investors and securities issuers for some kind of rating by someone who is trusted. So some entities we call "credit rating agencies" will continue to exist, and as long as the market calls for them, they will "deserve" to exist.

The Securities and Exchange Commission could regulate the agencies more tightly in an effort to enhance their trustworthiness with market participants, but I am skeptical that second-guessers working for the government will be much better than those working at the agencies now. Likewise, I am skeptical that requiring different letter grades for asset-backed versus other securities will make much difference. And I fear that approving more agencies as "nationally recognized" would encourage more ratings shopping (which I think will go on even if the agencies are formally barred from providing consulting services to issuers).

I think the best that can be done to make the ratings process more effective is to require more disclosure by the agencies, not only of their ratings methods, but also the time periods of data used to assess default probabilities. Perhaps a big red star (or equivalent) should be posted on ratings backed by less than ten years of data. In short, perhaps if the ratings process were much less opaque, investors would trust them more, and their ratings would deserve that trust.



The agencies, like investment bankers, are not objective.

HAMAD AL-SAYARI

Governor, Saudi Arabian Monetary Agency

Rating agencies have damaged their reputation in the structured products area and with the "issuer pays" model. When agencies also offered other services to the company they rated, could they carry out the job of rating the client objectively? Not really. Their role became more akin to that of an investment banker rather than an external analyst. They should not be disenfranchised but their brief should be scrutinized.

Too many investors relied on ratings instead of their own due diligence. After what has happened it would be challenging for the agencies to regain their old influence.

In rating structured products, the agencies made heavy use of computer models. The recent report published by the Bank for International Settlements suggested ways in which rating agencies can improve in this area. But there is a system-wide problem as well, when the agencies rate structured products and vehicles as well as rating the underlying collateral that they are invested in. When the market value and rating of the collateral (such as subprime mortgages) changed, this produced a "knock on" effect in the system.

Ratings have always tended to be backward-looking because they process historical data. But they are no different from other financial players who find it very difficult to tell when a bubble is in progress. If regulators failed to prevent the financial crisis, could rating changes on their own have stopped it?

Credit ratings are widely used in regulatory frameworks, such as with the minimum capital requirements in the Basel framework. The International Monetary Fund's Global Financial Stability Report has said that rating agencies will continue to be a fundamental component in the functioning of financial markets. Regulators already have the power to assess whether a rating agency is doing its job adequately, and if they think it is not, it can be removed from the list of approved agencies. I think the way forward is to have much stronger external supervision, as the European Commission is pushing for.

Regulators need to reclaim their authority.

CHARLES W. CALOMIRIS
Henry Kaufman Professor of Financial Institutions, Columbia Business School

Prudential bank regulation links capital requirements to the ratings of the debts held by the bank in its portfolio, and ratings also limit the debts that insurers, mutuals, and pensions are permitted to purchase. Thus, government has transferred substantial regulatory power to ratings agencies, since they now effectively decide how much capital banks must hold and which securities are safe enough for regulated intermediaries to hold.

Ironically, giving rating agencies regulatory power reduces the value of ratings by creating an incentive for ratings shopping by issuers, which breeds grade inflation, and makes the meaning of ratings harder to discern. Regulated investors, not just issuers, encourage ratings shopping and grade inflation to make the menu of high-yielding securities available to them to purchase larger. The regulatory use of ratings changes the constituency demanding a rating from free-market investors interested in a conservative opinion to regulated investors looking for an inflated one.

The right solution is for regulators to reclaim the regulatory power that has been transferred to rating agencies (so-called NRSROs) to both award ratings and determine the meanings attached to ratings. Such reform becomes even more important in light of soon-to-be-adopted Basel II capital rules, which allow bond ratings to be used to measure default risk in regulating the portfolios of banks that do not develop their own models under Basel II's Internal Risk-Based (IRB) Capital Rules.

One solution is to reform regulations to replace letter-grade ratings with numbers measuring the estimated risks of investments (their default probabilities and the expected losses given default). NRSROs whose numerical "ratings" habitually underestimate these *ex post* observables could be held to account by having their NRSRO status suspended for a time. Even better would be to eliminate the regulatory use of ratings. Regulation could replace NRSRO opinions with true market discipline on banks and other intermediaries by requiring them to issue mandatory subordinated debt, as numerous academics have advocated.

As currently organized, eliminate them.

