

## White Paper on Rating Competition and Structured Finance

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As subprime mortgage losses cascade throughout the global financial system, attention has turned to the structure and performance of the bond rating industry. Faulty ratings on securities backed by subprime mortgages are believed responsible for billions of dollars in losses. This White Paper argues that any such faulty ratings are due in part to conflicts inherent in the issuer-pays rating agency business model. Such conflicts, when combined with existing structured finance practices, have led to widespread rating shopping. Efforts to increase competition among rating agencies may exacerbate the problem unless fundamental changes occur in the structured finance area, particularly in attitudes toward unsolicited ratings.

### Background

Today's credit rating industry traces its roots to the 19<sup>th</sup> century commercial credit bureaus, whose simple grading systems helped facilitate trading among merchants. At the same time, the birth of the US corporate bond market was underway as financing for the bulging nation's railroads was desperately needed. Large sums were required and the expected horizon of borrowing was many years. Because banks alone could not meet these needs, bonds became the preferred financing vehicle for the many, initially quite separate, railroad companies dotting the landscape of the late 1800s.

Seeing a need for information to assist potential buyers of railroad bonds, several enterprises began marketing "manuals" of financial data and other statistics. Poor's manuals were soon joined by John Moody's railroad and industrial manual. This was a difficult business because the barriers to entry were fairly low and high volumes were necessary to cover printing and distribution costs. Moreover, demand was highly dependent upon market conditions, which tended to be quite volatile around the start of the 20<sup>th</sup> century.

After losing his manual business following the panic of 1907, John Moody decided to implement an idea suggested to him by an associate. He created a system that graded bonds according to their investment quality. The 1909 publication of *Moody's Analyses of Railroad Investments* thus marked the beginning of the bond rating industry. In the following decades, Standard Statistics (later merged with Poor's) and subsequently, Fitch, joined the ratings fray.

By convention, bond ratings are opinions of relative credit quality.<sup>1</sup> These are expressed using comparable, simple rating systems. Most rating agencies rely on a rating system expressed, from highest to lowest, as AAA, AA, A, BBB, BB, B, CCC, CC, C

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<sup>1</sup> Recently, with the advent of structured finance, ratings also acquired a numerical meaning *via* bond default studies. The measure became either the expected loss for a portfolio of similarly rated securities or the "average reduction in yield" for such a portfolio.

and D, while Moody's has continued to use its Aaa, Aa, A, Baa, Ba, B, Caa, Ca and C system.

As the acceptance of ratings grew, so did their application. The large rating agencies today assign credit ratings to corporate bonds, commercial paper, preferred stock, syndicated bank loans, sovereign nations, municipal obligations, infrastructure projects, structured finance transactions, bank deposits and mutual funds.

### **Managing Conflicts**

Prior to 1970, rating agencies did not accept payment from rated bond issuers.<sup>2</sup> Instead, they financed their rating operations through manual sales and investment advisory services. Rating agencies were well aware of the conflicts of interest posed by the "issuer-pays" business model. By accepting payment from an issuer, a rating agency sacrifices its independence. It has a vested interest in the success of a bond offering and in the welfare of the issuer. Despite this conflict, the issuer-pays model now dominates the industry.

Market features and business practices have evolved to help offset this conflict of interest. These safeguards, however, do not eliminate the conflict.

### *Reputation Risk*

First and foremost, the credibility (and therefore the value) of a rating presumably derives from the reputation of the issuing agency. Any agency suspected of selling high ratings would, in a free market, see its business deteriorate as such ratings would not influence bond pricing decisions. The market would discount or ignore ratings of agencies whose reputation is tarnished.

It is argued that building a stellar reputation requires a long-term horizon and view. Yet managers of publicly owned rating agencies are subject to intense short-term pressure to demonstrate earnings growth. It takes tremendous discipline to turn away business, particularly when competitors are building market share.

Recent rating mistakes, while undoubtedly harming reputations, have not materially hurt the rating agencies.<sup>3</sup> On the contrary, rating mistakes have in many cases been accompanied by an increase in the demand for rating services. One could conclude that reputation risk is not an important deterrent to poor ratings.

