

## Special Comment

# Moody's Global Credit Research

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## The Way Forward for the Credit Rating Industry in 2009

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One of the more succinct and accurate descriptions of credit is "confidence". When we collectively look back in 12 months and judge this New Year, one determinant of success – perhaps *the* determinant – will be how far financial markets have advanced from working around the consequences of lost confidence to its restoration. In this regard, the effectiveness of measures that market participants, including governmental authorities, have taken and will continue to take in the coming months will play a key role in that important process.

The various contributors to the current pandemic of lost confidence are by now well-chronicled, starting with the performance of U.S. sub-prime home mortgages and then of rated mortgage-backed and related securities originated in 2006 and early 2007. Moreover, it is now clear that significant latent vulnerabilities had been developing in the infrastructure of the global financial markets, and that once exposed these weaknesses could, and would, have severe and reverberating consequences.<sup>1</sup>

For Moody's and other credit rating agencies (CRAs), restoring the perceived credibility of ratings, particularly in securitization, is both a responsibility and an opportunity to adapt to the market evolution we are witnessing. I will briefly discuss some of the more significant firm- and industry-level actions currently being taken to advance the quality and transparency of our credit ratings. Importantly, however, several important actions will require some external support. In particular, I will address two such areas:

- 1) Competition in the credit rating agency industry; and
- 2) Information disclosure for securitized instruments.

<sup>1</sup> Some of these weaknesses include exceptional leverage and business models that relied on secondary markets for liquidity of complex instruments in periods of stress; the interaction of asset valuation and capital; insufficient risk management practices; interlinked market participants; and limited transparency.



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The first requires market and regulatory concurrence around industry structure and the nature of competition within the industry.<sup>2</sup> The second requires reform of existing regulatory rules governing prospectus and on-going information disclosure in the area of structured finance. Changes in these areas necessarily call for involvement from the public and private sectors and are vital links in the larger effort to restore credit market confidence.

### I. Moody's Actions to Advance Quality and Transparency

Moody's has always believed that critical examination of our industry and our role in the broader market is a healthy process that can encourage best practices. We have taken actions to enhance the quality of our analysis and improve the reliability of our credit ratings in light of changing market dynamics in the past and we certainly are doing so now. These initiatives include refining our rating methodologies, increasing the transparency of our analysis, and adopting new measures to reinforce processes and policies that address potential conflicts of interest. We are well-aware that there has been a loss of confidence in our industry and we have worked with market participants and oversight authorities to better understand their concerns and implement effective measures that meet the collective goal of restoring confidence.

During the 18 months since the credit crisis began Moody's has undertaken numerous internal initiatives aimed at enhancing the quality, transparency and reliability of our credit ratings. We have taken steps to:

- Strengthen the Analytical Integrity of Ratings
- Enhance Consistency across Rating Groups
- Improve Transparency of Ratings and the Ratings Process
- Increase Resources in Key Areas
- Bolster Measures to Avoid Conflicts of Interest; and
- Pursue Industry and Market-Wide Initiatives

The individual actions and initiatives that we have pursued in each of these areas are important but numerous. We catalog and discuss them in Moody's Special Comment, *Strengthening Analytical Quality and Transparency*, which was first published in August 2008 and recently updated in December 2008. The updated Special Comment is available on Moody's website at [Strengthening Analytical Quality and Transparency](#).

One initiative that I wish to highlight is especially important to addressing issues of confidence in structured finance: our introduction of additional measures to help the market better understand the characteristics and performance attributes of securitized instruments. These added metrics, known as **V Scores** and **Parameter Sensitivities**, seek to address two distinct questions asked by investors: (i) what is the degree of uncertainty around the assumptions that underlie our structured ratings; and (ii) how sensitive are Moody's ratings to changes in our key assumptions? We believe that supplementing our traditional ratings with answers to these questions will improve market understanding, a key ingredient to confidence. Moreover, these additional metrics are intended to respond to the interests of various oversight authorities, which have asked that rating agencies more clearly distinguish the performance expectations of securitized instruments versus corporate and public finance obligations. Our Rating Methodology for **V Scores** and **Parameter Sensitivities** is available on Moody's website at [Updated Report on V Scores and Parameter Sensitivities for Structured Finance Securities](#).

