How and Why Credit Rating Agencies Are Not Like Other Gatekeepers

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Brookings-Nomura Seminar

September 28, 2005

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>
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<th><u>Late 1990s</u></th>
<th><u>2005</u></th>
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- Ratings on $2-5 trillion of securities
- Operating margins of 30%
- 20,000 issuers
- Possible Moody’s spinoff, value of perhaps $1bn

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- Ratings on $30 trillion of securities
- Operating margins of >50%
- 40,000 issues, 745,000 securities
- Moody’s market cap of $15bn

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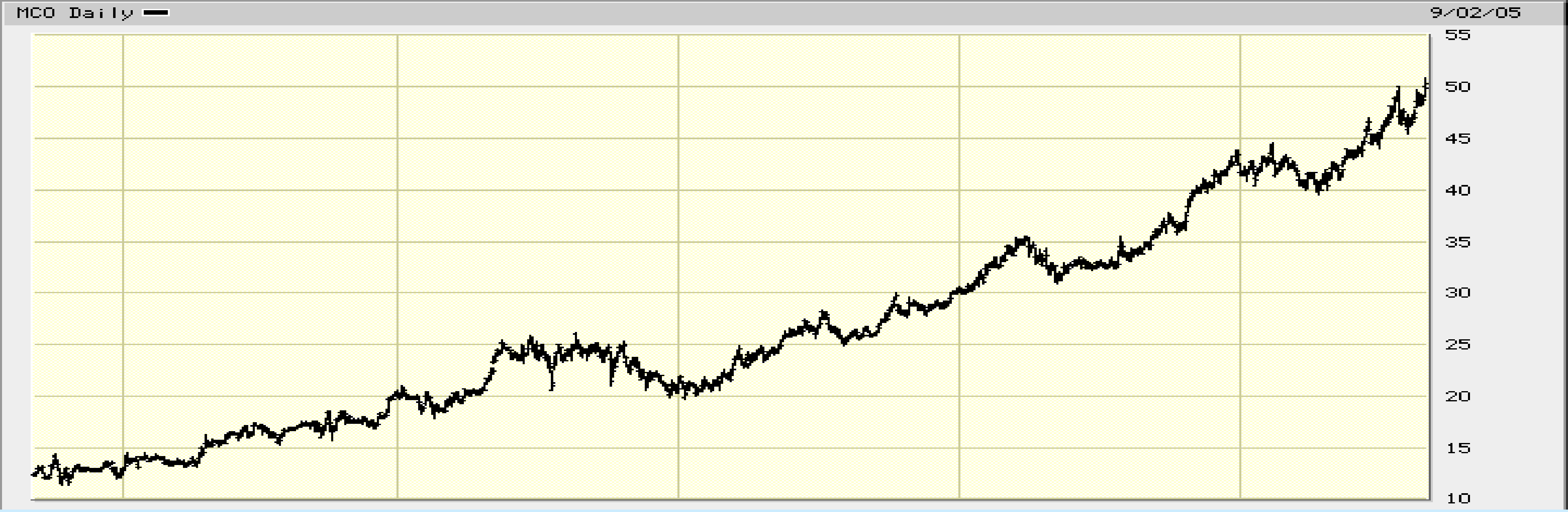
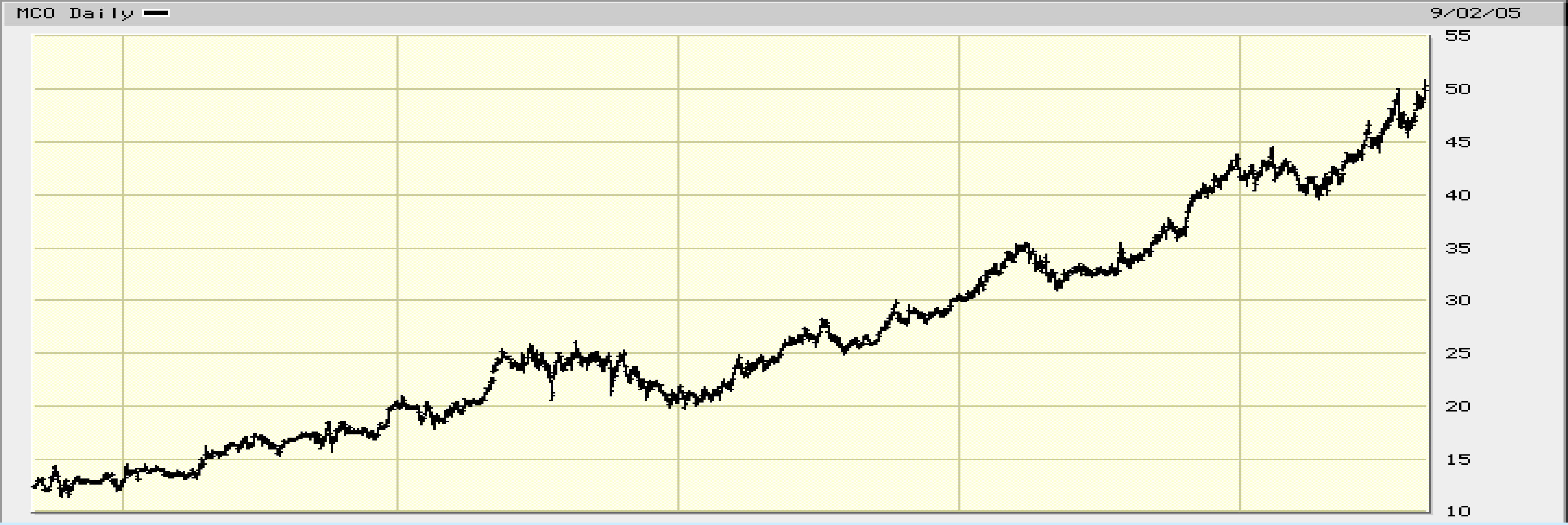