### *Separating Analysis from Business Pressures*

Independent, non-conflicted ratings do not take into account revenue implications for the rating agency. A popular practice that helps meet this objective is the rating committee. More specifically, a rating committee where those with business objectives have little, or at best, equal voting rights, can help resist some of the pressure exerted by an issuer. Even better would be a rating committee in which such individuals play no role whatsoever. Also, a larger committee may (though not necessarily) have a smaller stake in the rating outcome, further improving rating independence.

### *Transparency*

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<sup>2</sup> As such all ratings were "unsolicited," or not requested by the issuer.

<sup>3</sup> Notable and often cited mistakes were East Asia, Enron, WorldCom and Parmalat.

Publicly available rating methodologies, providing sufficient detail to guide a layman towards plausible rating outcomes, are one of the most important tools to counteract the issuer-pays conflict. A transparent methodology makes it difficult to justify a higher-than-warranted rating outcome.

Transparency in the financial situation of the rated issuer or obligation is also important in managing the conflict. For one thing, an issuer with publicly available financial data is open to scrutiny by a wide range of market participants. It is easier for investors to apply rating criteria and compare with published ratings when there is financial transparency. Moreover, as a defense against “rating shopping,” any rating agency can (in principle) assign a rating to an issuer with transparent financial reports.<sup>4</sup> As discussed below, many structured finance transactions fail this transparency test.

### *Objectivity*

A related characteristic, objectivity, can provide a defense against conflicted ratings. What is typically meant by objectivity is that a rating methodology is based on non-subjective, observable, criteria. Objective ratings are not subject to the whims of any particular analyst or rating committee.

Complications can arise, however, when trying to balance an objective methodology against the desire to be “forward looking,” or able to include new or unanticipated factors into a rating. Analysts will often argue that they need to be flexible in applying a methodology. So long as the arguments for deviating from a published methodology in a given situation are clear (and publicly available), this complication can be managed.

### *Scale*

A large rating agency is less likely to suffer financially by assigning low ratings to a given issuer. Since no single issuer can materially affect the revenue of the rating agency, the temptation to sell a high rating is more easily offset by reputation concerns. Consequently, a larger rating agency is more likely to have the financial resources, and therefore discipline, to stand up to any individual rated issuer.

### *Governance*

In addition to these defenses, various corporate governance safeguards must also be in place. It is generally agreed that a large, diversified corporate parent should not own a rating agency. Corporate pressures may cause the agency to “lowball” ratings for competitors of its sister companies. If the rating agency is publicly owned, the board of directors (often with their own corporate affiliations) must not participate in rating decisions. One could argue that the need to meet financial targets of any kind places undue pressure on the quality of ratings under the issuer-pays framework.

### **Competition and Ratings**

Because the rating industry tends to be dominated by a few large firms, many observers assume that greater competition can improve the quality of ratings. One of the goals of

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<sup>4</sup> Rating shopping occurs when an issuer (or its banker-agent) seeks to select a rating agency that offers the highest rating.

the Credit Rating Agency Reform Act of 2006 is to open the NRSRO recognition process to a wider array of firms.<sup>5</sup> Unfortunately, increased competition can instead lead to rating shopping and a race to the bottom, in terms of ratings quality.

It is useful to examine briefly what is meant by ratings quality. Rating quality is difficult to quantify. Most market observers equate rating quality with rating accuracy. Although there are no official measures in place for determining rating accuracy, the basic idea is that the more accurate a rating system, the better it discriminates *ex ante* between those issuers (or obligations) that default and those that do not.<sup>6</sup> Because defaults tend to be somewhat rare, establishing a rating system's accuracy can be difficult, particularly if one focuses on a single industry or region.

Many users of ratings are focused not on the accuracy of ratings, but rather on subjective features, such as speed of execution, responsiveness to inquiries, or other aspects of service.<sup>7</sup> In the absence of clearly articulated and observable rating system objectives, competition among rating agencies often occurs along these dimensions. While commendable as goals, these have nothing to do with protecting investors.

