

Rating Agencies: Is There an Agency Issue?

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Anytime advice is offered in a financial matter, there is a potential agency issue. The agent collects information, interprets it and disseminates it to principals who use the product of the agent's work in making financial decisions. This is true of stockbrokerage, asset management, private banking, equity research and a host of other retail and institutional financial advisory services.

The agent is in business to maximize earnings. Revenues have to be generated from somewhere. The only case where potential agency problems (i.e., conflicts of interest between the agent and the client receiving the advice) do not occur is when the agent's sole source of revenue consists of fees paid by the client. In all other cases the potential for conflict of interest exists. Examples:

- § A broker-dealer with a sales force compensated by commissions.
- § An investment bank issuing research reports and recommendations that is itself involved in securities originations, merger and acquisitions advisory mandates and secondary market trading.
- § An insurance company that sells "bundled" financial services such as variable annuities.
- § An asset manager who is compensated by firms producing the assets that he or she sells to clients.

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Agencies that rate others for a fee clearly have a similar potential for conflict of interest. Such cases include publications that rate consumer products or vendors of financial services and while at the same time obtaining advertising revenues from those who are rated. Raters that refuse to have financial ties to the objects of their ratings and therefore avoid even the appearance of conflicts of interest (such as *Consumers Union*) are usually among the most highly regarded in the ratings business.

Credit rating agencies likewise are subject to agency problems, since rating fees paid by issuers comprise their principal source of revenue. At the time of the industry's inception a hundred years ago with the publication of Moody's pioneering bond books, the issue did not exist as revenues came almost entirely from the sale of publications, and none came from fees paid by issuers. This situation changed later and became more of a problem with the growth in the importance of rated securities in the financial system and the insistence on ratings by institutional investors, their clients, and their regulators. Ratings also became particularly valuable in some of the least transparent instruments of the capital markets notably foreign corporate or sovereign bonds, non-investment grade and emerging market debt, and structured financial products such as asset-backed securities. In such cases the rating agencies added a perspective not available from public sources information gained from direct (often privileged) contact with the issuer's management by experienced analysts who know which questions to ask.

It is equally clear that a *reputation* for technical competence, continuity, transparency, objectivity and impartiality comprises the principal asset of the rating

agencies, without which there would be no justifiable demand for their ratings.²

Consequently, this dependence on reputation has become the principal market-driven safeguard against exploitation of any potential conflicts of interest in the ratings business. And the fact that the two leading rating agencies, Standard & Poor=s and Moody=s, have between them an 80% share of the market for credit ratings also suggests that the marginal temptations to offer improved ratings for reduced fees (to get the ratings "mandate@) is unnecessary and totally out of proportion to the costs to the firm of serious damage to its reputation.

The rating business has grown with the process of financial disintermediation, as bank debt has been replaced by securities issued in one financial market after another B a fundamental redirection of financial flows that generates significant gains for the end-users of the financial system. This transition has largely been completed in the United States, where it began more than twenty years ago, and is spreading now to other areas of the world, notably in the euro-zone, where capital markets are developing faster than most observers had anticipated. Such systemic changes in financial intermediation have made the rating business more attractive to investors in ratings firms and at the same time has created more competition for the market leaders, thus exposing them to temptations to exploit their businesses= inherent conflicts of interest in order to increase their profits or shore up their share prices.

²Inferential evidence can be found in the reputational collapse of sell-side equity research conducted in firms active in corporate finance, which is widely regarded as strongly influenced by the need to generate advisory and transactions fees.

The paper examines the issue of conflicts of interest in the credit rating agency business. It addresses the role of rating agencies in the current financial system, how rating agencies achieve credibility, how they are compensated and price their services, and how they manage their agency and conflict-of-interest problems. It also considers the regulatory and litigation exposures with which agencies must learn to live in order to conduct their business, and how concerns about these exposures may be a compelling deterrent to misconduct. Some observers have complained that, despite such considerations, rating agencies remain essentially unregulated unlike all other institutions involved in debt issuance. Others insist that, despite the fact that "...rating agencies are a bit of a cozy club, effectively [the raters] are rated by the market, and if they started to lose credibility [the issuers] would stop paying for their services."³

Financial Market Infrastructure: Where Rating Agencies Fit In

Useful trading information is often expensive. It has to be created, absorbed, processed and acted upon promptly to be applied effectively in the market. Sometimes gathering this information this is not a big problem. In the foreign exchange market, perhaps the most perfect in the world, dealers can check rates electronically with brokers and other dealers around the world on a 24-hour basis virtually year-round. All major players have almost the same information almost all the time, and also essentially the

³Steve Holmes of Fleming Asset Management as quoted in Katherine Morton, "Time to Face the Image Problem," *Credit*, April 2000.

same costs of doing transactions. So success or failure in this virtually seamless market depends mainly on the dealer=s *interpretation* of whatever information is available at the moment.

In this context, credit rating agencies perform a valuable function by producing and assembling information which many investors in less transparent markets would find prohibitive to develop on their own. It may be shared with a large numbers of creditors, each of which typically has a relatively small stake in the borrowing entity. The information helps avoid both Type I and Type II errors in the lending process B i.e., extending credit that in retrospect should not have been extended, and not doing so when in retrospect credit should have been given. And the information is now widely available, especially in the age of the Internet, to all kinds of securities investors, both institutional and retail.

Rating agencies maintain proprietary systems for transforming a host of quantitative and qualitative information into the ratings themselves. Their role can be two-fold B signaling and certification. *Signaling* involves new information or interpretation provided to the market, which influences how a particular debt issue gets placed B it lowers the cost of capital for the issuer and simultaneously improves portfolio efficiency for the investor. *Certification* involves the eligibility of a particular debt issue with regard to portfolio eligibility standards set by regulators, fund trustees, or boards of directors.

Such information clearly has important public goods characteristics. Once it is released there is no way to prevent access to free riders. So, for example, banks that undertake expensive credit analysis would be reluctant to release it and encounter free-

riding by other banks which have not made comparable investments B although in syndicated credits a bank may be able to recoup some of its costs in the front-end fees that typically are disproportionately distributed to lead managers of such transactions. The key to the economic viability in the ratings business is to reconcile the public-good nature of credit information with the need for the producers of that information to cover their costs and earn an appropriate return.

Some rating agencies (e.g., A.M. Best and KMV) make their ratings available on a subscription basis and thus remain vulnerable to their clients= sharing this information B although there are both technical and legal ways of limiting the economic damage. Most other rating agencies publicly disclose their ratings and therefore cannot extract a fee from users B as do security firms who make their research available in return for “soft dollars@ associated with directed order flow and brokerage commissions. The only alternative is to charge the issuer for each rating. This represents a cost to the borrower that is shared with investors in that the costs are reflected in interest rates and/or fees.

Issuers seeking a rating clearly benefit from that rating. Either they expect to receive a lower spread or they expect to access a broader investor pool (especially if regulators or fund trustees and directors require that certain rating parameters be met in order for a security to be qualified for a portfolio), or both. Those spread- and eligibility-effects are contingent on the perceived value of the rating, and hence drive the willingness to pay for it. Reputation is the key aspect of the ratings franchise, and is earned over a long history of rating a broad array of financial instruments in various geographic markets. The franchise

is difficult or impossible to duplicate in the short term, so that pricing ought to be susceptible to monopoly rents B although the existence of such rents is impossible to determine without insight into the pricing process or the size of any excess returns in the ratings business.

The basic economics of the ratings business are thus based on the fact that it is impossible to charge for information once it has entered the public domain. This is amplified by exaggeration of the importance of ratings because of a general underinvestment in credit research, combined with pressure for rapid-decision-making on the part of individual issuers and investors. Its symptoms include understaffing and undercompensation in credit analysis, inexperience among credit analysts, and over-reliance on credit agency research regurgitated on a “quick and dirty” basis as in-house research by financial intermediaries.

Rating agencies, in short, play a key role in the infrastructure of the modern financial system. By reducing information costs, they dramatically enhance both static and dynamic market efficiency, the results of which are widely spread among financial intermediaries and end-users of the financial system. They therefore generate positive externalities and, in effect, constitute public goods whose benefits cannot be internalized by the agencies themselves due to the nature of rating production and distribution. The only “pressure point” the agencies have (as the revenue basis for a viable business) is the ability to charge fees to issuers, thereby extracting what is arguably a small part of the economic rents accruing to the issuers and their shareholders. Rents from the availability of the ratings to investors remain uncompensated. The potential interest conflict facing rating

agencies is therefore unavoidable. The question is not whether such conflicts of interest exist. They do. Rather, what checks and balances are there which prevent the conflicts of interest from being *exploited*?