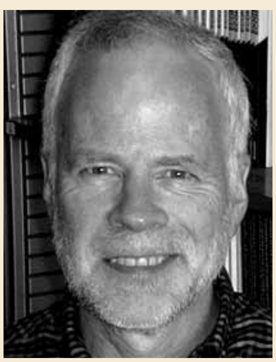
SYLVAIN ROCK RAYNES
Principal, R&R Consulting

The first question to answer is whether there is a need to have independent third-party valuation. The answer is an overwhelming yes. For obvious reasons, neither the buyer nor the seller can be credible valuing a security. The buyer is just as conflicted as the seller. Only people who do not understand finance believe that buyers are innocent people who have been swindled by evil investment bankers. Wall Street is said to be ruled by greed and fear. This is a far-reaching misunderstanding, because the truth is that greed is a negative, not a positive concept. Greed (love) is merely the absence of fear. In our very being, all of us are afraid. It is only when regulation is such as to conceal fear that we are doomed. This is why bull markets take years to unfold, but bear markets happen overnight.

Only after you realize that an independent assessment is needed, who or what shall provide it becomes important. The valuation method can be based on a human being, a so-called rating agency analyst, or else it can be a mathematical formula like the Black-Scholes [BS] option-pricing equation. In fact, a transparent numerical algorithm is far preferable to a human being. Anyone can look up an equation and arrive at identical conclusions. Manipulation is easily discovered.

Given that the primary market in structured finance is non-linear, there will always remain one arbitrary parameter requiring arbitrage. The arbiter can be a person (the current system) or an agreed-upon dataset that can serve as the tie-breaker. Since the structured finance *a priori* problem is amorphous—we are mostly speaking of brain-dead special purpose companies holding pools of loan-assets, a purely numerical algorithm like the BS formula is possible, and ought to be implemented.

In doing this however, just keep in mind that a man-made system always contains a fatal flaw. If everyone decides to conspire for his own benefit, nothing can be done. We are simply trying to raise the difficulty level and extent of successful conspiracies, in the hope of preventing them from ever occurring in the first place. In short, rating agencies as currently organized and sanctioned are not necessary and should be eliminated.



Fundamental reforms are needed, including rethinking Basel II.

BARRY EICHENGREEN
George C. Pardee and Helen N. Pardee Professor of Economics, University of California, Berkeley

Our Asian friends were telling us ten years ago—if only we'd listened—that it was a mistake to rely too heavily on the rating agencies. The rating agencies have mixed motives, creating conflicts of interest. Their fee structures encourage them to cater to the issuer and to succumb to grade inflation. Their customers want a rating no matter what, so they have an incentive to draw overstrong conclusions from dubious models. Some recent steps, like the agreement with Andrew Cuomo to modify their fee structures, may help on the margin. But two more fundamental changes are required. First, we should recognize that it was a mistake to utilize commercial credit ratings in the Basel II capital adequacy reform. In the wake of the credit crisis, Basel II will have to be rethought, and this is a good piece of ballast to throw overboard. Second, the rating agencies are going to shape up only if they come under more competitive pressure, so that poor performance means loss of market share and, ultimately, franchise. More competition requires freer entry and, in turn, properly implementing the Credit Agency Reform Act of 2006 intended to increase competition by making it easier for potential entrants to obtain preferred status from Securities and Exchange Commission staff. The ball is in the court of the Basel Committee and the SEC.

Yes, and effective reforms are possible.

HELMUT PERLET
Member of the Board of Management and CFO, Allianz SE

In my opinion, yes, credit rating agencies do deserve to exist. Their product (credit evaluation) is essential to keeping capital markets functioning properly. The current capital market situation illustrates the negative economic impact a lack of transparency can cause. In addition, by probing the creditworthiness of companies and sharing their assessment and their rationale in a transparent way with the capital markets, their work is cost-effective and valuable, especially for retail clients.

Although it is true that the rating agencies have never been able to predict the bursting of an economic or financial bubble, this does not render them irrelevant, as this is not their task. They should assess the financial strength and the credit risk and thereby complement the minimum standards set by the regulators. If the rating agencies do this effectively and in a transparent way, their actions help to avoid the emergence of a financial bubble in the first place.

In my view, the current regulatory framework has shortcomings and adjustments are needed. One of the top priorities must be the avoidance of conflicts of interest (arising, for example, from the simultaneous provision of rating and consultancy services by one and the same agency). Improvements in the regulatory framework should also focus on the organizational structure of a rating agency, its exact mandate, transparency requirements, and the need for adequate resources and staff qualification levels at all times.

However, in the interest of both investors and the rated companies themselves, we should avoid overregulation and focus on the necessary adjustments. Effective reforms are possible. If these measures are taken, the credit rating agencies can help reduce financial market risks substantially.

Yes, but never rely solely on the agencies for anything.