The target market for bond ratings most accurately falls under the label "institutional buy-side." That is, today's rating agencies are organized to cater to large fund managers and other investor-agents. These well-funded participants hold tremendous sway with banks, broker dealers and bond-issuing companies. Many asset managers are themselves governed by ratings-based investment guidelines. These guidelines, in turn, lead many of these professionals to "game" ratings, rather than view them as helpful investment signals.<sup>8</sup>

Consider the rating needs of a typical bond fund manager. When deciding whether or not to buy a particular bond, the manager wants an accurate, independent opinion of the bond's credit risk. Upon purchasing the bond, however, the manager's interest in an accurate rating deteriorates. In particular, the manager does not want to see the bond's rating downgraded. In addition to causing a possible decline in price and subsequent portfolio losses, a downgrade may actually force the manager to sell the bond (due to the aforementioned guidelines), even if he or she is disposed to keep it. In other words, a rating agency focused on pleasing fund managers will not necessarily provide a product that protects investors.

### *Network Effect*

It is widely accepted that competition and market forces offer benefits under most circumstances, in terms of resource allocation and efficiency. Where there is a market failure, however, the competitive solution may not be optimal. One type of market

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<sup>5</sup> The US Securities and Exchange Commission first established the Nationally Recognized Statistical Rating Organization (NRSRO) designation in 1975 as part of capital regulations for broker dealers. It is now used for a wide range of regulatory purposes. Today there are eight NRSROs.

<sup>6</sup> A default rate, calculated for a given rating category and time horizon, is not a clean measure of rating accuracy.

<sup>7</sup> Auxiliary services, including "research" and access to analysts, pose their own conflicts.

<sup>8</sup> The performance of fund managers typically involves comparison against one or more bond index benchmarks. Ratings are generally used to create these benchmarks.

failure that permeates the rating industry is a *network effect*. An example of a network effect is a language. A specific language gains currency and, hence utility, through wide adaptation. The larger the number of speakers, the greater is the language's usefulness. This imparts a monopoly status to an established language. Competition – that might arise from a parallel language – if anything, wastes resources through the need to employ interpreters and duplicate documents.

Ratings are a type of language. They too gain currency when widely “spoken” and understood. When discussing the attributes of a bond, traders and investors prefer to speak in one rating language. They want to be sure, for example, when told that a bond is rated BBB, it is of a known credit quality. Clarifying that the BBB is from XYZ rating agency often simply confuses the matter.<sup>9</sup> Consequently, any emerging, competing risk language will face much resistance until it reaches a critical mass of users.

Like a language, a rating system gains currency when both coverage and distribution are broad. Wide coverage – across obligations, issuers, sectors and regions – facilitates investment comparisons. Wide distribution also increases the chances that users will prefer one rating system to another. Unfortunately, the high costs of achieving broad coverage and wide distribution form a barrier to entry.

Most financial news and data providers allocate space for just one or two rating systems. Large investors and others buy feeds from the major rating agencies and must configure their databases and display systems to handle each rating system.

Issuers generally do not enjoy meeting with rating agencies. Beyond enduring uncomfortable questions, they must prepare presentations and allocate scarce time and personnel for meetings. They do not want to meet with 10 rating agencies. Nor do they want to buy the services of 10 rating agencies.

In other words, there is a network effect at the rating industry level and smaller network effect with respect to an individual rating agency. In order for a competing system to displace the established rating paradigm, it must entice a critical mass of users. Such early adopters must be willing to bear costs without yet benefiting from the network effect. And in order for a new rating agency to become successful, it must achieve broad coverage and distribution at a substantial financial risk.

As illustrated below, under certain conditions, competition between rating agencies leads to rating shopping and thus to sub-par rating opinions.

### **Shopping for Structured Finance**

The recent failure of rating agencies to signal in a timely and accurate fashion the condition of many securities backed by subprime housing loans can be traced to weaknesses (or outright failures) in the protections against conflicts of interest cited above. It is instructive to describe first the rating process for structured transactions.

The structured finance industry arose as a partnership between Wall Street and the rating industry. In principle, modern structured transactions can trace their lineage to practices used to package the obligations of the US government sponsored enterprises (GSEs), such as those of Fannie Mae and Freddie Mac. These organizations issue

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<sup>9</sup> It is important to understand that there is no law or regulation that defines the risk inherent in a given rating category. Rating agencies' efforts to see that their ratings are equivalent is their way of propagating the network effect.

securities backed by so-called “conforming” loans used to finance home purchases. Even though the underlying loans are subject to credit risk, the GSEs guarantee the securities backed by risky loans. The principal risks, therefore, stem from changes in interest rates and the somewhat related risk of prepayment. What Wall Street brought to the table was the repackaging of GSE securities into bonds that represented various bets on the direction of these risks.