The classic argument is that when such conflicts of interest exist, they will be exploited unless special steps are taken to make such exploitation impossible or unprofitable. The appearance of a major conflict of interest scandal involving the rating agencies could, by itself, compromise the value of that franchise & possibly fatally. Moreover, systematic conflict exploitation would over time show up through a higher incidence of credit problem situations and defaults in an environment where continuous comparisons of ratings by different providers are made by the media and by investors using the services of rating agencies.

The Global Agencies & Coverage and Business Structure

Exhibit 1 lists the principal global and regional credit rating agencies. The three global rating agencies & Moody's, Standard & Poor's and Fitch IBCA Duff & Phelps ("Fitch") – form core of the industry. The international coverage of the major rating groups differs to some degree, with all three having substantial coverage in the US and Europe, but with Moody's having a somewhat greater Asian coverage and S&P focusing somewhat more heavily on Latin America. Fitch (which now also includes Thompson BankWatch) has improved global coverage and on the whole has much of its relative competitive strength outside the US. Japanese raters (JCI, Mikuni and R&I) provide limited

global coverage. There is one global specialist covering the insurance sector, A.M. Best, one providing business credit information, Dun & Bradstreet, one providing global quantitative credit scoring services (KMV), and a variety of national or regional raters, notably in Japan, Sweden, Canada, Germany and Italy. These include Capital Intelligence, covering mainly peripheral markets in the Middle East, Asia and Eastern Europe. In addition, there are a number of local credit rating agencies in emerging market countries B see Exhibit 2.

In addition to ratings of individual fixed income issues, the three major rating agencies have expanded their product lines. They now offer comprehensive “borrower ratings” which look at the financial strength of the issuer of debt as opposed to that of individual debt issues that are subject to specific provisions. Another product is bank loan ratings B including the effects of seniority, collateral, loan covenants and various other repayment protections -- which make it possible to compare recovery rates on impaired bank loans with bonds in default. There also are “financial strength” ratings of banks, which includes an assessment of the operation of the governmental safety net B i.e., the stand-alone credit risk associated with a given bank in the absence of the local safety net. And there are “sovereign ceilings,@ which address questions of country risk and notionally set the maximum rating for all foreign-currency debt issues by borrowers from particular countries.

The ownership of rating agencies varies substantially. Some, such as A.M. Best, Moody=s, Dun & Bradstreet, KMV and Mikuni, are independent, publicly-owned companies. Others like Standard & Poor=s and (formerly) Thomson BankWatch have

been part of publishing companies. Still others are owned by commercial banks, merchant banks and institutional investors, and in some cases are parts of industrial conglomerates. Especially in emerging markets, financial intermediaries are often among the owners of credit rating agencies, and international organizations – notably the International Finance Corporation – have taken an active role in getting agencies established as an important part of local financial market infrastructures. Below we profile the three global generalist raters -- Moody's, Standard & Poor's and Fitch.

The New Moody's Corporation

In December 1999, the Dun & Bradstreet Corporation announced that, to improve overall shareholder value, it was going to split the company into two separate parts – a business information unit (the traditional D&B credit information and other businesses), and a credit ratings business (Moody's), the shares of each of which would be traded in the market. On September 30, 2000 the share distribution took place. The two companies were separated, and Moody's became, for the first time in its 100-year history, a publicly traded corporation reporting to the SEC.

Moody's only business is the publishing of credit ratings and the sale of certain investment advisory products. In June of 2000 Moody's employed 1,500 people in 14 countries and published ratings on approximately 100,000 corporate debt issues by about 5,000 different issuers, plus 68,000 public finance obligations. Revenues amounted to \$564 million in 1999, of which close to 90% were from ratings services. Of the rating

revenues for the first quarter of 2000, 37% came from corporate ratings, 33% from structured finance ratings, 23% from financial institutions and sovereign ratings, and 7% from public finance ratings. About 40% of Moody=s ratings in 2000 were below investment grade. Of all Moody=s revenues for the first quarter 2000, 72% were derived from sources within the United States. Income before taxes in the first quarter 2000 was 61.5 million (a margin of 44.1%) and after taxes, \$34.3 million (a margin of 24.6%).⁴ Moody=s stock was first traded at a market capitalization of approximately \$4 billion, reflecting an approximately 25 times the firm=s price-earnings ratio.⁵ Thus the “ratings franchise value@ at Moody=s would appear to be relatively high in economic terms.

Moody=s entire business is tied to publishing and updating rating analyses for various forms of debt obligations. Debt issuers believe that markets place a high value on a Moody=s rating, and are willing to pay a fee to Moody=s to obtain a rating. Moody=s also sells information and management tools to investors, and much of this information is based on its ratings analyses. The firm is registered as an investment advisor under the Investment Advisers Act of 1940 (not all rating agencies are so registered), and has been designated as a Nationally Recognized Statistical Rating Organization (NRSRO@) by the SEC. In 1997, the SEC proposed regulations that would define the criteria requiring that applicant meet certain SEC monitored standards for granting NRSRO status. Moody=s

⁴Registration statement on Form 10 filed with the Securities and Exchange Commission by The New D&B Corporation, June 27, 2000.

ratings are used by a variety of institutional investors, financial services firms, and by banking and securities regulators to classify risk exposures.

Moody's has a policy of charging a fee in advance for every rating that is requested of it. There is a standard fee schedule that reflects a volume discount for entities that have multiple issues outstanding. It occasionally will rate an issue that does not involve an issuer's request for a rating as a service to the market, in which case it does not charge a fee. Sometimes, a rating applicant cancels its request for a rating after learning what the rating will be, in which case it will not be published. In most cases rating applicants obtain more than one rating, and are known to shop around for the best ratings. Moody's competes principally with two large rating companies, Standard & Poor's and Fitch, as well as with various non-US agencies and specialty firms. The firm is, however, clearly among the best known and highly regarded rating services, and as a result issuers often feel they must have a Moody's rating to achieve the lowest possible cost of funds.

Standard & Poor's Corporation

Standard & Poor's Rating Services (S&P) was founded in 1916 and developed into the principal competitor to Moody's as a supplier of credit information and risk analysis to investors in fixed-income securities. Initially, S&P ratings focused on conventional debt issues of corporations and general obligation bonds of states and municipalities. Later, S&P ratings encompassed the full range of credit-related products as they appeared in the market, including commercial paper, sovereign debt, mortgage- and

⁵The new D&B Corporation had a market capitalization of about \$3 billion at the same time.

asset-backed securities, loan-anticipation notes, project-finance debt, municipal revenue bonds and special agency issues, bond insurance, fixed-income and money market mutual funds, debt supported by letters of credit, as well as preferred stock.

Standard & Poor=s was an independent company until 1966, when it was acquired by the McGraw-Hill Companies, Inc., a publishing firm active in textbook publishing, media and information services. McGraw-Hill publishes *Business Week*, and a variety of trade publications, and provides Internet portals in aviation, construction and energy, healthcare information and broadcasting stations.

Remarkably, McGraw-Hill has remained an independent firm in an industry that went through at least a half dozen waves of technological change and consolidation and that saw many of its competitors swallowed-up into media conglomerates like AOL Time Warner, Pearson PLC and News Corp.⁶ For the S&P business, this has (according to S&P itself) meant a relatively high degree of independence with two sets of “buffers” between the rating activity and the issuers – one between the Ratings Group and S&P itself, and the

⁶McGraw-Hill the firm was founded in 1909 by James H. McGraw and John A. Hill, who formed an alliance of their publishing companies by merging their book publishing businesses but keeping the remainder of their operations separate, each growing rapidly in part through acquisitions. Hill=s death in 1916 eventually led to a full merger of the two businesses into the McGraw-Hill Publishing Company in 1917. The company continued to grow and went public in 1929, the year in which *Business Week* was first published. James McGraw=s son, James Jr. was CEO until 1950 and was succeeded by his brother, Curtis W. McGraw, under whom expansion continued beyond the firm=s traditional base in engineering and sciences into the social sciences, business and management, and from higher education textbooks into high school and elementary level educational publishing, a course continued under his brother Donald C. McGraw with numerous acquisitions in an array of publishing and business information areas. S&P was added in 1966. McGraw-Hill contributions in the securities area included the creation of the CUSIP numbering system to track securities in 1968. Following a series of further acquisitions in areas like broadcasting under CEO Shelton Fisher, Harold McGraw, grandson of the founder, took over the firm in 1974. He was succeeded by Joseph Dionne in 1988, marked by ventures into custom publishing, the Internet and a new corporate identity as the McGraw-Hill Companies, and succeeded in turn by Harold McGraw III, who had been with the firm since 1980. The firm is marked by a strong commitment to sustained independence and (arguably) the continuing influence of the McGraw family in the company=s affairs.

other between the S&P corporate entity and its owner, the McGraw-Hill Companies. Although one might argue that true independence is tested by continually changing business pressures, there has never been any allegation that the parent company has made any effort to interfere in S&P ratings activities.⁷ S&P claims that it bases its ratings “on a rigorous, defined methodology and freely published criteria...@⁸

At a time when other aspects of information provided to the financial services market infrastructure -- such as investment banking research⁹ and audits conducted by major CPA firms also engaged in consulting and investing in audit clients -- have been subject to intense criticism, S&P and its parent make a major effort to maintain a convincingly independent profile.