<sup>2</sup> The need for regulatory concurrence assumes that ratings continue to be used in regulation. Moody's maintains its support for the elimination or reduction of such use, but we acknowledge that discussion of potential market solutions must accommodate the possibility of regulatory use continuing.

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### II. Initiatives in Need of Third-Party Support

The traditional role of credit rating agencies has been to publish independent and objective opinions about the credit quality of issuers and debt securities. Specifically, rating agencies have served the market by reducing information asymmetry between borrowers and lenders. We sift through the vast amount of available information, analyze the relative credit risks associated with debt securities and/or debt issuers and provide our analysis to the investing public for free.<sup>3</sup> Confidence is reinforced to the extent that high standards, fairness and skill are demonstrable either directly to the market or to oversight authorities, who in turn can transmit their findings.

While we recognize that we must independently continue to change and adapt our practices in step with the market, let me now turn to the central purpose of my discussion. There are two areas where we need help from third parties to enhance the quality of and confidence in our ratings.

#### A. The Nature and Impact of Competition in the Credit Rating Agency Industry

*"Even more than accountants and lawyers, rating agencies must trade on their reputations."<sup>4</sup>*

At the outset, let me say that the help we need with respect to competition in our industry is seemingly straightforward: *credit rating agencies should be encouraged to compete against one another principally on the basis of the quality of their opinions.* In this regard, it is crucial that oversight initiatives introduced with the good intention of enhancing industry performance do not inadvertently accomplish the opposite by undermining *healthy* industry competition. In particular, among many policymakers and private sector commentators, it has become commonplace to debate business model changes and/or greater levels of competition as mechanisms for improving rating agency performance. The positions are varied and at times conflicting, arguing for:

- an elimination of the issuer-pays business model because of the inherent conflicts it presents;
- mandatory implementation of a subscriber ("investor")-pays model because it directly aligns the incentives of the credit rating agency with those of the paying subscribers, who it is presumed are not conflicted;
- an establishment of a single government run credit rating agency because governments are assumed to be more neutral observers and therefore better positioned to balance the competing needs of the market; and, finally,
- irrespective of business model, the creation or encouragement of more CRAs, for the simple reason that more CRAs must be better than fewer.

Each position embeds important perspectives about conflicts of interest and the nature of competition in the credit ratings industry. There is, however, a tautological tension at the core of the debate: competition necessarily creates conflicts. That is to say, whoever (or whatever) is the "object" of competition can exert influence on the entity that is competing for it.

Consequently, an important starting point is acknowledging that the only parties likely to pay for ratings – whether issuers, investors or governments – are parties directly interested in the outcomes. So long as credit rating agencies compete for business, potential conflicts of interest will exist and attempts to persuade rating agencies about their credit perspectives could – and historically have – come very democratically from all sectors. A few simple examples:

<sup>3</sup> Some have likened credit ratings to "public goods". In economics, a public good is one that is "non-rivalled" and "non-excludable", meaning, respectively, that consumption of the good by one individual does not reduce availability of the good for consumption by others; and that no one can be effectively excluded from using the good. The "public good" of credit ratings fundamentally relates to their:

a. *quality*, which in turn, derives from (i) the quality (completeness and accuracy or truthfulness) of information used in the rating process; and (ii) the ability to independently and objectively analyze information; and  
b. *accessibility*, which relates to the dissemination of the resulting credit opinions to the investing public – both large and small investors – fairly and simultaneously.

<sup>4</sup> The Use and Abuse of Reputation, Economist, April 6, 1998, at 18.

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- **Issuers:** issuers are motivated to see their ratings sustained or, ideally, upgraded.
- **Short Investors** (for example, hedge funds that take a significant short position on a particular company): as subscribers under an investor-pays model, they may be highly motivated to encourage a negative rating action – and the more negative and unexpected the action, the better.
- **Long Investors:** similar to their short counterparts, long investors are understandably interested in the outcome of rating actions. Before they purchase a security they may prefer lower ratings to obtain higher yields; following a purchase (especially for those who trade actively) they are likely to want to have ratings maintained or raised rather than lowered.
- **Governments:** governments, often faced with competing financial market and social policy objectives, may seek to have ratings “protect” nationally or systemically important issuers such as large industrial employers or banks.