Because the GSEs only buy so-called conforming loans, there appeared an opportunity to issue securities backed by non-conforming loans: those with balances greater than the GSE limits as well as those to borrowers of less than stellar credit standing. To issue these, a banker or arranger creates a bankruptcy-remote Special Purpose Vehicle (SPV) whose function is to buy a pool of loans and issue securities to finance the purchase of the pool.<sup>10</sup> The obligations of the SPV are tranching in such way as to insure that any losses (from delinquent and foreclosed loans) accrue first to the lowest tranche (or security class), and then to the next higher tranche, and so forth.

In order to assign a rating to the highest (or any other) tranche, typical practice is to model the loss distribution of the entire loan pool. The objective is to calculate the expected loss for the tranche and match that loss to historical loss rates observed in the corporate bond market. Consequently, a structured finance rating committee for a new issuance does not vote on a rating, *per se*, but rather on the amount of support (subordinated to the rated tranche) needed to achieve the desired expected loss rate.<sup>11</sup>

There are a number of ways to model expected pool losses for residential mortgage-backed securities. Most are designed to build a certain amount of leeway into the assigned rating. Common practice is to replicate a severe downturn in the housing market through statistical methods. Unfortunately for the modelers, outside of the Great Depression, there have been few instances of a widespread decline in home prices and little historical experience with subprime borrowers.

Other asset types have been used as underlying collateral for structured transactions. The most common are based on pools of automobile loans, credit card receivables, commercial mortgage loans and corporate bonds. Securitization techniques have also been applied to the tranches of existing securitizations and to pools of derivative securities.

### *Rating Shopping*

Somewhat unique to the structured finance market is the opacity of rated securities. In certain situations, the details of the underlying asset pool and often the structure of the transaction are not publicly available for external scrutiny.<sup>12</sup> And unless the banker/originator brings a transaction to a rating agency for evaluation, the agency will generally not have enough information to assign it a rating.

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<sup>10</sup> The SPV is designed to be legally isolated from a bankruptcy of the sponsor.

<sup>11</sup> A similar, often-used approach is to model the change in internal rate of return on the tranching security and compare this against established rating benchmarks. For existing securities, a rating committee may vote to revise ratings, as support levels are fixed.

<sup>12</sup> By contrast, nearly every corporate bond issuer is required to file publicly, detailed financial statements.

The role of rating agencies is particularly important to the structured finance process. Investors rely on agency ratings when making purchase decisions because of the opacity described above. Moreover, the tools to analyze credit risk, even with transparent assets, are beyond the grasp of many investors. Rating methods are quite technical, often relying on advanced statistical techniques. Documentation supporting a transaction can be equally daunting, reading more like a legal brief than helpful financial guidance. In turn, a solid understanding of how to value structured securities remains elusive. No one “model” dominates pricing practices in structured finance. Instead, there are literally dozens to choose from.

The business of rating structured finance securities is highly competitive. For one thing, the fees (and corresponding margins) tend to be high relative to other product lines.<sup>13</sup> Structured finance is perhaps the largest single product line for the major rating agencies, representing 40% or more of total revenues. Moreover, growth in structured finance helped fuel high price/earnings multiples for rating agency shares. So there is intense pressure for each agency to see its structured finance practice thrive.

In addition to being profitable for rating agencies, structured finance is very profitable for the arranging banks. Consequently, the incentive to see a transaction close is strong. This has led rating agencies to compete on standards of credit support. The rating agency most willing to assign a low level of support to a given transaction is most likely to receive the mandate to rate it.

The result is a situation in which rating shopping dominates the structured finance business.<sup>14</sup> Reputation risk is in effect traded for short-term financial gain. Bankers can wield tremendous power and play the rating agencies off of one another.<sup>15</sup> They are able to do this because many investors see the ratings of Moody’s, S&P and Fitch as interchangeable. Consequently, many investors will purchase a security with ratings from two (or sometimes just one) of the three major agencies. Support levels migrate to the lowest possible values as agencies maneuver to maintain market share. The agency with the highest support level on a given transaction will lose the deal and, over time, its structured finance business.