⁷S&P emphasizes in its publicity materials that it operates without government mandate and has no links whatsoever to any investment banking firm, bank or other type of financial intermediary, and does not engage in any type of trading or underwriting activities. “Our sole mission is to provide objective, insightful risk analysis and evaluation.”

⁸Standard & Poor=s Website at <http://www.standardandpoors.com/ratings/>

⁹See for example Gretchen Morgenson, “How Did So Many Analysts Get It So Wrong?@ *New York Times*, December 31, 2000.

Fitch

Long the weakest of the principal US rating agencies, Fitch Investors Service in 1997 merged with the IBCA Group in London to “put together two complementary companies that shared a dedication to analytical quality, openness in their reasoning, and first-rate client service@ in the form of Fitch IBCA.¹⁰

Like Moody=s and S&P, Fitch has been a designated by the SEC as a Nationally Recognized Statistical Rating Organization since 1975. It has attempted with mixed success to encroach on the two major agencies= market shares with aggressive marketing in both the corporate and municipal bond areas, and particularly in structured finance. Some have argued that the presence of an aggressive third competitor has encouraged ratings-shopping among issuers and that Fitch has tended to have the Asoftest@ rating criteria B countered to some degree by dual-rating requirements imposed on issuers by the markets or by regulators. In 2000 Fitch acquired two additional rating agencies. The first was Duff & Phelps, a second-tier US rating agency with significant strengths in a relatively narrow range of issuers. The second was Thomson Financial BankWatch, an international rating agency concentrating on the financial services sector. Fitch is arguably Europe's leading rating agency, and has particularly emphasized its coverage of European corporate bonds B a market that has experienced substantial growth since the advent of the euro in 1999 B along with its worldwide coverage of

¹⁰Fitch IBCA Website at <http://www.fitchibca.com/>

financial institutions and sovereign governments. Fitch employs over 600 analysts and staff in 21 offices worldwide.

Fitch is owned by a French conglomerate, FIMALAC SA, that was founded in 1991 when it divested its interests in several French real estate and media companies and redeployed the assets in the acquisition of Fitch IBCA and a variety of other businesses, including the world=s fourth largest storage company of chemical products, a manufacturer and distributor of office supplies and furniture, and providers of alloys derived from precious and non-precious metals. FIMALAC has 4,000 employees in some 30 countries located in Europe, North and South America, East Asia, Africa and Australia. A French investor, Marc Ladreit de Lacharrière, indirectly owns 64% of the group=s total capital, with the remaining 36% held by the public and listed on the Paris Bourse.

The ownership and control of Fitch is thus very different from both of its major competitors. It is non-US and non-publishing, with indirect linkages to industry.

International Activities and Joint Ventures

Each of the three major rating agencies has pursued a strategy of globalization, in part to reflect the growing international integration of fixed-income markets among the OECD countries and in part to pick up new business in local markets, especially in developing countries. Their contribution in creating both global consistency and setting local standards for credit analysis is doubtless significant and has been actively promoted by multilateral agencies, notably the International Finance Corporation, part of the World

Bank Group. The multilateral institutions somewhat belatedly came to the realization that the functioning of local banking and capital markets makes a disproportionate contribution to economic growth, and began to redirect their focus toward those markets from dominant reliance on project financing. This includes viable bank regulation and supervision, efficient exchanges, clearance and settlement, security market supervision, etc. Clearly the presence of internationally recognized credit rating agencies fits well into such a program. Examples of local credit rating agencies in some of the emerging market countries are provided in Exhibit 1.

In providing ratings and research covering over 150,000 debt obligations issued by corporations, financial institutions, governments and governmental entities in over 100 countries, New York-based Moody's maintains offices in London, Paris, Frankfurt, Madrid, Milan, Limassol (Cyprus), Tokyo, Singapore, Hong Kong, Sydney, Toronto, São Paulo, Mexico City, San Francisco and Dallas. The firm claims to be able to achieve consistency in rating standards through its direct presence in these financial markets. However, to achieve greater penetration of international markets, especially of the less transparent emerging financial markets that cannot justify a stand-alone presence but where the contribution of rating agencies can be greater than in the more transparent major financial markets Moody's has elected to establish alliances with leading local credit rating agencies. This includes Korea Investors Service (Korea); Dagong Global Credit Rating Co. (People's Republic of China); ICRA Ltd. (India); Clasificadora de Riesgo Humphreys Limitada (Chile), and Humphreys Argentina S.A. (Argentina). These focus exclusively on ratings in the local-currency debt markets, and presumably leverage off Moody's

reputation. How extensively Moody's is able to monitor and control the professional standards and conduct of these alliances is not known.

Standard and Poor's has direct local ratings representation in Argentina, Australia, Brazil, Canada, France, Germany, Hong Kong, Italy, Japan, Mexico, Russia, Spain, Singapore, Sweden and the United Kingdom. Like Moody's, it has a number of local affiliates including ones in the Philippines, India, and Russia. Fitch has a direct local presence in Argentina, Australia, Brazil, Chile, France, Germany, Hong Kong, Mexico, Singapore, South Africa and the United Kingdom, as well as several affiliated companies such as Apoyo & Asociados Internacionales SA (Lima), Clasificadores S&S C.A. Sociedad Clasificadora de Riesgo (Caracas) and CASE (Mumbai).

It is clear that each of the three major rating agencies has made significant efforts to cement its position in the principal national financial markets and to transfer its approach to debt ratings into those markets. All of the principal local markets for fixed-income securities in the OECD countries are covered by a direct presence of at least two of the three major agencies, and all three in the case of the premier markets. There seems little doubt that the leveraging of the firms' reputational capital into these markets has substantial benefits in terms of market transparency and efficiency, and that these benefits are at least partly the product of sharp competition between them. However, much of this competition is conducted through distant branch offices or partly-owned affiliates over which the parent organizations may not have effective supervisory control.

Competitive Structure and Pricing

Though close to a duopoly (even in the presence of a third major contender), the credit rating business raises some interesting issues regarding the ability of smaller agencies to survive. It appears that most of these smaller rating agencies in fact obtain their revenues from subscribers, as shown in Exhibit 3, which is also true of such global specialists as A.M. Best and KMV. Subscription-based raters generally use quantitative rating models and have no particular need for proprietary information from issuers. Their costs are sufficiently low to make a subscription-based business approach commercially viable. All of their ratings are therefore “unsolicited” and they play a very useful, complementary role in the financial market infrastructure with respect to the fee-based majors.

The rating agencies are reluctant to discuss specific fees charged for ratings. One study estimates that S&P fees for public corporate debt issues ranged from \$25,000 to more than \$125,000 per issue, with the usual fee amount being 0.0325% of the face amount of the issue.¹¹ Moody’s typical charges were understood in 2000 to be approximately 3-5bp on the issue amount, with a minimum of \$25,000 and a maximum of \$80,000 (except for complex issues where the charges could run considerably more), and some discounts are available for large, multiple issuers.

In terms of sectoral distribution, U.S. banks contributed the largest share of rating agency revenues in the late 1990s, due to the large number of debt issues offered by the

¹¹William F. Treacy and Mark S. Carey, “Credit Risk Rating at Large US Banks,” *Federal Reserve Bulletin*, Vol. 84, November 1998.

banks (fees were said to average over \$100,000 per agency), followed by utilities and industrials (averaging between \$25,000 and \$100,000 per issue per agency per year).¹²

As noted, there is substantial evidence that rating “shopping” has occurred from time to time, particularly at the critical break-point between investment-grade bonds and non-investment grade (“junk”) bonds, since many institutional investors are prohibited from investing in the latter. A Federal Reserve Bank of New York study in 1996 indicated that issuers often gained an investment-grade rating from a third agency if one of the two major agencies rated their bonds as non-investment grade.¹³

Nevertheless, one study suggests that the existence of three competing rating agencies is in fact valued by the financial market.¹⁴ Firms that obtain Fitch ratings tend to have higher Moody=s and S&P ratings than those that do not. They also tend to secure lower yields on debt issues, after controlling for their Moody=s and S&P ratings. The ratings are also likely to be more stable, and they are more likely to receive an upgrade from the other two agencies than firms that do not have a Fitch rating. And in cases of split ratings, Fitch tends to serve as a tie - breaker, an event that has had significant impact on bond yields.