2001 2002 2003 2004 2005



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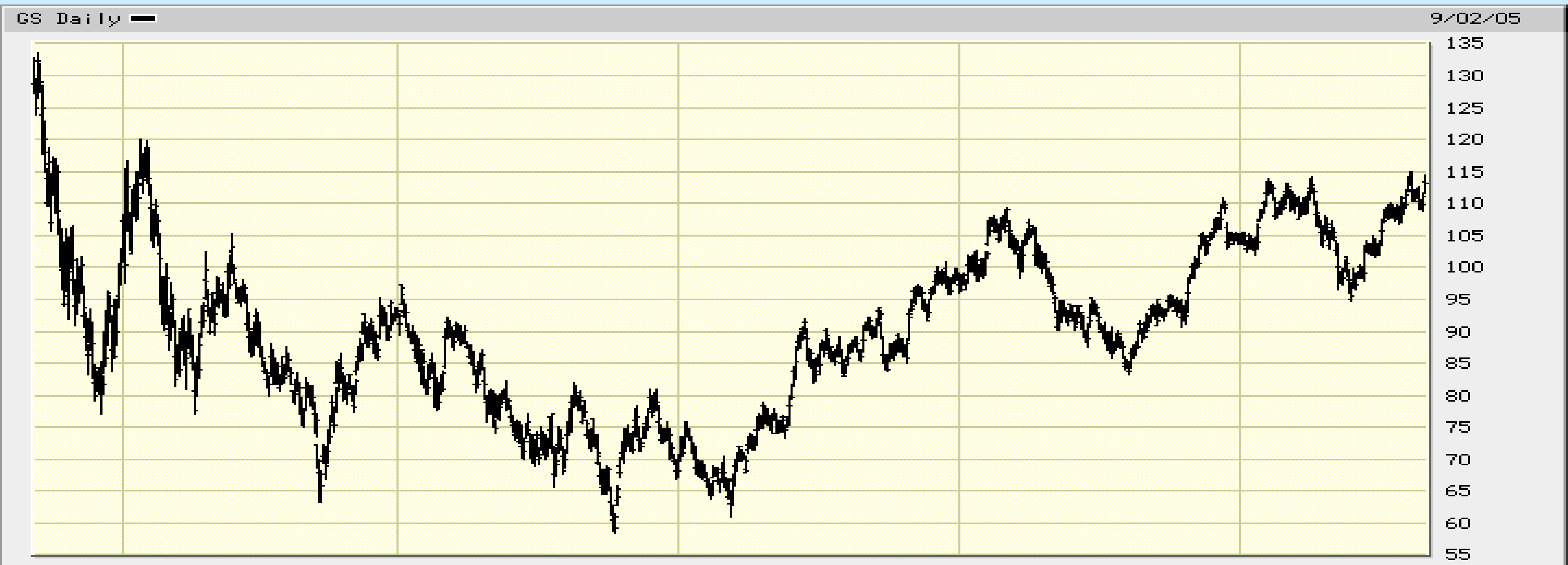
