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Secretary
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**COMMENTS ON THE PROPOSED RULES FOR NATIONALLY RECOGNIZED
STATISTICAL RATING ORGANIZATION**

I would like to thank the Commission for having given the opportunity to participate to this consultation. I look forward to continuing dialogue with the Commission and I am willing to answer² any questions or queries you may have regarding this comment.

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Summary & main conclusions

- Current issues related to rating agencies - conflicts of interest, transparency and market perceptions, competition... - are broadly similar to those raised in 2002, as the main concerns related to the rating system have not been addressed/resolved by regulatory authorities during previous regulatory processes (Part I, see pages 4-10).

- Specific issues related to structured finance products were already raised/identified by some regulatory authorities. In particular, the Bank for International Settlements published a report in 2005 in which it was stressed the possible issues arising for structured finance products, *i.e.* model risk and conflicts of interest (Part II, see pages 11-12).

- As regulatory authorities did not address sufficiently the issues raised in 2002, they contributed to the current market turmoil. Does the current regulatory process will improve the “rating system”? Some proposed rules of the Commission are welcome and may increase its integrity. Nonetheless, the Commission has to take into account specific elements pointed out in this Comment (Part III):
 - first of all, some amendments/proposed rules are not adequate and the Commission has to consider preliminary ratings, conditions for competition... in order to “improve ratings quality for the protection of investors and in the public interest” (see pages 12-17);

 - secondly, in order to reach this goal, four issues should be taken into account (see pages 17-21): could reputational risk generate a conflict of interest? Could a supervisory body be useful in order to monitor/oversee the rating industry rather than imposing strict rules? Despite of calls for international cooperation, for which reasons is it possible to have doubts that one day it will effectively enter into force? Is it efficient to use rating for regulatory purposes?

Introduction

In 2002, the regulatory process of the rating industry was reinitiated³, after some corporate failures (Enron and Worldcom collapse materialised this period), with the analysis of the role of rating agencies in financial markets. Three actions took place:

- because investors wanted more transparency from rating agencies, some of them like Moody's and Standard & Poor's carried out surveys [*e.g.* Moody's (2002a, 2002b) and Standard & Poor's (2002)];
- issuers and investors called for more transparency from rating agencies and for regulatory oversight [*e.g.* the AFP survey (2002)];
- regulatory authorities that have/want to regulate rating agencies because of political pressures/mandates and public concerns.

Transparency, market perception, reliability, independence, conflicts of interest, competition were the main themes analysed in 2002. The criticisms levelled at the rating industry mainly concerned the “Main Three”. For instance, the hearings conducted by the US authorities in 2002⁴ mainly dealt with Standard & Poor's, Moody's and Fitch. This regulatory process led, in the United States, to the Credit Rating Agency Reform Act (2006) in order to “improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the rating industry.”⁵

Unfortunately, despite those numerous reports, codes of conduct, new rules ... most of the reports analysing the current market turmoil consider rating agencies as a key actor⁶. It appears that, except specific issues linked to the particularities of structured finance, criticisms are broadly the same than the one raised in 2002. Indeed, the proposed amendments of the Commission deal with conflicts of interest (the “issuer pay” model, the notion of “rating recommendation” as ancillary services, the participation of personnel in fee discussions) and with the instruction for Form NRSRO (rating performance measurements, disclosure of rating methodologies): those issues were more or less analysed during the

³ The SEC tried to improve its oversight on rating agencies, through its NRSRO qualification in 1994 and 1997.

⁴ See the hearings conducted by the U.S. Senate in 2002: United States Senate, 2002a, “Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Committee on Governmental Affairs United States Senate”, Committee on Governmental Affairs, March 2002, One Hundred Seventh Congress, Second Session; United States Senate, 2002b, “Financial Oversight of Enron: the SEC and Private-Sector Watchdogs”, Report of the Staff of the Senate Committee on Governmental Affairs, S.Prt. 107-75, October.