¹²Joseph Cantwell, “Managing Credit Ratings and Agency Relationships,” *Treasury Management Association Journal*, November/December 1998.

¹³Richard Cantor and Frank Packer, “The Credit Rating Industry,” *Journal of Fixed Income*, December 1995.

¹⁴Jeff Jewell and Miles Livingston, “A Comparison of Bond Ratings from Moody=s, S&P and Fitch IBCA,” *Financial Markets, Institutions and Instruments*, Vol. 8, No. 4, 1999.

A recent survey of 474 US industrial companies and 387 mutual funds that invest in publicly traded domestic debt securities assessed both investor groups' views of the three major rating agencies.¹⁵ The authors concluded that the two groups differ dramatically in their views of the agencies. Issuers think they need more ratings in order to ensure a "true" valuation in the marketplace, while institutional investors want fewer ratings to ease portfolio decision-making in the light of their own sophisticated internal credit analyses. B i.e., using agency ratings only as additional inputs to internal evaluation and for "certification" purposes. Another finding is that both issuers and investors consider Moody's and S&P ratings to be more accurate than Fitch's, leading to a differentiation in their respective certification values.

¹⁵ "How Do Bond Issuers and Investors View Credit Rating Agencies?" No author. Working paper submitted for journal publication, 2000.

The major rating agencies are complemented in many financial markets by local rating agencies. There is a question whether their standards are up to the level of the majors, and whether they are equally capable of managing potential conflicts of interest. In some countries, local rating agencies are owned by financial institutions and other firms involved in the financial intermediation process that could compromise the agencies' objectivity. In some cases local agencies have been associated with the majors in joint ventures, which could help to alleviate this problem. And there is evidence that local knowledge brought to bear by local agencies in countries like Japan actually does add to the information used by investors to price securities.¹⁶

Rating-shopping is a potential concern related to the industry's competitive structure. Recall that rating-shopping occurs when issuers seek out raters that will take a more benign view of creditworthiness, or offer to lower ratings fees than their rivals, or participate in collusive arrangements between issuers and raters to skirt portfolio restrictions or regulatory criteria, or search for countries or market environments in which raters take a more favorable view of the issuer. However, research has found that the ratings of the two major agencies are very highly correlated, suggesting a general lack of outlier ratings that might be the result of exploitation of conflicts of interest. Nevertheless, there is evidence that Moody's and S&P give lower ratings than the smaller agencies, and that this difference is systematic. On the other hand, rank correlations between major and smaller agencies is very high, suggesting that their *relative* ratings are also very similar. In

¹⁶Frank Packer, "Credit Risk in Japan's Corporate Bond Market," Federal Reserve Bank of New York, *Current Issues in Economics and Finance*, Vol. 5, No. 15, November 1999.

short, there does not appear to be any prima facie evidence of conflict of interest exploitation in empirical studies of relative agency rankings.¹⁷

Some observers have considered this a problem. For example Cantor and Packer note that “some agencies appear to have different absolute scales, rating bonds higher or lower on average than other agencies.” And even normal variation of opinion across agencies with the same basic scales confounds the use of ratings for regulatory purposes or for setting portfolio constraints. These problems multiply as the number of agencies and the differences between them increase.¹⁸

Another study, based on survey methodology, suggests a great deal of variation in how issuers and investors view the work of rating agencies. Issuers, for example, were found to favor multiple ratings in order to price issues more “accurately” (i.e., better for them), while investors generally favored one, or at most two, ratings from the dominant agencies B mainly in order to satisfy regulatory or certification requirements. The latter in many cases appear to rely primarily on sophisticated in-house buy-side analysis as opposed to the substantive content of agency ratings. Ratings from the two major agencies were universally favored on the presumption of higher-quality and more-consistent research, reinforcing the duopoly market structure, except in the case of split ratings.¹⁹

¹⁷*Credit Ratings and Complementary Sources of Credit Quality Information* (Basel: Bank for International Settlements, 2000).

¹⁸Richard Cantor and Frank Packer, “The Credit Rating Industry,” *Journal of Fixed Income*, December 1994.

¹⁹NN, “How do Bond Issuers and Investors View Credit Rating Agencies?” Unpublished Working Paper (anonymous journal submission).

A further consideration that limits monopoly power on the part of the rating agencies lies at the core of their business – human capital. The ratings business relies on a people who are carefully recruited, and who are then trained and gain experience in the complex rating process – including interactions with issuer management groups. These people soon find that their skills are quite portable. All of the rating agencies have long been considered prime territory for headhunters seeking analysts for investment banks and institutional investors. In many cases the agencies cannot compete with investment banks, for example, with respect to compensation, and focus their recruiting and retention arguments on job security, a reasonable lifestyle and steady, if gradual, promotion within the firm. Still, if people want to leave they will leave, and this diffuses the imbedded human capital and limits the potential for excess returns.

All of this having been said, there is at least circumstantial evidence that the ratings business is a very good business to be in.²⁰ Since S&P is part of a broad-gauge publisher whose divisional earnings are not publicly available, and since Fitch is privately held, only the new Moody's Corporation shown any relatively "clean" evidence of profitability. For the year 2000, following the firm's launch in the market, shares showed a total return of almost 52% in a flat or declining market, trading in February 2001 at a P/E of 21.57 with a return on assets exceeding over 40%. In addition, the stock has been relatively stable ($\beta = 0.80$). Such impressive performance, if representative of the other two agencies, clearly reflects

²⁰See Lawrence White, "Industrial Organization of Global Rating Agency Business," paper presented at this conference.

the value of the franchise and, by inference, the magnitude of the damage that could be inflicted through exploitation of conflicts of interest.

Ratings and the Regulators

Ratings are used in prudential supervision in a large number of countries. Exhibit 1 shows how credit ratings fit into the regulatory regimes of various developed and emerging markets countries. In a recent survey it was found that virtually all of the developed countries= banking regulators in one way or another used credit rating agency information in the financial regulation activities.²¹ Of the 12 BIS Basel Committee on Banking Supervision countries, 11 did so in 2000. To be certified by regulators B for example, being designated an NRSRO in the US B rating agencies must use techniques that are “rigorous, systematic, continuous and subject to some form of validation based on historical experience.@ They must also be independent and the methodology must be “as free as possible from any external political influence or constraints or economic pressures from assessed entities.@²² Four countries specifically note “credibility as a criterion for agencies whose ratings are used for supervisory purposes.

It is useful to think of financial regulation and supervision as imposing a set of "taxes" or "subsidies" on the operations of financial firms exposed to them. On the one hand, the imposition of reserve requirements, capital adequacy rules, interest/usury

²¹ *Credit Ratings and Complementary Sources of Credit Quality Information* (Basel: Bank for International Settlements, 2000).

ceilings and certain forms of financial disclosure requirements can be viewed as imposing implicit "taxes" on a financial firm's activities in the sense that they increase costs. On the other hand, regulator-supplied deposit insurance, lender-of-last resort facilities and institutional bailouts serve to stabilize financial markets and reduce the risk of systemic failure, thereby lowering the costs of financial intermediation. They can therefore be viewed as implicit "subsidies" provided by taxpayers.²³

The difference between these "tax" and "subsidy" elements of regulation can be viewed as the *net regulatory burden* (NRB) faced by financial firms in any given jurisdiction. Financial firms tend to migrate toward those financial environments where NRB is lowest C assuming all other economic factors are the same. NRB differences can induce firms to relocate where financial transactions are done as long as the savings realized exceed the transaction, communication, information and other economic costs of doing so. Since one can argue that, in today's global financial marketplace, transaction costs and other economic costs of relocating are likely to be small, one can expect financial market participants to be extremely sensitive to changes in current and perceived NRBs among competing regulatory environments. To some extent, the regulators responsible for particular jurisdictions appear to recognize this sensitivity and B in their

²² Ibid, pp. 41-47.

²³ See Edward J. Kane, "Competitive Financial Reregulation: An International Perspective," in R. Portes and A. Swoboda (eds.), *Threats to International Financial Stability* (London: Cambridge University Press, 1987).

competition for employment and value-added creation, taxes and other revenues B have engaged in a form of competition over NRB levels, a kind of "regulatory arbitrage."²⁴

Competition will spark a dynamic interplay between demanders and suppliers of financial services, as banks and securities firms seek to reduce their NRB and increase their profitability. If they can do so at low cost, they will actively seek product innovations and new avenues that avoid cumbersome and costly regulations. This may be easier when there are multiple and overlapping domestic regulatory bodies, as well as in the global case of multiple and often competing national regulatory authorities.