SUSAN M. PHILLIPS
Dean and Professor of Finance, George Washington University School of Business

Yes, credit rating agencies deserve to exist. However, the more relevant question is how they should be used. My own experience is that the reliability of individual credit ratings of securities, companies, and derivative contracts (if not technically securities) is uneven. In some cases, ratings are fair representations of risk, but in other cases, they are woefully behind the curve. In fairness, rating agencies rely on the information available to them, generally public information, and certain assumptions are made in the application of credit scoring models, such as liquidity and interest rates. But as we all know, firm and market conditions can change rapidly, making even recently rendered ratings old.

Credit ratings do provide information, but I think we should all recognize them for what they are: estimates based on models, data, and assumptions—hopefully, but not always, accurate and current. Moreover, analysts can be subject to the same herd instincts as traders and investors, making them sometimes reluctant to update models or assumptions to recognize trend changes. Reliance on ratings should be undertaken with considerable skepticism. External or independent verification and exploration of the assumptions, models, and, if relevant, composition of the underlying assets, is necessary.

Firms, funds, or investors that do not have the capacity to do their own fundamental credit analysis should at least find a secondary independent means to verify credit ratings. I also think we need to reexamine a developing practice of relying solely on credit ratings for regulatory or capital purposes. Credit ratings could contribute to regulatory or capital standards, but I don't think we have seen enough evenness in their reliability to assume they are adequate. President Reagan's advice seems applicable to credit ratings: "Trust, but verify."

Yes, but with big improvements.

JAVIER GUZMÁN CALAFELL
Director of International Affairs, Banco de México, and former Executive Director, International Monetary Fund

The search for the origins and causes of the current financial crisis has raised some questions regarding the role played by credit rating agencies. Indeed, the creation and explosive growth of mortgage-backed securities and collateralized debt obligations would not have taken place without the participation of credit rating agencies.

Typically, once a proposal to issue a new mortgage-backed security or collateralized debt obligation was presented, the issuers submitted a rating request to a credit rating agency. The latter would then assign a credit rating. This would allow the issuers to sell the security to investors, who used ratings as an indicator of the quality of the product they were buying.

We now know that many of the instruments that originally received high ratings turned out to be riskier than their ratings implied. Indeed, credit rating agencies downgraded a significant proportion of the original "investment-grade" securities.

Recent analysis on the role of the credit rating agencies in the current crisis found that there were major shortcomings in the rating process. For instance, transparency of policies and procedures was not adequate, and there were frequently discrepancies between the outcome of a rating model and the actual rating assigned. Question marks have also been raised regarding the possibility of conflicts of interest. In this respect, it must be noted that credit rating agencies were paid by the issuers themselves and the probability of issuers "shopping for ratings" could have contributed to the agencies granting higher ratings to retain their customers.

Notwithstanding, it is evident that credit rating agencies play an important role in modern capital markets, in part because the information they analyzed may be too complex for single investors to process thoroughly in a cost-efficient manner. However, it is also clear that a number of improvements are needed, both at the regulatory level and by the agencies themselves if they are to fulfill their responsibilities efficiently and effectively. This includes enhanced transparency, improvement of the quality of methodologies and data used in the rating process, an increase the degree of competition in the industry, and development of adequate safeguards to avoid conflicts of interest or to adequately handle them should they arise.

Effective reform is impossible.

YOSHIHIRO SAKAI
Senior Adviser, Development Bank of Japan, and Adjunct Fellow, Center for Strategic and International Studies

There is an enormous perception gap between the reality of credit rating agencies and the investors' illusions about their credibility. How many credit rating agency "experts" really understand the real risk of subprime CDOs? Probably not many, because most experts believe that their job is to "check," not to "create" mortgage derivatives. The real risk is obscured in the fabrication process of these products. Unless the expert is informed about particulars of the original subprime mortgage, assessing the true risk is impossible. I suspect the experts really believed the ratings they placed were correct. Perhaps they also believed that what they were being told by the companies they were rating was all true.

As there really was no question of the integrity of the ratings, investors (especially non-U.S. investors) such as Japanese banks took the credit ratings of CDOs that they were purchasing at face value. Investors outside the United States misunderstood the role of credit rating agencies and thought of them as if they were detectives. In reality, the credit rating agencies had become dysfunctional and the fire had already started by the time we realized what had been going on.

No effective reform of credit rating agencies is possible. Instead, we should, at the very minimum, have them placed under the regulation of Securities and Exchange Commission. We should then, by government mandate, form a "financial jury duty system" whereby professionals in the industry are required to work with the SEC for a set length of time to oversee activities. Although this won't solve all of the present ills, it will help reduce one of the most serious vulnerabilities in the global financial system.

Yes, but the agencies should not be seen as providing an absolute measure of risk.

ANDRES LIPSTOK
Governor, Bank of Estonia

The credit rating agencies have an important role to fulfill in financial markets by helping to reduce information asymmetry between issuers and investors, hereby facilitating efficient functioning of the markets.

