The Credit Ratings subcommittee of the FIMSAC has spent the last year exploring a variety of credit ratings related topics. One of the main areas of exploration has been conflicts of interest in the industry payment model (i.e. issuer pays for the credit ratings assignment and maintenance), and the impact, if any, on market structure and efficiency. The subcommittee has heard from many industry participants on this topic, and has hosted panels at FIMSAC meetings to expose the broader Committee to its deliberations. This discussion document presents some of the ideas debated by the subcommittee to potentially address industry conflicts of interest, and is meant to encourage FIMSAC and broader industry discussion and feedback.

Background

Credit ratings, and their utility, have been controversial for a number of years. Credit ratings, and credit ratings agencies (aka Nationally Recognized Statistical Rating Organizations or NRSROs) have been criticized for their role in the Global Financial Crisis. Some of the criticism stems from perceived conflicts of interest in the issuer payment model, as well as a significant market concentration among the top agencies suggesting a lack of sufficient market competition. As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, a number of aspects of the credit ratings industry were addressed. In addition to establishing self-executing requirements applicable to NRSROs and SEC rulemaking associated with NRSROs, the Dodd-Frank Act required the SEC to submit a report specifically related to a study on credit ratings for structured products as well as any recommendation for regulatory or statutory changes it determined should be made. The report was to discuss conflicts of interest associated with issuer-pay and subscriber-pay models, the feasibility of establishing a self-regulatory organization to assign NRSROs to rate structured products, metrics which could be used to determine the accuracy of credit ratings for structured products, and alternative compensation to incent accurate credit ratings for structured products. In addition, the Dodd-Frank Act directed the Commission to establish an assignment system to determine initial credit ratings of structured products, if it deems it necessary or appropriate in the public interest or for the protection of investors. The report was released in December 2012 and can be found here: https://www.sec.gov/news/studies/2012/assigned-credit-ratings-study.pdf

Subsequent to the Assigned Credit Ratings Study, the SEC hosted a Credit Ratings Roundtable in May, 2013. The roundtable explored multiple topics, including the potential creation of a credit rating assignment system for asset-backed securities (ABS), the effectiveness of the current system to encourage unsolicited ratings for ABS, and alternatives to the issuer-pay model.

Current Environment

The SEC's Office of Credit Ratings (OCR) is responsible for examining each NRSRO at least annually, in eight specific areas. OCR also monitors trends affecting the credit rating industry and liaises with international regulators on relevant topics. OCR reports on its findings annually. In their report, they provide market information, which sheds light on the concentration of the market. Following is excerpted from their December 2018 report:

Chart 2: Percentage by Rating Category of Each NRSRO's Outstanding Credit Ratings of the Total Outstanding Credit Ratings of all NRSROs, as of December 31, 2017*						
NRSRO	**Financial Institutions**	**Insurance Companies**	**Corporate Issuers**	**Asset-Backed Securities**	**Government Securities**	**Total Ratings**
A.M. Best	N/R	35.0%	1.0%	<0.1%	N/R	0.4%
DBRS	8.1%	0.8%	2.6%	9.5%	1.1%	2.3%
EJR	6.0%	4.2%	5.7%	N/R	N/R	0.8%
Fitch	24.9%	15.9%	16.9%	18.4%	11.8%	13.5%
HR Ratings	0.4%	N/R	0.2%	N/R	0.0%	0.1%
JCR	0.5%	0.3%	2.2%	N/R	0.0%	0.2%
KBRA	0.5%	0.2%	0.0%	5.1%	0.0%	0.4%
Moody's	23.3%	12.1%	25.5%	37.6%	34.3%	33.1%
Morningstar	<0.1%	N/R	0.3%	1.6%	N/R	0.1%
S&P	36.5%	31.6%	45.7%	27.7%	52.8%	49.2%