This situation was sustainable in the subprime area so long as pool losses remained subdued. Low support levels (which offer minimal protection to senior

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<sup>13</sup> Rating fees for plain vanilla corporate bonds are roughly 3 basis points (of par amount). Fees for structured transactions range from 6 to 13 basis points or more.

<sup>14</sup> "It was always about shopping around" for higher ratings, says Mark Adelson, a former Moody's managing director, although he says Wall Street and mortgage firms called the process by other names, like "best execution" or "maximizing value." "How Rating Firms' Calls Fueled Subprime Mess," *Wall Street Journal*, August 15, 2007.

<sup>15</sup> "...the Moody's Corp. unit said it was passed over and not hired for 75% of the commercial mortgage-backed securities rating assignments issued in the past few months as a result of its requirement that issuers add an extra layer of credit enhancement. Moody's said issuers are "rating shopping" -- meaning they were hiring competitors that would hand out higher ratings on securities." "Moody's Says It Is Taking Hit," *Wall Street Journal*, July 18, 2007.

securities) seemed sufficient in an atmosphere of easy money and rising home prices. But when losses began to materialize, ratings began to fall, and investor losses surfaced.<sup>16</sup>

### *Role of Regulation*

Certain market observers point to the use of ratings in regulation as a contributing factor to rating shopping. Because many regulations stipulate minimum rating levels without referencing a specific rating agency, such use contributes to the “commoditization” of ratings. When the SEC, the NAIC or a banking regulator officially recognizes a rating agency, its ratings assume a quasi-official status.

One reason this occurs is because many investment professionals simply do not place importance on a rating opinion as long as it meets a regulatory (or institutionally approved) minimum. Most investment managers try to maximize return subject to a specified risk level. In the fixed income universe, ratings are the language used to establish maximum allowable risk levels and are often seen as a constraint. There is in principle a link between ratings and expected return. But investment managers add value through independent research and finding opportunities regardless of the published rating.

Official status is thought to be a major contributor to demand for an agency’s ratings. Yet it is extremely difficult to estimate the benefits from official recognition. What is clear is that such recognition is highly sought after by new entrants.

Finally, regulators have indicated a bias against unsolicited ratings. In fact, unsolicited ratings provide an opening for new competitors – sometimes the only opening – and form an important defense against rating shopping. As discussed below, when an issuer or its banker cannot suppress an unwanted rating opinion, the incentive to “shop” rating agencies is reduced.

### **Alternative Business Models**

Given the conflicts inherent in the issuer-pays arrangement, it is worth considering alternative business models. We describe two of these here.

#### *Investor-Pays*

As previously noted, over its first sixty years, the bond rating industry did not charge issuers for ratings. Instead, ratings were financed mainly by manual sales and certain other investor-oriented services.<sup>17</sup> The primary purchasers of manuals were bankers and libraries.

In order to have access to ratings, one needed access to a manual from at least one rating agency. The manuals themselves were typically published annually. If ratings changed in the interim, investors would not have access to the updated ratings until publication of the next edition. This did not pose much of a problem during the relatively slow investing world of the mid-20<sup>th</sup> Century. But it certainly would not work today.

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<sup>16</sup> A further criticism of structured finance is that most rating methodologies are, by design, “backward looking.” Loss distributions are anticipated to follow historical experience and ratings (if monitored at all) are not adjusted until losses surface in the underlying pool.

<sup>17</sup> Early manuals also relied on advertising revenue.

With the increasing breadth of the bond markets, the number of rating manuals expanded dramatically. By 1928, Moody's alone published separate manuals for Railroads (subsequently re-named Transportation), Industrials, Public Utilities, Governments and Municipals and Bank & Finance (subsequently re-named Bank, Insurance, Real Estate and Investment Trusts). In turn, the costs of access to a comprehensive set of ratings rose.

The rating manuals were not designed to provide ready information about the actual ratings of various bonds. Rather than simple rating lists, they focused on financial information and issuer history. Many were not organized along obvious lines, such as the alphabet. They catered to a time when bond investing was a serious, deliberate affair and when the typical buyer was a buy-and-hold investor.