A domestic financial system like the United States may have multiple regulatory authorities too, complemented by a host of other regulators at the state and local levels. For example, at the federal level financial activities could fall into the regulatory domain of the Federal Reserve Board, the Comptroller on the Currency, the SEC, and the Commodity Futures Trading Commission, to name just the major regulatory agencies. Each of the fifty states also has its own regulatory body to deal with banking, securities and insurance. Every city and municipality has an agency responsible for local income taxes, real estate taxes, transfer taxes, stamp duties, and so on, all of which affect the NRB bearing on financial firms. The situation is complicated still further by ambiguity regarding the definition of a "bank," a "security," a "commodity," an "exchange," and so forth C blurring the lines of

²⁴See Richard Levich and Ingo Walter, "Tax Driven Regulatory Drag: European Financial Centres in the 1990s," in Horst Siebert (ed.) *Reforming Capital Income Taxation* (Tübingen: J.C.B. Mohr (Paul Siebeck), 1990).

demarcation between both products and firms, and raising questions about which regulatory agency holds jurisdiction.²⁵

NRB associated with regulations in onshore financial markets creates opportunities to develop parallel, offshore markets for the delivery of similar services. Barriers such as political risk, minimum transaction size, secondary market liquidity, firm size and credit quality help temper the migration of financial activity abroad, although offshore markets can be used to replicate a variety of financial instruments such as forward contracts, short-term commercial paper, bonds, Eurocurrency interest rate futures, and the like — many of which are exposed to significant NRB by national financial authorities. These pose a general competitive threat to onshore securities or banking activities, although entry and exit costs, currency conversion costs, and distance-related delivery costs — plus uncertainties surrounding these costs and problems of management control — are effective barriers to complete NRB equalization across countries.

The rise of regulatory competition and the existence of offshore markets thus underscores the fact that financial services firms often face a range of alternatives for executing transactions in any of several financial centers. The development of offshore currency and bond markets in the 1960s was a case where borrowers and lenders alike

²⁵Edward Kane (*op. cit*) has argued that regulation itself may be thought of in a "market" context, with regulatory bodies established along geographic, product, or functional lines competing to extend their regulatory domains. Financial firms understand this regulatory competition and try to exploit it to enhance their market share or profitability, even as domestic regulators try to respond with reregulation in an effort to recover part of their regulatory domain.

found they could carry out the requisite market transactions more efficiently and with sufficient safety by operating offshore, in what amounted to a parallel market. Domestic regulators usually want to have the transactions conducted within their own financial centers driven by their desire to maintain an adequate level of prudential regulation, sustain revenues from the taxation of financial services, support employment and output in the financial services industry and linked economic activities, or simply maximize their regulatory domain. And so the market for financial regulation is "contestable" in the sense that other national regulatory bodies or offshore opportunities offer (or threaten to offer) rules that may be more favorable than those of the domestic regulator.

As any factor of production or economic activity gains mobility, it becomes increasingly difficult to subject it to unreasonable regulation. In today's world communications costs are low and capital mobility is high, so it is becoming less and less feasible for a state or a nation to impose an NRB that stands too far apart from world norms. Still, it is likely that a long-run equilibrium can be sustained with a *positive* overall NRB. Financial firms ought to value location in the midst of an important and orderly market, their access to financing by lenders of last resort, and the opportunity to be headquartered in a stable and secure political climate. Indeed, we observe that those markets that are almost totally unregulated, such as the Eurocurrency market (with NRB approaching zero), have not in fact completely dominated financial transactions subject to location-shifting.

If financial institutions find it in their interest to pay some regulatory tax, the economic question then centers around the sustainable magnitude of this net regulatory

burden. It seems probable that the progressive convergence in regulation of banks, securities firms and other types of financial firms will continue. Players based in the more heavily regulated countries will successfully lobby for liberalization, and there will be an emergence among regulators of a broad-gauge consensus on minimum acceptable standards that will eventually be accepted by those countries with substandard regulatory regimes. The objective is to optimize the balance between market efficiency and regulatory soundness, so that market forces are free to become the main determinants of what transactions are carried out, where and by whom.

The rating agencies are an integral part of implementing NRB at the national level to the extent that they are incorporated in the regulatory process. They clearly impose costs on financial intermediaries such as institutional investors by limiting investments to certified securities and possibly displacing portfolio allocations B costs that eventually are borne by individual investors. They also increase costs to issuers and in some cases may cause deviations from optimum capital structures. At the same time, they generate substantially lower information costs as a public good, especially in less transparent financial market, which lowers NRB. Rating agencies, in short, generate both burdens in the form of monetary and non-monetary costs as well as benefits in terms of reduced information and certification costs, and therefore may be an important factor in the NRB equation.

An additional dimension comprises the BIS proposals to improve the “granularity” of bank capital adequacy standards in comparison to the crude credit risk “buckets” that have prevailed in recent years B along with their perverse effects in redirecting credit within

borrower classes. While the ultimate objective of the BIS proposals is to allow banks to use proprietary credit scoring models that, in turn, are themselves subject to regulatory vetting, one of the proposed options available to banks would be to use rating agencies' assessments (or those of national export credit agencies, or ECAs) as a basis for capital provisioning by banks. There is also the issue of mapping internal credit assessment onto the credit agencies' assessments. If adopted, the BIS proposals are likely to increase the demand for rating agencies' services, at least for a while, and further enhance their role in the financial market infrastructure.

Historically, the major rating agencies have been against the use of credit ratings in the regulatory process due to potential impact of rating changes on financial markets, incentives to engage in ratings-shopping, the accuracy of ratings in reflecting the underlying risks, the use of ratings as "automatic pilot" substitutes for proper credit analysis by lenders and investors, and the pressure that might be brought to bear on the agencies if they were to become too closely tied to the regulatory process including regulation of the agencies themselves. Their revenue streams would become increasingly driven by regulatory certification as the agencies' *raison d'être*, placing them on a slippery slope leading away from their historic mission of serving the information needs of private savers and investors.

Conflicts of Interest and Franchise Value

The previous sections of this paper have surveyed some of the principal structural elements of the global credit rating business and its use in a regulatory context within the

framework of the net regulatory burden. We have also indicated the key potential for conflicts of interest that is inherent in the major agencies= almost exclusive reliance on fees paid by issuers, and the reasons for this based on the concept of public goods. The key issue is therefore whether exploitation of this inherent conflict is in fact a problem, and whether it is one that could bear negatively on the functioning of financial markets.

Conflicts of interest can potentially occur at a number of “pressure points@ in the ratings process:

- At the initial contact between the issuer and/or its investment bank in soliciting a rating.
- In the application by the issuer of the agency=s rating model and assessment of an issue=s rating-sensitivity to changes in the structure of the offering and discussions with agency staff.
- During meetings between the agency=s staff and corporate management of government officials and the assembly of both public and private information.
- During the preparation of a recommendation to the rating committee, and during the committee meeting leading to the rating to be assigned.
- During the comment period made available to the issuer between the preliminary assignment of a rating and its publication.
- Following rating reviews which place an issuer on a Awatch list@ for possible re-rating B usually negative, stable or positive B after there has been an unexpected material change in the issuer=s fundamentals and announcement that a rating review is in process.²⁶

When an agency issues an unsolicited rating -- as S&P and Moody=s do in the case all taxable SEC-registered public issues in the US for which the issuer does not

²⁶According to S&P, about two thirds of such actions lead to a subsequent rating change.

request a rating B based on public information and the issuer argues that the rating is based on a lack of material information.

In the case of sovereign ratings, which generally set a “sovereign ceiling” for other issuers domiciled in the country concerned, and the government or issuers brings pressure to bear on the agency that it is being too conservative B pressure that may be especially telling where the agency is focusing on the soundness of the domestic banking system or where it has a significant business or joint venture in the country. Since reputation is the major agencies= key asset, it seems likely that besmirching the reputations of competing agencies is sometimes too tempting to resist. There is little evidence of such activity among the two major agencies, although the smaller ones have from time to time raised reputation questions about the two dominant players.²⁷ According to one spokesman, “We’ve been managing the issue of multiple constituencies for years. If we started inflating ratings to get business, it would become readily apparent to investors and our overall credibility as a rating agency serving the global credit markets would be at stake. We are constantly evaluating what we do and mindful of the investors we serve.”²⁸

A view critical of the “reputational capital” or “franchise value” concept of the conduct of rating agencies holds that reputation cannot be empirically linked to estimation of credit spreads, the use of credit derivatives and the large number of ratings-driven

²⁷*The Economist, idem.*

²⁸NN, “How do Bond Issuers and Investors View Credit Rating Agencies?” Unpublished Working Paper (anonymous journal submission).

transactions.²⁹ The author suggests that a “regulatory license” view of the role of credit agencies B which attributes value mainly to enabling investors to meet certain regulatory constraints through the use of agencies B dominates, and suggests that regulatory constraints should be replaced by bond market traded credit spreads (which reflect all available information known to investors). If the “regulatory license” view is correct, it would deprive the rating agencies of much of their value, at least in well-functioning markets. It also suggests that there is constraint on the exploitation of conflicts of interest by the rating agencies other than safeguarding reputation, namely credit spreads determined in the market. One safeguard thus is the market itself.