* N/R indicates that the NRSRO was not registered in the applicable rating category as of the reporting date.
Percentages have been rounded to the nearest one-tenth of one percent.
Source: NRSRO annual certifications for the 2017 calendar year, Item 7A on Form NRSRO

The NRSRO market remains concentrated, despite efforts such as Rule 17g-5, which was broadly designed to allow/encourage competition and reduce conflicts of interest. Many believe that 17g-5 has not been effective in promoting competition because rating agencies require revenue to cover the research costs that underlie substantive ratings. Thus, the economic incentives to compete in an unsolicited way are weak. With the objective of creating a broader, level playing field among a great number of NRSROs, the subcommittee has debated different initiatives to better achieve better outcomes on competition.

In addition to market concentration, there remains skepticism surrounding the issuer-pay model, and the potential conflicts of interest that accompany that model, specifically in the structured product space. The Credit Ratings subcommittee has heard from several market participants including investors, issuers, scholars and current and former NRSRO executives over the months leading up to the publication of this discussion document, including anecdotal evidence of conflicts ranging from analyst compensation (i.e. analysts motivated to provide ratings which result in obtaining business) to ratings shopping (i.e., an issuer chooses the rating agency that will assign the highest rating or that has the most relaxed criteria for achieving a desired rating).

A good deal of work has been done post-GFC surrounding oversight of NRSROs. This discussion document is designed to leverage feedback the subcommittee received through its assessment of these issues, in exploring an alternate model for credit ratings and other potential initiatives to address conflicts of interest. The subcommittee anticipates and welcomes receiving additional industry feedback, and will examine that feedback and determine the feasibility of advancing a preliminary recommendation to the FIMSAC in the future.

Discussion

The subcommittee considered asking the SEC to explore creating an entity to oversee a random assignment process for both structured products and corporate bond ratings, with at least two NRSROs being assigned to each issue, to provide diversity of views.

Issuers could continue to pay for ratings through fees assessed by the "oversight entity" and an additional amount could be set aside for the administration costs associated with the "oversight entity". This entity could be responsible for setting the compensation for initial and maintenance ratings.

The subcommittee also discussed the potential for the SEC to consider creating a workable (and simple) performance scorecard for the NRSROs, and exploring increased NRSRO public disclosure of deviations from ratings methodologies. Ultimately, as any random selection model matures, the selection could be based on performance, in that the higher the performance (more relevant and accurate ratings), the greater the chance of being selected to rate issues. The performance scorecard, outlined below, could be a starting point for such evaluation.

While many of the potential issues discussed could apply to municipal bonds, additional clarity is needed to determine if the SEC could implement an alternate model in the municipal bond market especially since it would mandate additional rating agency costs to the issuer. Other potential initiatives surrounding NRSRO performance scorecards and increased disclosure of deviations from ratings methodologies could also be considered for the municipal bond market.

There would need to be cooperation by various market participants regarding this approach for it to be successful. For example, index providers and investors may need to update their criteria and/or investment guidelines to broaden acceptance to all registered NRSROs, rather than citing specific NRSROs. This may take time to evolve, and it is outside of the purview of the SEC.

Details of an alternate model and other potential initiatives follow.

Random Assignment

The objective of using a random assignment system would be to remove the ability of the issuer to influence the NRSRO and/or the ultimate rating for a deal, thus eliminating ratings shopping. The two NRSROs, selected by the Oversight Entity using a random assignment process, could offer investors unbiased views of the probability of default for a given issue. To ease the transition process, issuers may have the option for one of the randomly assigned NRSROs to be selected from the pool of NRSROs which has rated securities for the issuer historically.

The issuer may still choose to hire additional rating firms outside the purview of the Oversight Entity to provide a rating. Issuers which choose to hire an additional firm to provide a rating could be required to delineate which ones were randomly selected by the Oversight Entity and which one(s) were selected by the issuer. In addition, issuers could be required to disclose at least the same information to the randomly selected agencies as the solicited agency to avoid information (dis)advantages.