My point is that all of these parties may want ratings assigned and maintained in a manner that is most beneficial to their interests, and those wishes might sometimes conflict with the “right” rating. This tension is understandable, expected by the credit rating agencies, and must be managed appropriately and transparently.

Finally, one additional alternative, variously referred to as a “market-pays” or “bond surcharge” model, deserves a brief comment. The principal perceived attraction of such a model is that it would “automate” the fee payment process by imposing some sort of surcharge on debt issuance that is thereafter allocated among CRAs. Leaving aside the complexities of the mechanism by which the model could be made operational,<sup>5</sup> the surcharge model is unique *only if* it ultimately allocates fees differently than by determination of interested parties – whether issuers, investors or governments. To achieve that would require some form of non-judgment-based fee allocation (for example, rotational or pro rata), with the consequence, and perhaps the goal, of *eliminating* competition – i.e., if “competition” could be eliminated, so too could “conflict”. However, if competition were eliminated, why would CRAs strive to produce better quality ratings? Perhaps the negative influences of competition would be redressed, but if fees are guaranteed (or, conversely, not achievable) regardless of the quality of a CRA’s opinions, the incentive for CRAs to innovate, update and adapt methodologies to changing market conditions – i.e., to enhance ratings performance – is removed. Consequently, while eliminating potential conflicts of interest may be achievable, it may not be a prudent objective.

Rather than seeking a non-competition model, such as I just outlined, Moody’s has consistently held that healthy competition in the CRA industry is crucial. It is the mechanism through which each participating CRA is motivated to improve. The answer, however, is not as simple as “more competition is good and less competition is bad”. According to circumstances the opposite may also be true. The critical question is “what form of competition” is being encouraged? Are rules and regulations (or the market) structurally encouraging competition for the most flattering ratings? Are they encouraging competition based on the most predictive ratings? Or are they encouraging something else entirely? Consequently, rather than debating “who should pay for ratings”, the debate is better focused on “how can the system encourage high quality ratings?” In our view, there are several areas that would benefit from greater external consideration:

- 1) Potential conflicts should be subject to specific oversight to determine if they are being effectively, demonstrably and transparently managed, regardless of business model. This might require, for example, periodic oversight reviews aimed at changes in market share or concentration of income among key customers;<sup>6</sup>

<sup>5</sup> This approach introduces intriguing complexities, such as how will the fees be apportioned: will fees be equally divided between all CRAs; will CRAs be paid and therefore authorized to assign ratings on a rotation basis; will distribution of fees be based on an arbitrary lottery system? In addition, who will be responsible for distribution the fees? It is conceivable that whoever is authorized to distribute the fees will be similarly conflicted as those entities discussed in the models above, which would negate the underlying purpose of instituting a surcharge model. More importantly still, which CRAs will be eligible to receive such fees? Obviously, if divided only among registered CRAs, or a sub-set of registered CRAs, such a system would leave others at an extreme competitive disadvantage.

<sup>6</sup> Since competing business models all derive fees from interested parties, how material any one party might be as a percentage of a firm’s income is a large and possibly under-emphasized source of conflict oversight and management.

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- 2) Regulation, to the extent it continues to utilize ratings, should not commoditize them. If the tendency is to view officially recognized CRAs as interchangeable, the incentives for them to compete on the basis of ratings quality and performance become diluted;<sup>7</sup> and
- 3) Market participants should understand what ratings can and cannot do and use them appropriately. The better this understanding and the more suitable the use of ratings, the more accurate will be perceptions and judgments about good quality versus poor quality ratings.

Finally, it is worth noting that the issuer-pays model embeds a significant public good – the release of ratings to the investing public simultaneously and for free. Small and large investors alike have equal and contemporaneous access. In contrast, for example, subscriber-models by definition cannot offer this public good (otherwise, who would subscribe for something they can receive just as quickly for free). Since different models reveal similar costs in the form of conflicts that must be properly managed, relevant differentiation comes from the benefits side of the equation.

### B. The Role of Information Disclosure

The second area where we need help from third parties is in improving *the availability and quality of underlying information for structured securities*. Similar to the analysis of other types of securities, analyzing structured securities is a data intensive process. The information needed to evaluate and monitor structured transactions is granular, often relating to the individual assets<sup>8</sup> in the structured pool and the legal features of the structure. Importantly, detailed and high quality data are essential inputs to the analytical methodologies, qualitative judgments and quantitative models that project cash flows from the assets and allocate those projected flows to the various tranches in the structured financing. Irrespective of the rigor of the methodological approach or the model used in the analysis, if the underlying data used is of inadequate quality or stale, the resulting analysis will in turn be similarly susceptible.

