Vincent C. Ross Institute of Accounting Research
New York University Stern School of Business

Ross Roundtable

on

Conflicts of Interest at Credit Rating Agencies

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Seymour Jones (NYU) welcomed the participants to a Roundtable discussion of the controversy surrounding the credit rating agencies (CRA's). The recent scandals and corresponding economic crisis highlighted the potential for conflicts of interest at these agencies. The economic crisis has had a far-reaching impact on every segment of our society. Experts from the financial sector, entrepreneurs, lawyers, regulatory agencies, credit-rating agencies, academe, and the accounting profession were invited to join the discussion with the objective of hearing "*all sides of the story*". Although representatives of the "Big 3"[1] CRA's have a long history of participating in NYU Roundtables, their absence spoke volumes.

Mark Lilling (Lilling & Co) commented that if Congress would be proactive rather than reactive, scandals and ensuing crises could perhaps be avoided. The role of the gatekeepers is to protect the investors. We need legislators with foresight; chronic myopia is unacceptable.

From the Ivory Towers: Pepa Kraft (NYU) presented a snapshot review of recent scholarly research on CRA's. Credit rating agencies are information intermediaries; they collect and process information and generate opinions on creditor's credit risk. Success is based on reputation, and they strive to provide high-quality ratings (opinions). Stock and bond prices are significantly correlated with ratings, thus providing evidence that CRA's provide value relevant information. Rating agencies are paid by the issuers[2] and have an ongoing business relationship.

Extant research finds subscriber-paid ratings are more frequent, timely, and less conservative than issuer fee-based ratings. Empirically, it has been difficult to assess if bribery exists when the issuer pays for the ratings. However, there is evidence that ratings were inflated upward preceding the financial crisis. Were they using the wrong models? Were they provided with other incentives? That is where the debate stands relative to esoteric instruments.

The quantitative and qualitative inputs used by CRA's are publicly available. The focus is on the balance sheet. Capitalization of off-balance sheet financing constitutes one of the major adjustments. Although the qualitative adjustments are a "black box", they are priced in the market. Some private debt contracts incorporate ratings as a measure of performance. A change in ratings will either change the rate of interest or trigger termination of the contract. There is empirical evidence that rating agency adjustments are more favorable for firms using rating-based contracts. Implications?

[1] Moody's, Standard & Poors, & Fitch
[2] Issuer paid fees replaced subscription fees in 1970.

"Enter the real world": Lawrence J. White (NYU) provided a cogent example of the real world dilemma/contradiction related to CRA's.

> "..an insured state savings association…may not acquire or retain any corporate debt securities not of investment grade" as determined by a credit rating agency. 12 Code of Federal Regulations 362.11
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> "..any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision". S & P's disclaimer printed with the ratings.

Starting in 1936 banks, insurance companies, pension funds, etc. were prohibited from investing in below investment grade bonds; these ratings (which come with a disclaimer) now had the force of law! Furthermore, the establishment by the SEC of Nationally Recognized Statistical Rating Organizations (NRSRO) created an opaque barrier to entry. The "Big 3" became the first members of this unpublicized *exclusive club*. The NRSRO "ratings" now became a badge of honor--coveted by all market participants.

In the late 1960s and early 1970s the CRA's switched from their "investor pays" model (which had prevailed since John Moody had first begun publicly rating railroad bonds in 1909) to the "issuer pays" model. Professor White believes that the issuer pays model did not "blow up" during the first three decades because

- Rating agencies were concerned about their reputations.
- With thousands of issuers, losing clients was not a concern
- In general, the financial instruments were "plain vanilla", making "errors" easy to spot.

NSRO's came out of the shadows when it became known that until 5 days before the Enron bankruptcy they had received investment grade, NSRO (SEC) ratings. True to their reactive nature, Congress passed legislation permitting the SEC to regulate NSRO's, but requiring more transparency, "and the opaque barrier to joining this distinguished country club started to evaporate."

What changed to cause a "blow up"? In the early 2000's securitizers of subprime instruments had to rely on the Big 3, which were now faced with:

- A very small group of issuers, whose threat of taking their business elsewhere would dramatically impact their profits.
- There was evidence of "shopping around" by the issuers.
- Complex structured financial instruments that defied existing measurement metrics.
- The threat to their reputation became less of a concern.

