How and Why Credit Rating Agencies Are Not Like Other Gatekeepers

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Overview

• How they differ
  – Profitability
  – Conflicts of interest
  – Structured finance (CDOs)

• Why they differ
  – “Regulatory licenses”
  – Liability

• Proposals
  – Market-based alternatives
  – Registration vs. recognition
  – Remove limits on liability (First Amendment)
Problem

“Agencies were soundly criticized for their failure to identify high profile credit meltdowns ahead of time and have been exposed to intense external scrutiny. Academic studies indicate that while agency information is helpful to, and relied upon by the credit markets, it is not believed to efficiently incorporate all public information ….” Pettit et al. (2004)
## How They Differ – Profitability

<table>
<thead>
<tr>
<th>Late 1990s</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratings on $2-5 trillion of securities</td>
<td>Ratings on $30 trillion of securities</td>
</tr>
<tr>
<td>Operating margins of 30%</td>
<td>Operating margins of &gt;50%</td>
</tr>
<tr>
<td>20,000 issuers</td>
<td>40,000 issues, 745,000 securities</td>
</tr>
<tr>
<td>Possible Moody’s spinoff, value of possibly $1bn</td>
<td>Moody’s market cap of $15bn</td>
</tr>
<tr>
<td>------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Revenue</td>
<td>1438</td>
</tr>
<tr>
<td>Expenses</td>
<td>652</td>
</tr>
<tr>
<td>Operating Income</td>
<td>786</td>
</tr>
<tr>
<td>Net Income</td>
<td>425</td>
</tr>
</tbody>
</table>
Moody’s Business Model

- **Issuers**
  - Ratings
  - Financial Instruments
  - ~87% Revenues

- **Intermediaries**
  - Financial Instruments

- **Investors**
  - Research & Opinion Products
  - ~13% Revenues

Note: Does not include revenue of Moody’s KMV.
Annual Revenue and Operating Margin

Revenue ($ Millions):
- 1999: $564
- 2000: $602
- 2001: $797
- 2002: $1,023
- 2003: $1,247
- 2004: $1,438

Operating Margin:
- 1999: 48%
- 2000: 48%
- 2001: 50%
- 2002: 53%
- 2003: 53%
- 2004: 55%
## Moody’s vs. Major Financial Publishers

<table>
<thead>
<tr>
<th></th>
<th>Mkt Cap</th>
<th>Revenue</th>
<th>Employees</th>
<th>Oper Marg</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dow Jones</td>
<td>$3.3bn</td>
<td>$1.7bn</td>
<td>7,143</td>
<td>9%</td>
</tr>
<tr>
<td>Reuters</td>
<td>$9.3bn</td>
<td>$5.3bn</td>
<td>15,475</td>
<td>11%</td>
</tr>
<tr>
<td>Moody’s</td>
<td>$15.2bn</td>
<td>$1.4bn</td>
<td>2,500</td>
<td>55%</td>
</tr>
</tbody>
</table>
Moody’s 2005 Proxy Statement

• Moody’s “does not believe there are any publicly traded companies that represent strict peers”

• For executive compensation, Moody’s looks instead to a “peer group” of “financial services companies with market capitalization comparable to the Company”
How They Differ – Conflicts

• Ancillary services
  – Pre-ratings assessments
  – Corporate consulting

• Unsolicited ratings
  – Extent is unclear
  – Opposite of other gatekeeper conflicts

• Primary differences: no crackdown
  – Voluntary codes of conduct
  – DOJ investigation of Moody’s unsolicited ratings
How They Differ – Structured Finance

• CDOs
  – The corporate credit spread “puzzle”

• Rationale:
  – Diversified portfolio of BBB corporate bonds trade at a 200bp credit spread
  – But the expected loss on this portfolio is only 25bp
  – So for every $100.25 of bonds, you can borrow $100 at AAA spreads (assume 75bp)
  – Arbitrage profit of 100bp
Managed Synthetic Arbitrage CDO

Bank Arranger

Super Senior Swap Fee
Super Senior Protection

Manager

SPV
Domestic in EU tax friendly venue

Mgt. Fee
Management

Note Proceeds

Premia
Protection

EUR 1 Billion Reference Portfolio

AA Bank Deposit Account Pledged as Collateral for CDSs

Note Proceeds

EUR 1 Billion of CDS referencing investment grade credits
Basel2 average rating

Super Senior CDS 10 bps Aaa/AAA (86.5%)

Aaa rated Notes L+ 50 bps (4.05%)

Aa2 rated Notes L+ 100 bps (2.5%)

Basel2 rated Notes L+ 150 bps (3.05%)

Reserve Account

Class D Notes Equity Notes (4.05%)

Source: http://www.tavakolstructuredfinance.com/securitization.html

* Subject to price restrictions and Arranger Bank maintaining a minimum AA- rating.