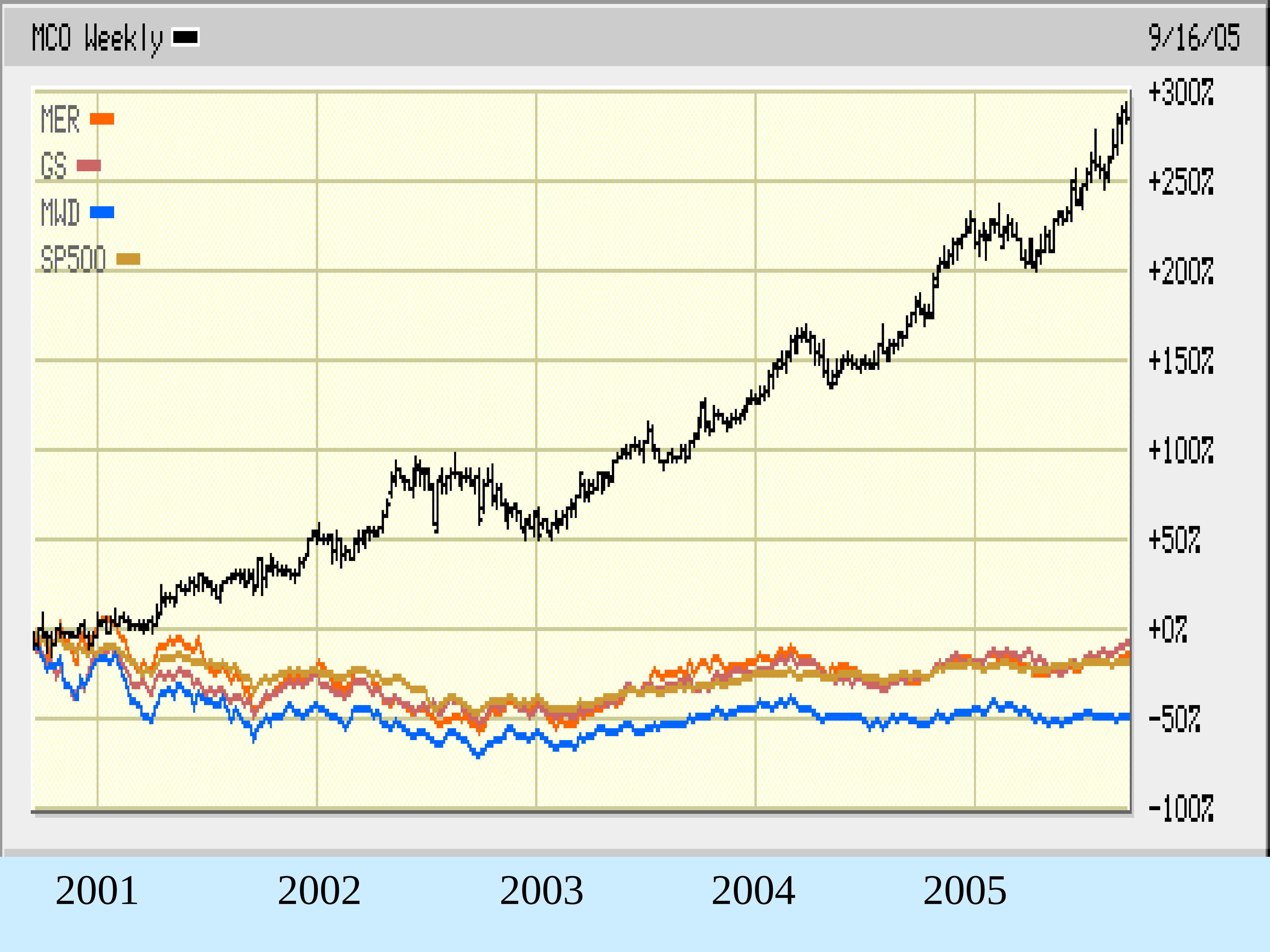
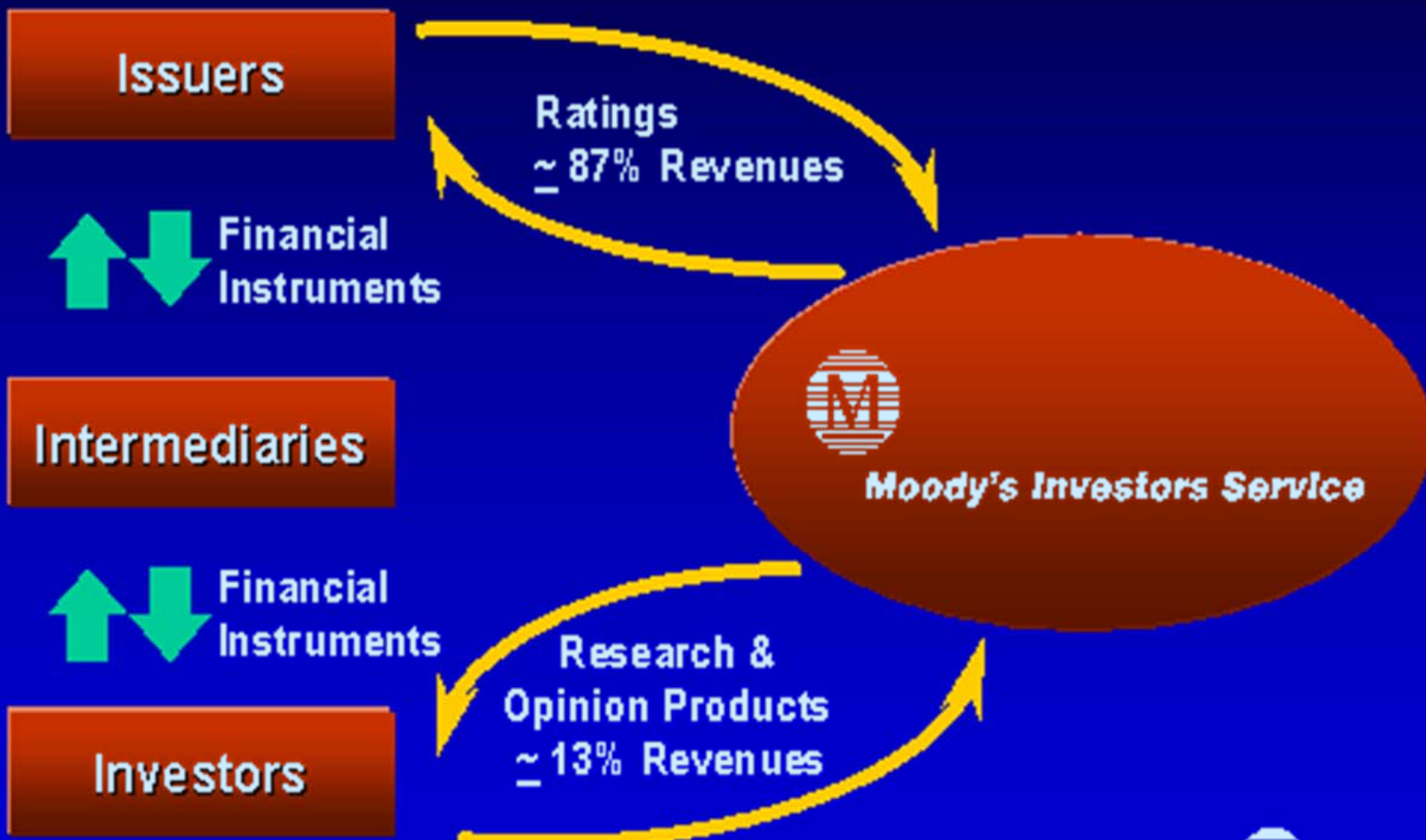