Research provides evidence that when ratings change, markets move. Professor White suggests that the *movement* may be related to the regulatory status of the bond or perhaps ratings simply follow market spreads. Are ratings leading the market or vice versa? There is no conclusive evidence that investors regard a change in ratings as information about default. The bond market is an institutional market, and he therefore believes that the financial institutions should have the responsibility of justifying the safety of their decisions. "Ratings should no longer have the force of law". Professor White strongly believes that without a dramatic reduction in regulation of the bond-information process, the efficiency of the bond market is at stake.

The big question? What has Dodd Frank[3] changed? Michael Koblenz (Mound Cotton Wollan & Greengrass) noted that the Act went into effect 10 months ago, and it will take time for the full impact, if any, of the Act to be realized. The creation of an "SEC Credit Rating Agency" office has been accompanied by "here we go again" amidst a background of yawns. The Office is required to draft regulation that will:

- Eliminate the First Amendment privilege.
- Place raters in the same position, relative to litigation, as auditors and expert witnesses.
- Require annual audits of CRA's with full disclosure of methodology, and documentation of all sources of information-- individuals and data.
- Require "Raters" to take exams and become licensed.
- Apply the rules of *Independence* required of CPA's and others.
- Submit annual reports to Congress.

From a lawyer's point of view, Mr. Koblenz believes that the threat of litigation will provide sufficient incentive for CRA's to be more cautious. The results of litigation against CRA's brought to date are mixed. In addition to the First Amendment issue, the question of "were the CRA's defacto underwriters[4]?" will be a deciding factor in many cases. What can be said at this point in time? Positive results are anticipated from the ACT's new rules of conduct and required documentation of internal controls. Will the outcome of the inquiry by the SEC into structured financial products result in increased protection for the investor? There is a long road ahead and lots of room for skepticism.

Responsa CRA's? To complement the discussion, Professor Roy Smith (NYU) provided a few statistics on the scope of CRA's and a sampling of CRA publicly available comments. In 2010, Moody's operated in 110 countries; rated 11,000 corporations, 22,000 public entities, 102,000 structured transactions and had 72% of the market share. At a time when their reputation was shredded and the economy was in a slump they reaped $500 million in after-tax profits.

The controversy:

- **Yes,** there is evidence that CEO's were "rate shopping" and paid CRA's 4 – 5 times their regular fees.
    - ❖ **But,** the facts[5] of the matter are the instruments were so obscure that without the ratings they could not be sold to regulated institutions, and therefore the "rating" became more valuable.
- **Yes,** the CRA's worked together with the issuer to restructure the issue to meet the specifications of their investment grade model.
    - ❖ **But,** that advice does not constitute acting as an underwriter.
- **Yes,** they made mistakes; they used the wrong model.
    - ❖ **But,** the whole industry was affected by the same misinformation.
- **Yes,** investors lost a lot of money.

[3] The Dodd–Frank Wall Street Reform and Consumer Protection Act

[4] Hence, subject to litigation.

[5] A subset of the facts.

- **But,** the loss was a result of price deterioration, and not the fault of the CRA.

Professor Smith believes that at this time the real issue is whether we are going to take away the requirements for ratings. Funds in which the public has an interest require regulation. Investors are unwilling to pay for advice. CRA's rate default risk on held to maturity instruments, and have been doing a good job for over 30 years. Ratings are based on thresholds that tolerate change, and soft corrections are made based on an understanding of the economics of the business, rather than the daily vagaries of the marketplace. In his opinion, the Big 3 are better than others, even with their flaws, and the efficiency of their operations cannot be duplicated.

> "Are they conflicted? Yes… but, conflict of interest doesn't have to be toxic...
> Are we trying to fix something that's not broken?"

In the discussion following the presentations participants voiced concern about the role the CRA's played in customizing the tranches to pass the investment grade threshold. There was also recognition that the rating agencies' experience with structured products was very limited, and therefore mistakes were made. However, the lawsuits against the CRA's are not for flawed opinions, but for fraud and deliberate misrepresentation. There was a consensus among all that regulation should be proactive instead of reactive. "Locking the gates after the horses escaped" is inefficient and ultimately costly. But, what if this was your first horse?

In the *ole days*, the Holy Grail of Wall Street was disguising debt as equity. "*We have come a long way baby.*" Artificial intelligence…ever increasing sophistication of computer technology…will continue providing Wall Street with permutations of exotic financial instruments of ever increasing complexity. The simple answer? Regulated industries should not be permitted to invest in instruments that can neither be defined nor evaluated by standardized metrics.

SEC versus IBM's RoboRate…checkmate?