As a public company Moody=s, for example, is subject to the requirement to report all material information concerning its business, including all of its operating and financial information, periodically. It is subject to regulatory and legal penalties for failing to report this required information accurately. As a registered NRSRO and Investment Advisor, its rating activities and professional conduct are subject to SEC review and sanctions. Ultimately the rating agencies enjoy *de facto* certification by the principal securities regulators, such as the SEC in the United States and the FSA in the United Kingdom, at least until something disturbs prevailing conditions. An SEC complaint or disciplinary action or the withdrawal of a certification could result in severe damage to the future ability of a rating agency to attract business. Most businesses are not scrutinized anywhere near

²⁹Frank Partnoy, “The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies,” Washington University Law Quarterly, Vol. 77, No. 3 (1999).

as closely as are rating agencies, nor they are as potentially subject to loss of shareholder value in the case of management failure or misconduct.

Second, and closely linked to regulatory and legal sanctions, are market penalties. Violations of legal or professional standards in conducting its rating business can make all outstanding ratings suspect, and destroy the perceived value of having a rating from the agency that granted it. Such conduct would appear to have disproportionately serious consequences on the future business and market value of the company. This concern should be reflected in management practices such as compensation policies. Moody's (in an interview with the authors) reported that its compensation policy for rating personnel was not to tie compensation or performance evaluation to the revenue stream of the business in any way.³⁰ Thus a potential moral hazard in which ratings could be overstated, or manipulated in return for higher compensation to the staff involved would appear to be precluded.

In its SEC filing, Moody's lists among the serious risks related to its business the fact that its "success depends on its ability to maintain its professional reputation and brand name." It depends on its reputation, it says, "in order to secure new engagements and hire qualified professionals." Further, it adds, "any event that hurts Moody's reputation including poor performance or errors in ratings (whether real or perceived) may negatively impact Moody's ability to compete." Indeed, in one hundred years in the ratings business, Moody's has not suffered any such major loss of economic value as a result of

³⁰Interview with Moody's employees Jerome S. Fons, Managing Director, and Richard Cantor, Vice

ratings misconduct, and it has probably learned how to manage the natural conflicts and temptations of the business, although as long as it is possible to fudge a rating, the company must remain vigilant. Reputation effects can be especially relevant in markets where there is imperfect information, as is the case with ratings.³¹

Third, in addition to the rating agencies= certification and franchise value, exploitation of conflicts of interest also tends to be constrained by their vulnerability civil lawsuits. For example, a 1983 default by the Washington Public Power Supply System, the 1991 default by Executive Life and the 1997 default by Orange County, California ass triggered legal actions against the rating agencies. Given the extremely litigious environment in the United States and the ability to bring civil actions in US courts in the event of problems incurred elsewhere in the world.

The Issue of Unsolicited Ratings

One nagging question is whether an issuer that is subject to an unsolicited rating of one of its issues is driven to negotiate a solicited rating in return for a fee and the hope that such a rating will be more favorable. However, in most unsolicited ratings the issuer does in fact participate. According to Moody=s, “a misperception has persisted that our unsolicited ratings are assigned without the benefit of issuer participation, whereas in the

President, July 2000.

³¹David M. Kreps and Robert Wilson, “Reputation and Imperfect Information,@ *Journal of Economic Theory*,@ Vol. 27, August 1982.

vast majority of cases issuers have in fact participated in the rating process.³² Moody=s designates each unsolicited rating as such in the respective press release. S&P issues *pi* (relying on an issuer=s public information and other information in the public domain) ratings, which are not based on confidential corporate information supplied by the issuer=s management and are reviewed each year based on new financial information. Or they may be triggered by a material event affecting the issuer=s credit standing. S&P=s *pi* ratings are not subject to shading or re-rating watch lists.

In 1996 the US Department of Justice initiated an investigation into a possible breach of antitrust laws in connection with the conduct of in the rating agency business. The principal focus was Moody=s use of unsolicited, or “hostile” ratings, which occur when an agency rates a bond issue even though it has not been explicitly mandated or paid to do so by the issuer. Moody=s defense was that it owed an obligation to investors as well as issuers, and was protected under free speech in notifying the public of its views, particularly when the firm considered competitors= ratings to be wrong. However, in a legal action against Moody=s in October 1995 the Jefferson County School District in Colorado accused the firm of “fraud, malice and wonton conduct@ in issuing a “punishment” rating of the District=s bonds after it had failed to hire the agency to rate them. Moody=s was also shown to have invoiced issuers of bonds subject to unsolicited ratings after the fact, with

³² “Designation of Unsolicited Ratings in Which the Issuer Has Not Participated,@ Moody=s press release, November 1999.

accompanying letters that appealed to wavering companies to A...reflect on the propriety of failing to pay for the substantial benefits that the issuer reaps from our efforts.@³³

Moody=s, in response said, “a rating is always solicited, as it is either requested by the issuer or investor, in most cases by both constituents. When Moody=s initiates unsolicited ratings, we always invite management to participate, a fact that has often been misperceived.@³⁴ Moody=s goes on to argue that unsolicited ratings are sometimes initiated where credit risk appears to be misunderstood or mispriced in the market or where the issuer is involved in a cross-border transaction into a market that has grown to rely on credit ratings B but that in all cases the firm aims at global consistency in its rating practices.

For its part, Standard and Poor=s does not do unsolicited ratings B given the absence of management cooperation B although it does issue its public information (*pi*) ratings for emerging market banks and European insurance companies, for example, where there is strong investor demand. It also provides *pi* ratings of bond issues in the US capital market where SEC disclosure requirements are felt to be sufficient to obviate the need for management cooperation. Critics have argued that unsolicited and *pi* ratings are basically the same thing, with the same underlying motivation on the part of the rating agencies.

³³As quoted in “Credit Rating Agencies,@ *The Economist*, April 6, 1996, p. 56.

³⁴Chester Murray, Managing Director, Moody=s Europe as quoted in Katherine Morton, “Time to Face the Image Problem,@ *Credit*, April 2000.

The element of compulsion certainly exists in a firm's response to an unsolicited rating "thrown over the wall." It can choose to cooperate and provide information to improve the accuracy and completeness of the basis for the rating, which would tend to improve market information whether or not the firm eventually pays for the rating. One apparent intent underlying unsolicited ratings is to prevent rating shopping or to respond to investor requests, although the Moody's allegations cast some doubt on at least part of this motivation. On the other hand, it is likely that some additional information or analysis does reach the market in this way B although the fact that they are based solely on publicly available information may on average imply a negative or conservative bias associated with such ratings.

Sometimes the use of unsolicited ratings has an impact on how the rating agencies themselves are rated. A recent study of the Japanese rating environment, for example, found that the two local rating agencies, Japan Credit Ratings and R&I provided higher-quality ratings than Standard & Poor's and Moody's, a result the authors ascribe to the use of unsolicited or indicative ratings by the two majors B which in turn suggests that the indigenous agencies can be more easily manipulated.³⁵ This raises the possibility that unsolicited ratings can actually mitigate conflicts of interest, rather than exacerbating them.

³⁵Joseph Cantwell, "Managing Credit Ratings and Agency Relationships," *Treasury Management*

The Problem of Local Involvements

Whereas the aforementioned legal, regulatory and market sanctions may well prove effective in the rating agencies= businesses in the world=s major financial centers, the same may not be true in secondary and emerging financial markets. Local markets are subject to political and business pressures that are sometimes very different from those in the key Anglo-American markets, for example, where all three of the global rating agencies are based. So there is always the question of conflicts of interest arising in such markets. Although these are likely to be limited to the local markets themselves, they always run the risk of more broadly contaminating the firms= global franchises.