MCO Weekly
9/16/05
MER
GS
MWD
SP500
+300%
+250%
+200%
+150%
+100%
+50%
+0%
-50%
-100%
2001
2002
2003
2004
2005

Moody's Income Statement Data, 2000-04 ($MMs)

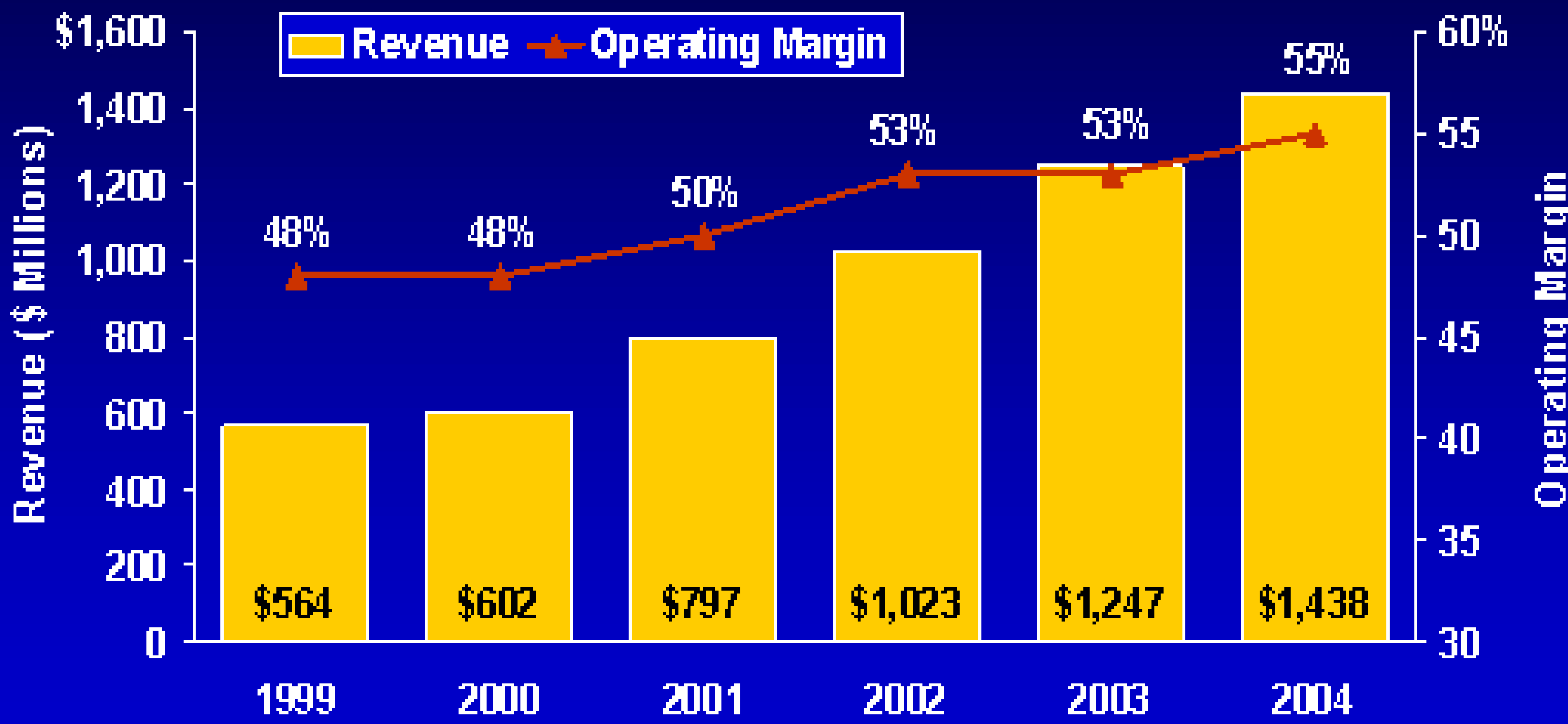
	2004	2003	2002	2001	2000
Revenue	1438	1247	1023	797	602
Expenses	652	584	485	398	314
Operating Income	786	663	538	399	288
Net Income	425	364	289	212	159

Moody’s Business Model



Note: Does not include revenue of Moody's KMV.

Annual Revenue and Operating Margin



Moody's vs. Major Financial Publishers

	Mkt Cap	Revenue	Employees	Oper Marg
Dow Jones	$3.3bn	$1.7bn	7,143	9%
Reuters	$9.3bn	$5.3bn	15,475	11%
Moody's	$15.2bn	$1.4bn	2,500	55%

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”