However, the structured finance market in the U.S. operates under a limited information disclosure model that requires receipt of non-public information to rate securities (in contrast to the market for public corporate and municipal securities). Simply put, prospectus and ongoing disclosure rules do not require the dissemination of sufficient information about the structure or underlying assets of a securitization to afford reliable analysis based on publicly available sources. Consequently, unlike the corporate market, where investors and rating agencies can each develop informed opinions based on publicly available information, in the structured finance market rating agencies and investors currently have the same dilemma: both lack sufficient *public* information about structured securities to form opinions. As a result, issuers choose to whom they provide information, which exacerbates issuers' ability to opinion shop. And I must add that this information barrier exists regardless of the business model a rating agency employs.

The recommended solution: *enhance and update the disclosure regime for structured instruments. Sufficient information about transaction structures and underlying asset pools should be provided by issuers and originators to the investing public so that they can make better-informed investment decisions.*

Why do I emphasize "to the investing public"?<sup>9</sup> There are three reasons: *first*, a critical mechanism for restoring confidence in the credit markets is to restore the investing public's confidence in the rating agencies. Giving investors access to the same information that rating agencies receive allows them to conduct their own analysis and develop their own independent views about securitized products. That, in turn, raises their ability to assess the work of the rating agencies and to provide a market-based quality control check. Investor confidence in the ratings industry will return more quickly if investors can "get under the hood" and independently determine whose work merits use.

<sup>7</sup> For example, the use of a "single rating requirement" by regulatory authorities facilitates an issuer's ability to rating shop.

<sup>8</sup> The assets are the source of payment to the securities issued by the SPV and it is therefore necessary to have credible and reliable information about the assets' characteristics. For example, in analyzing a mortgage-backed security, the following types of information may be useful for each loan in the structured pool: amount of the mortgage; location of the property; ratio of the loan amount to value of the property; ratio of the loan payment to the income of the borrower; and whether the property was the borrower's home or whether it was an investment. Examples of the type of information required on an ongoing basis to monitor a mortgage-backed security include performance measures such as loan delinquencies, foreclosures and losses.

<sup>9</sup> For a more detailed discussion of the rationale for the three points discussed here, please see "Comments of Moody's Investors Service on SEC's Proposed Amendments to NRSRO Rules," published on July 29, 2008, and available on moodys.com.

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*Second*, embedding enhanced information requirements in prospectus disclosures intended for investors will likely improve the information quality about structures and assets. Issuer indifference to information quality is less likely to be a problem if the information is subject to federal securities law requirements for accuracy and completeness than if it is left to the demands of competing rating agencies. The effect of alternative proposals to provide information only to CRAs is that structural conditions that induced rating shopping in the last credit cycle may induce “disclosure shopping” in the next. That is to say, the rating agency or agencies which demand the least information may have a competitive advantage over those that seek more information.

And, *third*, if sufficient information is made available to investors, then it is necessarily also available to those rating agencies not selected to rate a securitization. It is possible for such rating agencies then to offer unsolicited ratings and research, which broadens the range of information available to investors and can act as a self-policing mechanism against ratings inflation within the industry.

### III. Conclusion

The credit market turmoil that began in the U.S. in the summer of 2007 has been amplified in recent months by dramatic slowing of broader economic activity. What began as a significant, but relatively isolated, deterioration in the performance of sub-prime housing loans has led to a wave of negative events that have reverberated across a highly-leveraged, interconnected and, at times, opaque global financial system. More importantly, a credit crisis has transformed into a much wider and deeper crisis of confidence in the global markets. Credit rating agencies have an opportunity to help restore confidence in markets by restoring confidence in our industry.

Many necessary actions can and have been undertaken at the individual firm and industry level and we are committed to continuing along that path. Nonetheless, a few key actions and reforms as I have described above require help from the broader market and oversight authorities. For 2009, the description of credit is identical to the “way forward” for credit markets: confidence. The rebuilding process will be far more protracted than the events that necessitated it – which is all the more reason to get on with the task with energy, tenacity and coordination.

Thank you.

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