The rating agencies have faced criticism for not predicting downturns, or bursting of financial bubbles, and often behaving in a pro-cyclical manner. During the recent subprime crisis, their actions have raised concerns about possible conflicts of interest.

However, this criticism does not mean that the credit ratings have become useless. Nevertheless, for the ratings to fulfill their role effectively, it is paramount that market participants can be confident that ratings constitute an up-to-date assessment and adequately reflect the potential risks. The rating agencies need to assure quality and independence of their assessments, keep the ratings up to date, and avoid conflicts of interest while keeping their methodology and assumptions transparent.

More recently it has also been said that excessive reliance on credit ratings by investors has been a source of risk. In this regard, I would like to note that relying exclusively on credit ratings for valuation purposes should be avoided, as credit ratings are not absolute measure of risk over time, but rather a tool for assessing relative rankings of various instruments. It is therefore necessary that investors make informed assessments where credit rating can provide a valuable piece of information, but the ratings should not be used as the single input for valuation and decision making.

Initiatives are currently underway in Europe as well as in the United States to ensure that the abovementioned conditions are fulfilled. It is important, however, that the regulators focus their efforts on ensuring the integrity and transparency of the rating process, but refrain from evaluating the adequacy of the ratings *per se.*

Yes, but increased SEC oversight is essential.

HARALD MALMGREN
Malmgren Global LLC

The prevailing business model of rating agencies gives priority to ratings volume because issuers of debt instruments pay for ratings. Issuers often seek additional fee-paid assistance from rating agencies in devising debt securities, especially complex asset-backed securities like CDOs. Thus, ratings provided to investors embody fundamental conflicts of interest.

Moreover, focus on volume has resulted in widespread use of mathematical models in place of costly analyses of underlying corporate issuers. None of these models address potential systemic problems such as adverse credit events which became prevalent in the last couple of years as entire asset classes became illiquid.

Ratings fail to reveal methodology, or the degree of confidence in the underlying quality of information, as rating agencies choose to maintain opacity in the quest for maximizing client volume. Ratings of financial institutions such as banks and insurers are essentially focused on conventional measures of “survivability” or ability to fulfill obligations, without fundamental scrutiny of leverage, including extent of off balance sheet exposure and dependency of earnings on high risk trading relative to traditional financial services.

Nationalizing rating agencies would not be effective, and abolishing them would leave most investors without adequate due diligence. Therefore, public policy must address the need for reform of the current business model, with increased reliance on Securities and Exchange Commission oversight.

In light of these apparent weaknesses, the reforms needed are evident. Raters should evaluate the underlying issuer as well as specific debt instruments. Such measures of financial strength as “survivability” or ability to pay should include assessment of leverage and overall risk exposure of financial enterprises.

In cases where the issuer provides insufficient information, a rating should be withheld. And the buyer should pay the fee, to demonstrate “due diligence,” or accept liability for self-evaluation.

All forms of securitized debt should be issued in standardized format, with identification of issuer and clear description of contents. One-of-a-kind CDOs and other asset-backed securities should no longer be permitted. With standardization, issuers would fall under the same SEC oversight framework applicable to issuance of other types of securities, and civil liability for deception or incorrect information embodied in such debt securities should fully reside with issuer. To reinforce responsibility, CEOs and CFOs of issuing enterprises should be required to sign off on debt instruments offered to investors.

The SEC itself should take much larger responsibility for oversight of issuance of all forms of securities by the financial sector.

Yes, but enhanced transparency is key.

JØRGEN ØRSTRØM MØLLER
Visiting Senior Research Fellow, Institute of Southeast Asian Studies, Singapore, and Adjunct Professor, Singapore Management University & Copenhagen Business School

The world has had rating agencies earning good money even if they failed in their evaluations. The following steps should be contemplated. Rating agencies should be kept not only legally, but also *de facto* separated from the financial institutions they evaluate; they should not only evaluate companies, but be drawn into evaluating assets. National financial regulatory bodies should have the right to investigate the background for the rating of financial companies and assets.

Some people talk about the justification of rating agencies and it is correct that they failed, but without such agencies any chance of reestablishing the system is remote. The way ahead is to ask for more transparency and more accountability. People should have the right to know about the risk associated with an asset and if rating agencies cannot do that or shy away who should then do it?

Not only financial institutions, but also the ordinary consumer/investor should have the right to ask for a credit assessment of assets they buy and the rating agencies should deliver such assessments. It is a strange situation that the consumer/investor is better protected buying a tomato than Lehman Brothers minibonds. That cannot go on. It is difficult to see any alternative to a much broader range of tasks for rating agencies under accountability. We cannot make a system credible without transparency and accountability.