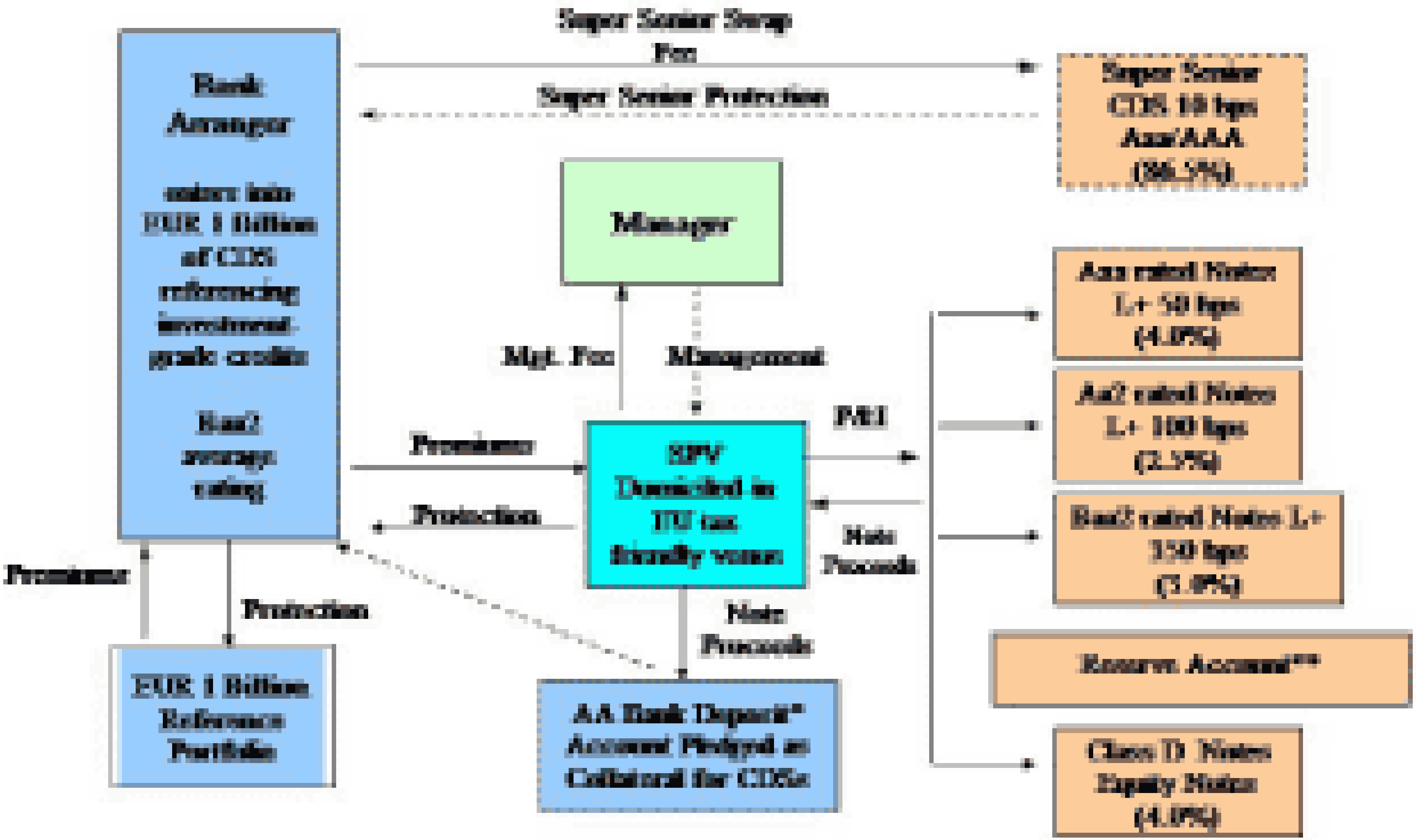
How They Differ – Conflicts

- 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



* Subject to price restrictions and Arranger Bank maintaining a minimum AA- rating.
** Excess Spread and accumulated loss tests trigger cash trapping.