⁵ *In* U.S. Securities and Exchange Commission, 2008a, “Proposed Rules for Nationally Recognized Statistical Rating Organizations”, 17 CFR Parts 240 and 249b, Release n°34-57967; File n°S7-13-08.

⁶ See for example the report of The President's Working Group on Financial Markets (2008): “the principal underlying causes of the turmoil in financial markets were (...) a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies (...) flaws in credit rating agencies' assessments...”

previous regulatory process. Furthermore, in 2005, the Committee on the Global Financial System studied the role of ratings in structured finance and identified that model risk and conflicts of interest constituted the possible issues arising for structured finance markets and concluded that “the occurrence of worst case scenarios on the basis of mispriced or mismanaged exposures might thus lead to situations in which extreme market events could have unanticipated systemic consequences.”⁷

Consequently, regulatory authorities, and the Commission in particular, have to learn from this experience. Some of the proposed rules may address problems related to the credit rating system. Nonetheless, from my point of view, some key issues are not necessarily identified/addressed. This comment is divided into three parts: the first one demonstrates that current issues are broadly similar to those raised in 2002; the second one stresses that the specific issues related to structured finance were already identified in 2005; the last one comments the Commission’s proposals and discusses key issues.

Part I - Current regulatory issues are broadly the same than the one raised in 2002

The amendments proposed by the Commission aiming at dealing with conflicts of interest and transparency address concerns raised in 2002. Furthermore, the will expressed in amendments to increase competition is an old issue: regulatory authorities and the Commission in particular have to understand the key role they played.

1 - Amendments to conflicts of interest

Addressing the Particular Conflict Arising from Rating Structured Finance Products by Enhancing the Disclosure of Information Used in the Rating Process

Once again, the “issuer fee model” used by the main rating agencies is criticised. Actually, it is a concern since they have adopted this business model in the 70’s! At first sight, it is logical to consider the fact that a rating agency paid by the issuer, which wants to “obtain the best grade”, constitutes a conflict of interest. Nonetheless, it seems broadly admitted by market participants that credit rating agencies, i.e. the “Main Three”, manage this conflict of interest because credibility is probably one of the most important criterion of this

⁷ In Bank for International Settlements, 2005, “The role of ratings in structured finance: issues and implications”, Committee on the Global Financial System, January.

industry. For example, the Commission (2003) stated that “the practice of issuers paying for their own ratings creates the potential for a conflict of interest. Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally, and temper their diligence in probing for negative information (...) The larger rating agencies and a number of other market participants agree that the issuer-fee model creates the potential for a conflict of interest, but believe that the rating agencies historically have demonstrated an ability to effectively manage the potential conflict”⁸. For which reasons this potential conflict of interest is still a concern despite of this general acceptance?

As noticed by the Commission, the “issuer/underwriter pay” conflict is more acute in structured finance “because certain arrangers of structured finance products repeatedly brings rating business to the NRSRO”⁹. Besides, the Staff of the Office of Compliance Inspections and Examinations (2008) underlines this weakness: “the combination of the arrangers’ influence in determining the choice of rating agencies and the high concentration of arrangers with this influence appear to have heightened the inherent conflicts of interest that exist in the “issuer pays” compensation model.”¹⁰

One should also consider that few rating agencies practices and the development of ancillary services create/exacerbate this potential conflict of interest and contribute to have doubts about the independence of rating agencies. For instance, the fact that rating agencies do not charge fees when issuing a preliminary rating reinforces this “issuer/underwriter influence” on two sides¹¹:

- rating agencies “increase” their dependence to the issuer/underwriter/arranger as they can be “forced” to respond to the willingness of the latter in order to be paid and conserve/gain market share;
- it reinforces rating shopping practices as the issuer/underwriter/arranger can look for the best rating.