Capacity issues may arise, in that due to market concentration, there may be too many deals chasing too few NRSROs. Expertise and resource constraints may differ by product and sectors as well. As a result, NRSROs could be required to disclose products and sectors that they are qualified to rate in order to be considered as part of the random assignment (perhaps as an addendum to the registration process). Additionally, selected NRSROs could be allowed to opt out of selected ratings assignments due to capacity, resource and/or expertise constraints. As the Oversight Entity would set prices, particularly complex ratings assignments could be priced distinctly to help keep opportunities relatively equal related to potential NRSRO margins. If a randomly selected NRSRO opts out, another NRSRO would be randomly selected. The pool of NRSROs could contain both legacy and "new" NRSROs (i.e. NRSROs which may have no experience with a particular issuer).

This discussion did not contemplate altering the existing process for NRSRO registration, except potentially an addendum to "opt-in" into a particular sub-class, as noted above.

Payment for Ratings

The current compensation model of issuer-pays could remain if NRSROs are randomly assigned, as the inherent conflict of interest would be mitigated. NRSROs could be encouraged to disclose fees as well as resources committed to the ratings process, to not only allow investors insight on the information value of the rating but also to enable the Oversight Entity to better set pricing.

Performance Evaluation

Another idea discussed by the subcommittee is to request that the SEC create a workable (and simple) performance scorecard for the NRSROs. An example of this could include:

- Annual disclosure of companies/issuers downgraded (and upgraded) which exceeded two ratings categories (i.e., Single-A plus to Triple-B plus) within the past 12 months, 24 months and 36 months
- Annual disclosure of companies/issuers downgraded (and upgraded) which exceeded 5 ratings categories within the past 12 months, 24 months and 36 months
- Annual disclosure of companies/issuers downgraded (and upgraded) which exceeded 7 or more ratings categories within the past 12 months, 24 months and 36 months

This scorecard could apply to all rating categories (i.e., structured products, corporate credit, munis, governments, etc.).

Additionally, in an effort to increase disclosure, the subcommittee considered asking the SEC to investigate the feasibility of requiring NRSROs to publish a ratings assignment based solely on a quantitative application of their ratings methodologies (e.g. similar to Moody's internal metric scorecard[1]). This could allow investors to determine where NRSROs are adjusting their ratings higher or lower based on qualitative factors and create a transparency into potential conflicts of interests (e.g. if there was a consistent deviation from quantitative ratings in a certain sector). A common performance metric standard and scorecard could evolve that would be common to all NRSROs. Investigation into the feasibility of this could extend to all rating categories (i.e., including munis, governments, etc.).

<u>Company Disclosure on Utilization of Specific NRSROs</u>

The subcommittee also considered asking the SEC to consider requiring companies to include in their annual 10-k filings a summary report detailing which NRSROs were chosen (randomly or otherwise) to assign ratings for the previous year, and accompanying rationale to support those choices.

<u>Oversight Entity</u>

The subcommittee also discussed the possibility that the composition of the Oversight Entity could be structured similar to that proposed in the Franken-Wicker Amendment. While the make-up of the Credit Ratings Board discussed in the Franken-Wicker Amendment was not prescribed, some details were given. Particulars include having an odd number of members, ensuring that investors represent the majority of the Board, and having at least one representative from the NRSROs and issuers. Having an "independent" member is also a consideration. The Oversight Entity members could have finite terms.

<u>Conclusion</u>

While this is a very complex topic with global ramifications, these challenges should not inhibit additional study and potential action to improve the structure surrounding the credit ratings industry. The time to explore improvements is now, and market participants and other observers are urged to provide feedback over the coming months.

[1] "Scorecard' is a terminology used by Moody's to refer to their sector / product based guidelines that determines the factors can be used in most cases to approximate credit profiles in a given sector / product. While not an official rating, it is a systematic determination of the most likely drivers of the ratings of an issuer.