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

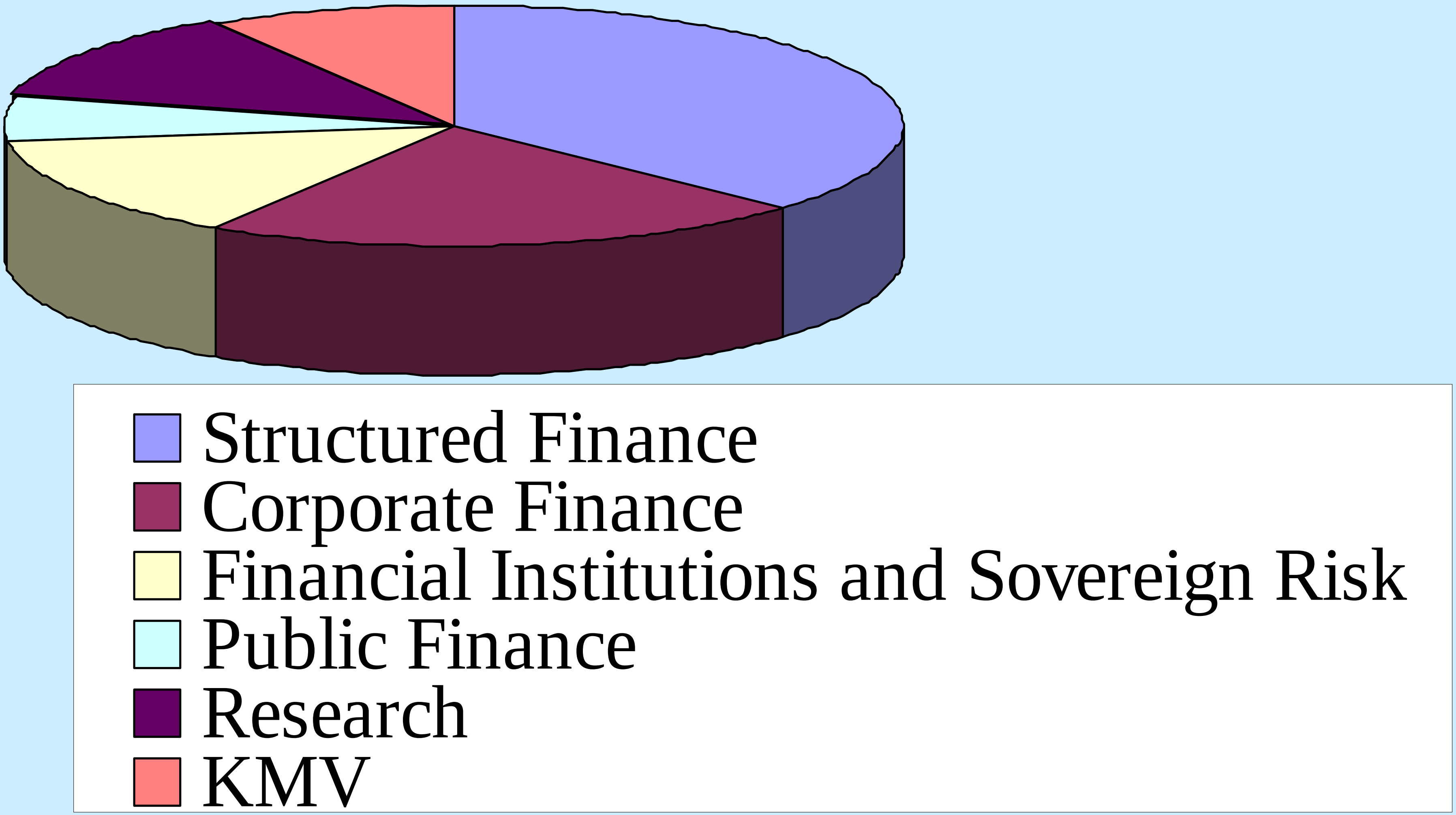
How They Differ – Structured Finance

- 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

	ABS (all)	Corp Year 4	Corp Year 7	Corp Year 10
AAA	0.25%	0.19%	0.52%	0.99%
AA	0.50%	0.57%	1.20%	1.99%
A	1.00%	0.81%	1.81%	3.04%
BBB	2.00%	1.81%	3.94%	6.08%
BB	8.00%	9.49%	14.20%	17.47%
B	16.00%	21.45%	26.15%	28.45%

Moody's 2004 Revenues



Why They Differ – Reputational Intermediaries

Pure Gov't Rater	Pure Private Rater
USDA	Good Housekeeping
	Financial Publishers
	S&P/Moody's?