** Term not spread and accumulated fees not trigger cash trapping.
How They Differ – Structured Finance

• Explanation 1: Arbitrage
  – Corporate bonds are not liquid and it is costly and difficult to diversify

• Explanation 2: Shell Game
  – People will buy anything AAA regardless of risk
  – Default prob/correlation assumptions are wrong
  – Statistical models are flawed

• Perhaps there remains a high degree of undiversified credit risk in CDOs
## S&P Default Rate Assumptions for CDOs

<table>
<thead>
<tr>
<th></th>
<th>ABS (all)</th>
<th>Corp Year 4</th>
<th>Corp Year 7</th>
<th>Corp Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>0.25%</td>
<td>0.19%</td>
<td>0.52%</td>
<td>0.99%</td>
</tr>
<tr>
<td>AA</td>
<td>0.50%</td>
<td>0.57%</td>
<td>1.20%</td>
<td>1.99%</td>
</tr>
<tr>
<td>A</td>
<td>1.00%</td>
<td>0.81%</td>
<td>1.81%</td>
<td>3.04%</td>
</tr>
<tr>
<td>BBB</td>
<td>2.00%</td>
<td>1.81%</td>
<td>3.94%</td>
<td>6.08%</td>
</tr>
<tr>
<td>BB</td>
<td>8.00%</td>
<td>9.49%</td>
<td>14.20%</td>
<td>17.47%</td>
</tr>
<tr>
<td>B</td>
<td>16.00%</td>
<td>21.45%</td>
<td>26.15%</td>
<td>28.45%</td>
</tr>
</tbody>
</table>
Moody's 2004 Revenues

- Structured Finance
- Corporate Finance
- Financial Institutions and Sovereign Risk
- Public Finance
- Research
- KMV
### Why They Differ – Reputational Intermediaries

<table>
<thead>
<tr>
<th>Pure Gov’t Rater</th>
<th>Pure Private Rater</th>
</tr>
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<tbody>
<tr>
<td>USDA</td>
<td>Good</td>
</tr>
<tr>
<td></td>
<td>Housekeeping</td>
</tr>
<tr>
<td></td>
<td>Financial</td>
</tr>
<tr>
<td></td>
<td>Publishers</td>
</tr>
<tr>
<td></td>
<td>S&amp;P/Moody’s?</td>
</tr>
</tbody>
</table>
Why They Differ – Reputational Failure

• Gatekeepers needed only if constraints on issuers are inadequate

• Paradox: gatekeepers suffer some of the same reputational limitations as issuers
  – Low expected costs of “bad” behavior
  – Agency costs
  – Ex post verification of statements about quality
  – So: it’s rational to deplete reputational capital

• Benefits: repeat play, additional assets
Why They Differ – Regulatory Licenses

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<td></td>
<td>Good Housekeeping</td>
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<tr>
<td></td>
<td>Financial Publishers</td>
</tr>
</tbody>
</table>
## NRSRO-Based Regulation

<table>
<thead>
<tr>
<th>Category</th>
<th>CFR</th>
<th>Statute</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture (Title 7)</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Banks and Banking (Title 12)</td>
<td>34</td>
<td>3</td>
</tr>
<tr>
<td>Commerce and Trade (Title 15)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity/Securities (Title 17)</td>
<td>30</td>
<td>2</td>
</tr>
<tr>
<td>Education (Titles 20, 34)</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Transportation (Titles 23, 49)</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Telecom (Title 47)</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>69</td>
<td>8</td>
</tr>
</tbody>
</table>
Annual Federal Agency Decisions Based on NRSRO Status
Why They Differ – Liability


- Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.
Why They Differ – Liability


- Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press, or of the credit rating agencies; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.
Why They Differ – Liability

• No Section 11 liability, Reg FD N/A
• Common law claims
  – WPPSS (1983) and Executive Life (1991)
  – Orange County (1996)
  – Enron (2005)
• Antitrust
• Subpoena enforcement
Why They Differ – Liability

• First Amendment claim
  – No Supreme Court precedent
  – Not well litigated
  – Privilege is qualified, not absolute

• Distinctions
  – Active involvement vs. mere information gathering
  – Complexity of issue
  – Role of fees
Proposals

• Reduce regulatory licenses
  – Open market to new NRSROs
  – Market-based alternatives
  – Replace “recognized” with “registered”

• Create threat of liability
  – Legislative approach
  – Judicial approach
  – Resolve First Amendment issue
Modified Strict Liability

vs.

[Two images of individuals]
Modified Strict Liability

• Make gatekeepers strictly liable to issuers
  – For damages from judgment or settlement
  – Limited to scope of gatekeepers’ role
  – No due diligence defense

• BUT limit the amount of liability
  – Permit gatekeepers to contract to limit liability to a percentage of issuer damages, subject to a minimum, or
  – Impose a regulatory minimum liability based on gatekeeper revenues
Conclusion

• Credit rating agencies are not like other gatekeepers
  – They are more profitable, subject to greater conflicts, and more involved in structured finance
  – The reasons are regulatory licenses and lack of liability

• Proposals should reduce regulatory licenses and impose liability