In time, however, bond rating "surveys" and "guides" offered timely and concise rating coverage. Ready access to the rating on any obligation became the norm, reflecting the trend towards increased trading of bonds. These quick reference guides opened the rating industry to a new threat, the photocopier. With the advent of photocopying, rating agencies suffered the "free rider" problem, whereby non-paying investors could benefit from relatively easy (even if illegal) access to rating lists. Moreover, in the US public finance market, the investor base per bond was too small to support adequate analysis. Sensing this, S&P began charging issuers for public finance ratings and was quickly followed by the other rating agencies. Soon thereafter, all issuers were charged for ratings.

One could argue that ratings are a "public good," and should be available to all market participants. For one thing, rating analysts in the US are exempt from fair disclosure laws. These securities laws prevent the disclosure of non-public information to market participants. Rating agency personnel are viewed as special because of the role of ratings in the securities markets. And because ratings are used in many regulations, open access to ratings would seem to fulfill a broader public policy purpose. Restricting ratings to a select group of investors willing (and able) to pay for them may stoke populist fears.

An investor-pays model therefore faces economic hurdles relating to the free rider problem and from ratings' public good status. Newspapers are subject both to the former, and to a lesser extent, the latter hurdles. They typically rely on advertising revenues to meet the costs of supporting a large editorial staff, printing and distribution. This poses a conflict, in that a newspaper might refrain from negative reporting about a large advertiser. Many newspapers carry official notices, lending them minor public good status.

#### *A Mutual Rating Organization*

Today's major rating agencies are large, complex organizations with staff numbering in the thousands. They have offices in countries around the world. In order to attract qualified personnel, they must compete with insurance companies, mutual funds, commercial banks and investment banks. Mutual ownership, once common in the insurance industry and still widely used by credit unions, can offer an alternative means to garner the resources necessary to compete on a global scale.

Unlike public ownership, a mutual organization operates for the benefit of its members. Members supply capital and receive shares in the mutual. As owners, they

also share in any profits accruing to the enterprise. Such co-ops offer myriad benefits to their owner-customers, particularly in a non-profit setting.

A mutually owned rating agency would have as shareholders commercial banks, investment banks, mutual funds and other institutional investors. One need only look at the client list of any large rating agency to identify potential candidates. Unlike the shareholders of many mutual organizations, these are large, sophisticated entities.

A mutual rating agency would not need to charge issuers for ratings. Its shareholder/customers would pay for access to ratings and any affiliated commentary. Access to ratings themselves would be free to all, but the costs would be borne chiefly by the shareholders. Any profits would be distributed back to the shareholders as dividends or reinvested in the agency. Losses would be covered by shareholder assessments.

Because each shareholder would have a stake in the success of the rating agency, its ratings would likely crowd out those of any competitor. The more widely owned, the quicker this might happen. For one thing, issuers would generally prefer the “free” ratings of the mutual agency, doubly so if they knew that leading investors followed such ratings.

The shareholders would in theory operate the rating agency to provide the best possible ratings within prudent cost guidelines. Managers would answer to the owner/users, rather than to a public board of directors. Resources would be channeled to meet the mutual needs of shareholders.

Unfortunately, organizing such a diverse group of natural competitors itself provides a sufficient barrier to success. There are institutional, regulatory and legal constraints to deal with. And unless the world is convinced that the current system is broken, generating enthusiasm for such an endeavor may be difficult.

### **A Prescription for Structured Finance**

If we accept that the issuer-pays model is the only viable alternative, an effort must be made to minimize the risk of rating shopping. To summarize, relatively tranquil markets, little reputation risk, high fees and opaque structures facilitated rating shopping within structured finance. Some of these features will self correct, others must be addressed head-on.

Recent market turmoil has removed the appetite for highly complex, opaque structured products. The market for CDOs and CDOs of CDOs (“CDOs squared”) has seen its heyday and may never return in the same shape or form. The same might be said for Structured Investment Vehicles (SIVs) and many synthetic-based products, which rely on derivatives. Demand for securitizations of subprime mortgages is certainly likely to remain low for many years to come.