In early 2000 controversy erupted over the major rating agencies= respective assessment of Mexico=s economic prospects. It was alleged that the respective competitive positions of S&P and Moody=s in the Mexican ratings business could perhaps explain their very different assessments of the country=s debt service prospects. Moody=s had put the country=s long-term foreign currency debt under review for a possible upgrade from junk to investment grade status, citing Mexico=s improving debt service burden and reflecting analysts= perceptions of reduced risk. Standard & Poor=s rated Mexico=s long-term foreign currency debt as non-investment grade, one notch below Moody=s, and indicated that it would not be considering an upgrade until after the Presidential elections in July 2000 B Mexican presidential elections have frequently coincided with substantial economic and financial turmoil and policy changes.

Moody's announcement was widely praised by the Mexican government and sparked a rally in local bond and equity markets, bolstering Moody's chances of winning mandates for a long queue of government entities and corporates planning to issue bonds in the ensuing months. Moody's denied that its aggressive selling effort had anything to do with the unexpected upgrade six months before the Presidential election, citing the primacy of reputation and credibility as the firm's key selling tool.³⁶ Some observers noted that in the presidential elections six years earlier, in 1994, it was S&P that was bullish on the country and Moody's was more cautious, coinciding at that time with a strong marketing effort in the country by S&P. Late 1994 saw a large and poorly-handled Mexican devaluation followed by a financial crisis and massive international bailout early in 1995, events not anticipated in either rating agency's assessment at the time.

The rating agencies have not been alone in feeling the pressure of governments in response to their assessments. In February 1999 Goldman Sachs analysts targeted the financial condition of Thailand's largest bank, Bangkok Bank, as a potential threat to the country's financial stability, driving down the price of its shares. The Thai Ministry of Finance immediately chastised Goldman Sachs and implicitly threatened to withdraw government business, which in turn was coupled to the threat of lost private-sector business from companies hesitant to incur the disfavor of the Ministry of Finance. Goldman Sachs hastened to apologize and make amends (but it did not withdraw its analysis).

³⁶Jonathan Friedland and Pamela Druckerman, "Moody's, S&P Are at Odds Over Future of Mexico," *Wall Street Journal*, February 7, 2000.

In the same vein, commentators noted that Morgan Stanley had been dismissed in 1997 as financial adviser to Shandong International Power Development in China after publishing a negative research report and that retribution in the case of unfavorable research was hardly unusual in Asia, where links between government, private companies and powerful families are much closer than in some other parts of the world.³⁷

The issue of loss of control of reputational capital may be more problematic in the case of the joint ratings ventures that each of the three agencies have created, mainly in peripheral markets in developing countries. The strategic objective appears to be to fill-in their presence in non-OECD financial markets, especially those with promising local bond markets. Both S&P and Moody's have focused their joint ventures in the major emerging markets, some of which have the potential for further integration into the global capital markets. Fitch IBCA seems to be concentrating its joint ventures on truly peripheral emerging markets in North Africa, Pakistan, etc., in some cases in concert with the International Finance Corporation whose mandate includes the development of viable indigenous financial markets. It seems clear that the rating agencies can be a very constructive component of the financial market infrastructure in such countries, although their minority positions in these joint ventures expose them to agency conflicts under stress conditions.

Conclusions

³⁷Mark Landler, "Investment Banks Must Soothe Asian Sensibilities," *New York Times*, March 12, 1999.

This paper has considered key dimensions of the global credit rating business in the context of the potential for exploitation of conflicts of interest. We conclude that:

1. The credit rating business is a major contributor to financial market efficiency, bringing about important reductions in information costs and improving both static (capital allocation) and dynamic (continued capital redeployment in the face of new information) market properties.

2. The basic linkage between rating agency activities and systemic benefits is the production of positive externalities in the form of unpriced public information whose value cannot be easily captured by the agencies themselves but which often provides the basis for returns by the market's intermediaries and end-users. Public policy plays an important role by virtue of its certification of agencies for various regulatory purposes. In a net regulatory burden context, the positive external effects of the rating process go a long way toward reducing NRB, arguably contributing to the fact that the most competitive global financial centers are those where the rating agencies are most intensively engaged.

3. The highly concentrated and transparent nature of the ratings business and barriers to entry facing new competitors B including regulatory and certification issues B creates an overriding concern with preserving franchise value on the part of owners which, in itself, provides the key safeguard against exploitation of conflicts of interest in the agencies= business model, i.e., one forced to rely on issuer fees. Vulnerability of the franchise is bolstered by the prospect of regulatory decertification and legal action against the agencies.

4. In the light of what appears to be a highly profitable business the credit rating agencies appear to have gone to great lengths to ensure that reputation losses are avoided. This includes the ownership of the agencies themselves which is certainly in the case of Moody's and S&P is aware of the concentration of value in the reputation of the franchise, and are willing and able to insulate the rating business from other pressures to maximize earnings at the expense of issuing inaccurate ratings. It also includes internal operating procedures and compensation policies, which appear to be carefully designed and policed to avoid conflict. Creation of not-for-profit or government-based rating agencies in order to provide an additional safeguard against exploitation of conflicts of interest does not appear to be necessary to protect issuers or investors against the agencies' potential conflicts of interest.

5. All of the major rating agencies are actively involved in financial markets where some of the aforementioned safeguards may be hard to maintain, especially in the case of difficult to analyze markets and joint ventures with direct or indirect market participants. The consequences of misconduct in an under-controlled area (along the line of a Barings Brothers Singapore experience) could be serious, and could result in damage to a firm's reputation. But a greater risk to reputation might be in erring (or mishandling an error once made) in a large but risky market, such as Russia, where extremely competent and unusual expertise would be necessary to achieve an accurate rating. If such a rating turned out to be inaccurate and seriously misleading to investors, and the securities failed, the agencies could be blamed and discredited (or worse).

For a long time the major credit rating agencies have preserved a reputation for honesty, and professional conduct in providing bond ratings. They have made mistakes in the past, but they have never been scandalized or suffered a significant franchise value loss as a result of misconduct. In recent years however, there has been dramatic growth in the demand for ratings B especially ratings of highly complex securities and non-investment grade securities issued by countries and corporations in difficult to manage areas of the world. This increasing demand has attracted a new array of competitors for the principal two rating agencies, and the new competitors are eager to increase their market shares. Meanwhile, institutional investors are becoming increasingly sophisticated about bond analysis, and may be less reliant on credit ratings than they were a number of years ago. Competition will inevitably increase in the years ahead, and this competition may tempt the agencies to protect their earnings and market share positions by activities that might be construed as exploitative of inherent conflicts of interest. The regulators that certify them as national credit rating agencies (as do the stockholders of the agencies themselves, whose investments are at stake) need to be especially vigilant in the years ahead.

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Exhibit 1
Global and Regional Rating Agencies: Size Ownership, and Geographic Distribution of Ratings Assigned

Rating Agency	Employees	Ratings Assigned	Ownership	Geo Dist of Ratings	Global/Regional
A.M. Best Co.	> 400 analysts, statisticians, and editorial pers.	5,400	Independent	65 countries	Global
Bonniers Kreditfakta I Norden AB	20	All companies (780,000)	The Bonnier Group	Sweden	Regional (Sweden)
Canadian Bond Rating Service	35	> 500 corporate and public issuers	Private		Regional(Canada)
Credit Safe AB	21	690,000 out of 770,000 (in Sweden)	Norwegian company	Sweden	Regional (Sweden)
Dominion Bond Rating Service	30	> 500 corporate and gov. issuers	Private		Regional (Canada)
Dun & Bradstreet	11,000	Database of 53m companies	Independent	230 countries	Global
Egan-Jones Credit Rating Co.		2,000 companies		US	Regional (US)
Euro Ratings AG	7 analysts		Independent shareholders	Germany	Regional (Germany and Austria)
Instantia Creditsystem AB International	5	All companies (780,000) via KreditFakta Databases	Private (The Köster family)	Sweden	Regional (Sweden)
Italrating DCR SpA		53	One Italian investment bank (50% of the Capital) and Duff & Phelps (15%)	Italy	Regional (Italy)
Japan Credit Rating Agency, Ltd(JCR)	74	600	Leading institutional investors, including major insurance companies and banks	35 countries	Global
Japan Rating and Investment Information, Inc. (R&I)	140	1,100	Nikkei Newspaper		Global
KMV Corporation		25,000 firms	Independent		Global
Lace Financial Corp.		1,000 largest US banks; 250 foreign banks; 2,500 largest US credit unions; 35 largest title insurance companies			
Mikuni & Co.		4,000 issues, 1,600 firms	Independent	Japan	Regional (Japan)
Moody's Investors Service	1,500	> 9,000	Dun & Bradstreet	70 countries	Global
Neufeld's Credit Information AB	2	A few companies	Private (Robert Neufeld)	Sweden	Regional (Sweden)
R&S Rating Services AG	8 analysts		Independent, major shareholder Bavarian employer's association	Germany	Regional (Germany)