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

Pure Gov't Rater

Pure Private Rater

USDA

S&P/Moody's

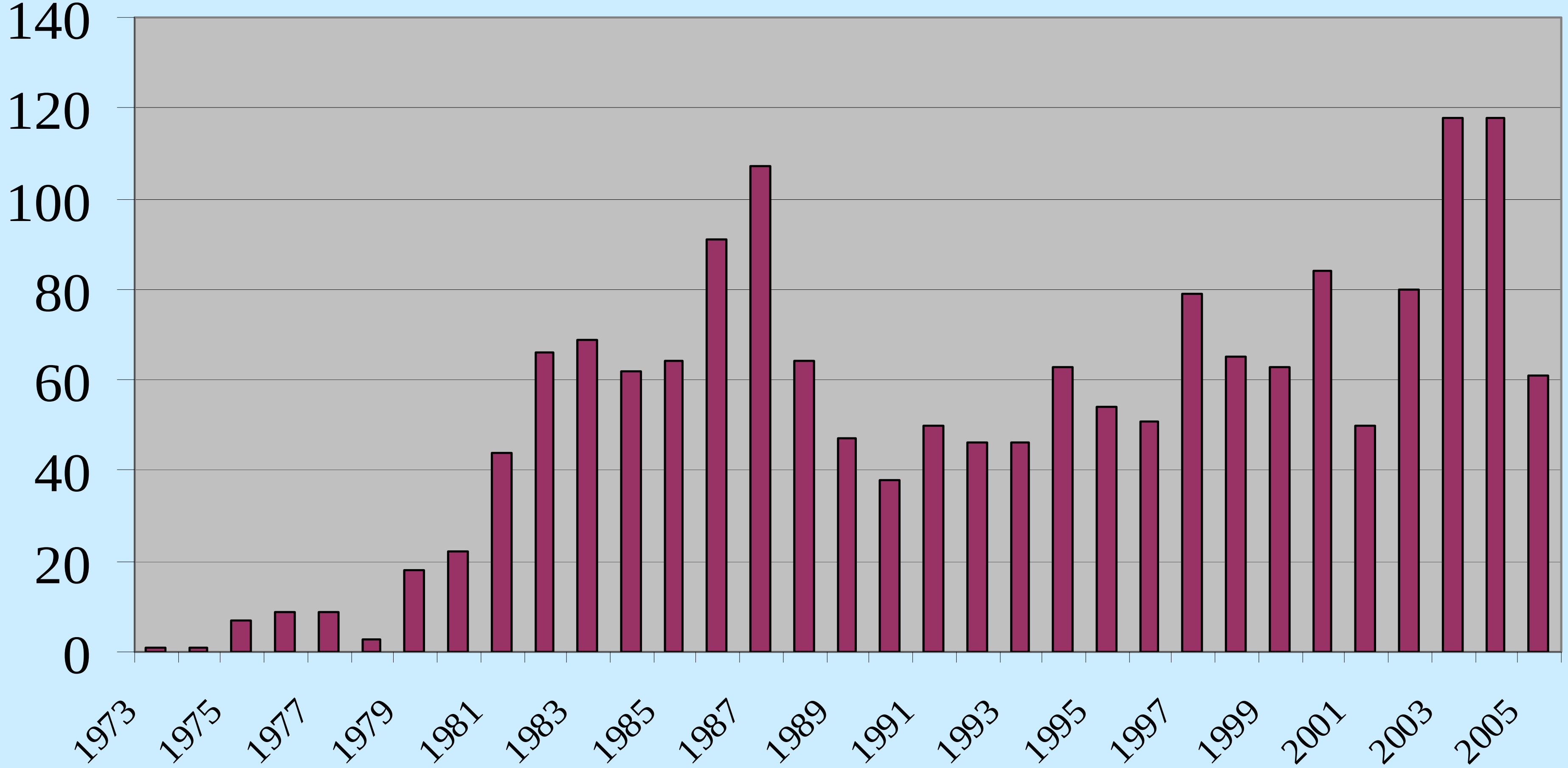
Good Housekeeping

Financial Publishers

NRSRO-Based Regulation

	CFR	Statute
Agriculture (Title 7)	3	
Banks and Banking (Title 12)	34	3
Commerce and Trade (Title 15)		
Commodity/Securities (Title 17)	30	2
Education (Titles 20, 34)	1	1
Transportation (Titles 23, 49)	1	1
Telecom (Title 47)		1
Total	69	8

Annual Federal Agency Decisions Based on NRSRO Status



Why They Differ – Liability

Amendment I. Freedom of Religion, Press, Expression. Ratified 12/15/1791.

- 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.

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Why They Differ – Liability

- No Section 11 liability, Reg FD N/A
- Common law claims
  - WPPSS (1983) and Executive Life (1991)
  - Jefferson County School District (1995)
  - 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.

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