In order to prevent rating shopping in any future structured finance business, fundamental changes must be made in the way transactions are created and marketed. As mentioned previously, banker/originators decide which rating agency can or cannot view the details of a new securitization. This prevents certain agencies from offering an unsolicited rating opinion.

The power to suppress an unwanted rating opinion is at the heart of the rating shopping problem in structured finance. There must be a shift in the balance of power if rating shopping is to be contained. Specifically, any stigma associated with unsolicited ratings must be banished and biases in regulation eliminated.

For example, section 3.9 of the International Organization of Securities Commissions (IOSCO) Code of Conduct Fundamentals for Credit Rating Agencies (CRAs) states:

For each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be identified as such. The CRA should also disclose its policies and procedures regarding unsolicited ratings.

The implication is that unsolicited ratings are necessarily inferior to those solicited and paid for by the issuer. Paragraph 108 of the Basel Committee on Bank Supervision's International Convergence of Capital Measurement and Capital Standards (Basel II) raises further concerns when discussing External Credit Assessment Institutions (ECAIs):

As a general rule, banks should use solicited ratings from eligible ECAIs. National supervisory authorities may, however, allow banks to use unsolicited ratings in the same way as solicited ratings. However, there may be the potential for ECAIs to use unsolicited ratings to put pressure on entities to obtain solicited ratings. Such behaviour, when identified, should cause supervisors to consider whether to continue recognising such ECAIs as eligible for capital adequacy purposes.

Although ostensibly addressing potentially anticompetitive practices, intense pressure from European corporate issuers was likely the motivation for this guidance.<sup>18</sup>

Competitive forces will not improve the quality of ratings without the ability to offer an unsolicited opinion. For their part, rating agencies must not use unsolicited ratings in anticompetitive ways. Anticompetitive behavior might occur, for example, if a major rating agency were to enter a new market and "dump" free ratings in order to drive out potential new entrants.

Regulatory authorities must insist that future structured finance transactions be sufficiently transparent in their structure and in the details of the underlying collateral that any rating agency may offer a credible opinion, whether it was selected by the originator or not.

Rating agencies must publish and abide by transparent methodologies for rating structured securities. They must provide these for every asset class and each must meet certain minimum criteria. The overriding principle is that an outside party following the methodology should be able to conclude to the rating (or, more specifically, support level) reached by a rating committee. At most, any deviation would be minor. If the rating methodology is expressed in terms of a model, that model should be available to all

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<sup>18</sup> Some rating agencies were believed to be assigning low unsolicited ratings as a way to threaten issuers to purchase their services (and thereby get higher ratings).

(for free) so that any sufficiently competent user can replicate the rating/support outcome. In those instances where a rating agency deviates from its methodology, it must explain why.

For existing transactions, there should be adequate public disclosure of the underlying asset pool performance and sufficient disclosure of the parameters and thresholds that might lead to a rating change. This assumes that transactions are indeed monitored once completed. It does not mean, however, that rating agencies should operate in a totally mechanical fashion. There must be room for human judgment and effort should be made to encourage forward-looking criteria. But the emphasis should, first and foremost, be on transparency.

Even if market forces do not render them extinct going forward, the rating of complex structures should be avoided or prohibited. Complexity is attractive to rating agencies because fees can be much higher than those for simpler, generic securitizations. Complexity, however, is anathema to transparency, and thus opens the gate to rating shopping.

These suggestions are meant to assure the survival of the rating industry, not to drive it into poverty. Unless the incentive to shop ratings is removed, the industry risks obsolescence. Alternative risk measures will emerge and gain currency. While this may happen on its own accord, better ratings may forestall such an outcome.

### **Conclusion**

Rating agencies perform a valuable social service. Their opinions can help improve the efficiency of capital markets. Conflicts inherent in the issuer-pays business model have instead contributed to faulty ratings for many structured finance securities. Increased competition alone will not fix the problem. Rather, fundamental changes must be made in the way structured finance securities are created and marketed. Increased transparency in the structure and performance of individual transactions, along with increased transparency in rating agency methodologies, will allow investors and rating agency competitors to assure standards are being met. In order for competition to succeed, biases against unsolicited ratings must fall.