Source: Bank for International Settlements, *Credit Ratings and Complementary Sources of Credit Quality Information* (Basel: BIS, 2000)

Exhibit 1 (Continued)

Rating Agency	Employees	Ratings Assigned	Ownership	Geo Dist of Ratings	Global/Regional
Standard & Poor's	1,000 analysts	3,478 global corporate issuers (1997); 2,614 US corporate issuers (1997)	<i>McGraw-Hill (publishing and media)</i>	>70 countries	Global (22 offices)
SVEA Kredit-Information AB	3	All companies (780,000) via KreditFakta Databases	<i>Private (Lennart Agren)</i>	Sweden	Regional (Sweden)
SVEFO Svergie AB	30	All companies (780,000) via DreditFakta Databases	<i>Telia AB (largest phone company)</i>	Sweden	Regional (Sweden)
Thomson Financial Bankwatch	69 analysts	>1,000 (650 issuers, 400 issues)	<i>Thomson Corporation</i>	85 countries	Global (6 offices)
Unternehmensratingagentur AG	12 analysts		<i>Independent</i>	Germany	Regional (Germany)
Upplysningscentralen AB (UC AB)	160	All companies (780,000)	<i>4 largest private Swedish banks</i>	Sweden & Norway	Regional (Sweden, Norway)
Merged agencies					
Duff & Phelps Credit Rating Co	>600 empl.	68% of Latin American debt issues, 64% Chile, 77% Costa Rica, 45% Mexico, 75% Peru, 100% Colombia, 70% Venezuela	<i>Independent</i>	>50 countries	Global
<i>Fitch IBCA</i>	400 analysts	10,163 global issuers; 9,033 US issuers	<i>FIMALAC (French conglomerate)</i>	70 countries	Global (29 offices)
<i>Fitch (2000)</i>	1,100 employees	1,600 financial institutions, over 800 corporates and 700 insurance companies, 67 sovereigns, 3,300 structured financings and 17,000 municipal bonds ratings (US tax-exempt market)	<i>FIMALAC (French conglomerate)</i>	75 countries	Global (40 offices)
Outside G10					
<i>Rating Agency Malaysia Berhad</i>		>400 banks	<i>Owned by commercial, merchant banks, Finance companies, Asian Development Bank, Fitch IBCA</i>		
Capital Intelligence	11 analysts		<i>Independent</i>	37 countries	Regional

Notes

1. Ratings assigned may be either to issuers or to issues. (Further work is needed to consider how multiple issue ratings might be brought together to give a representative issuer rating.)

Exhibit 2
Local Credit Rating Agencies

Country	Name	Ownership Name	Ownership Type	Instruments Rated
Argentina	DCR Argentina Fitch IBCA Argentina S.A. Standard & Poor's Argentina Branch VALUE Calificadora de Riesgo S.A.	DCR Argentina Fitch IBCA Standard & Poor's Argenhold SA (80%)	Joint venture (Duff & Phelps) Subsidiary Subsidiary Local	Bond and stock Bonds, stock,preferred, securitization , and bank deposit Bonds Bonds,stock,securitization,and certificates of deposit
Brazil	SR Rating/Duff & Phelps			Bonds
Chile	Fitch IBCA Chile Duff & Phelps de Chile Ltda. Feller Rate-Clasificadora de Riesgo Ltda	Fitch IBCA ECONSULT Credit Rating Ltd. Feller Rate	Subsidiary Joint venture (Duff & Phelps) Local (Strategic alliance with S&P)	Bonds and stock Debt instruments,stocks,commercial papers,and certificates of deposit Bonds,stock,and time deposits
Colombia	Duff & Phelps de Colombia S.A.	Duff & Phelps	Subsidiary	Bonds
India	Duff & Phelps Credit Rating India Private Ltd. Credit Analysis & Research Ltd. (CARE) The Credit Rating Information Services of India Ltd (CRISIL) ICRA Ltd.	Duff & Phelps Credit Analysis & Research Ltd (CARE) CRISIL ICRA Ltd.	Subsidiary Local Local Local	Bonds Bonds and time deposits Bonds,commercialpaper, and structured obligations Bonds and commercial paper
Israel	MAALOT-The Israel Securities Rating Ltd.	MAALOT	Local	Bonds
Korea	Korea Investors Service Co. Korea Management Consulting & Credit Rating Corporation National Information & Credit Evaluation, Inc.	Korea Investors Service Korea Development Bank (93%) National Information & Credit Evaluation, Inc.	Local Local (Subsidiary of KDB) Local	Bonds and commercial paper Bonds and commercial paper Bonds and commercial paper
Malaysia	Rating Agency Malaysia	Rating Agency Malaysia Berhad	Joint venture (Duff & Phelps)	Bonds and preferred stock
Mexico	Fitch IBCA Mexico S.A. de CV Duff & Phelps de Mexico, Sa de CV (DCRMEX) Standard & Poor's SA de CV S&P Ca-Val	Fitch IBCA Duff & Phelps de Mexico, SA de CV (DCRMEX) Standard & Poor's	Subsidiary Joint venture (Duff & Phelps) Subsidiary	Bonds Bonds and securitization Bonds

Exhibit 2 cont'd....

Country	Name	Ownership Name	Ownership Type	Instruments Rated
Pakistan	DCR-VIS Credit Rating Company Limited The Pakistan Credit Rating Agency (Pvt) Ltd. (PACRA)	DCR-VIS PACRA	Local Joint venture (Fitch IBCA)	Bonds and Stocks Bonds
Peru	Duff & Phelps del Peru S.A. Apoyo and Asociados Internatinal S.A. Equilibrium Bank Watch Class and Asociados S.A.			Bonds,preferred stock,and time deposits Banks,financial institutuions, bonds,share,stocks,all debt in stru Banks,financial institutions, bonds, share,stocks, all debt instru Banks,financial institutions, bonds,shares,stocks, all debt instru
Philippines	Credit Information Bureau, Inc.	Credit Information Bureau, Inc.	Local	Bonds and commercial paper
Portugal	Companhia Portuguesa de Rating S.A.	Sociedade de Avaliacao de Empresas e Risco, Lda	Local	Bonds and commercial paper
South Africa	CA-Ratings Fitch IBCA South Africa (Pty) Ltd.	CA-Rating Fitch IBCA	Local Subsidiary	Bonds Bonds
Thailand	Thai Rating & Information Services Company Ltd.	Thai Rating & Information Services Company	Local (3-year Strategic Partnership with Fitch IBCA)	Bonds
Tunisia	Maghreb Rating	Inter Arab Rating Company	Joint venture (Fitch IBCA)	Bonds
Venezuela	Duff & Phelps de Venezuela, S.A.	A qualified group of local professionals	Joint venture (Duff & Phelps)	Bonds

Source: Financial Times, 1998

Exhibit 3

Market Practices of Rating Agencies

Rating Agency	Payment By	Unsolicited Ratings
A.B. Best Co.		
Bonniers Kreditfakta I Norden AB	Subscriber	Y
Canadian Bond Rating Service		
Credit Safe AB	Subscriber	Y
Dominion Bond Rating Service		
Dun & Bradstreet	Subscriber	Y
Egan-Jones Credit rating Co.		
Euro Ratings AG		N
Instantia Creditsystem AB International	Subscriber	Y
Italrating DCR SpA	Rated body	N
Japan Credit Rating Agency, Ltd (JCR)	Rated body	Y
Japan Rating and Investment Information, Inc. (R&I)		
KMV Corporation	Subscriber	Y
Lace Financial Corp.	Subscriber	
Mikuni & Co.	Subscriber	
Moody's Investors Service	Rated body	Y
Neufeld's Credit Informatin AB		Y
R@S Rating Services AG	Rated body	N
Standard & Poor's	Rated body	N
SVEA Kredit-Information AB	Subscriber	Y
SVEFO Sverige AB	Subscriber	Y
Thomson Financial Bankwatch (Issuer)		
Thomson Financial Bankwatch (Long Term)		
Thomson Financial Bankwatch (Sovereign)		
Unternehmenstratingagentur AG (URA)		N
Upplysningscentralen AB (UC AB)	Subscriber	Y
MERGED AGENCIES		
Duff & Phelps Credit Rating Co.		N
Fitch IBCA		Y
Fitch (2000)		
OUTSIDE G10		
Rating Agency Malaysia Berhad (RAM)	Rated body	
Capital Intelligence	Subscriber	Y

Notes

1. With the exception of KMV and Lace Financial, the subscriber fee charged is for access to the rating of a single company (including own rating).

Source: Bank for International Settlements, *Credit Ratings and Complementary Sources of Credit Quality Information* (Basel: BIS, 2000)

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