⁸ *In* U.S. Securities and Exchange Commission, 2003a, “Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws”, U.S. Securities and Exchange Commission, June 2003, Release n°33-8236, 34-47972; File n°S7-12-03. See also Cantor and Packer (1995a) and Covitz and Harrison (2003).

⁹ *In* U.S. Securities and Exchange Commission (2008a), see footnote 5.

¹⁰ *In* U.S. Securities and Exchange Commission, 2008b, “Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies”, by the Staff of the Office of Compliance Inspections and Examinations Division of Trading and Markets and Office of Economic Analysis, July.

¹¹ “Typically, the rating agency is paid only if the credit rating is issued, though sometimes it receives a breakup fee for the analytic work undertaken even if the credit rating is not issued.” *In* U.S. Securities and Exchange Commission (2008b).

This issue is not new! This kind of problems has already been raised in previous consultations. Raingeard (2003, 2004, 2005a) pointed out that preliminary corporate ratings¹² used by certain rating agencies increase this potential conflict of interest and submitted the idea to prohibit this practice.

Rule 17g-5 Prohibition on Conflict of Interested Related to Rating an Obligor or Debt Security where Obligor or Issuer Received Ratings Recommendations from the NRSRO or Person Associated with the NRSRO

This proposition is more or less linked to the issues related to ancillary services raised in 2002. The lack of thinking on ancillary services - as far as I know, regulatory authorities do not identify the different advisory/ancillary services proposed by rating agencies and their affiliates; IOSCO (2008) only proposes to “force” credit rating agencies to disclose “what it considers, and does not consider, to be an ancillary business and why”¹³ - has probably contributed to this result. For instance, concerning structured finance, some practices raise concerns. Is it “efficient” (for the rating industry) that rating analysts make proposals regarding the design of structured finance products? Is it efficient that rating agencies develop services related to price transactions on the secondary market¹⁴? In order to ensure that the rating industry keeps its credibility, the Commission has to deal with these points.

Rule 17g-5 Prohibition on Conflict of Interest Related to the Participation of Certain Personnel in Fee Discussions

It is well-known by market participants and regulatory authorities that, in order to reduce the potential issuer’s influence and increase transparency, rating agencies should ensure the independence of people involved in the rating process through policies and procedures; in order to ensure the credibility of the rating’s system, direct or indirect capital link with issuer should be prohibited; and the disclosure to regulatory authorities and/or to

¹² After the initial contact between the agency and the issuer and the communication of the appropriate information, few rating agencies (NRSROs and non-NRSROs) provide a preliminary rating, which can be comprised within a range (e.g. a preliminary rating A+/A; in certain cases, a probability of realisation is indicated). If the issuer accepts this preliminary rating, the rating procedure is engaged; otherwise, he can drop the process.

¹³ In IOSCO, 2008, “The role of credit rating agencies in structured finance markets”, Technical Committee of the International Organization of Securities Commission, March.

¹⁴ See Aguesse P., 2007, “La notation est-elle une réponse efficace aux défis du marché des financements structurés”, Autorité des Marchés Financiers, Direction de la Régulation et des Affaires Internationales, Risques et tendances n°2, mars.

market participants when issuers exceed a certain percentage of the revenues should be required. This kind of issues has been analysed since 2002.

Despite of this knowledge and rules concerning some of those conflicts of interest, the Staff of the Office of Compliance Inspections and Examinations (2008) notices that “while each rating agency has policies and procedures restricting analysts from participating in fee discussions with issuers, these policies still allowed key participants in the rating process to participate in fee discussion.”¹⁵ Consequently, the Commission has to deal with this problem.

2 - Amendments to the Instructions for Form NRSRO

The Commission is proposing to enhance ratings performance measurement statistics on Form NRSRO and the disclosure of rating methodologies. Those issues are related to rating agencies’ transparency and market perceptions.

The Commission seems to have operated a major shift since 2007. Indeed, until its new rule in 2007, it appeared to primarily rely on the reliability and credibility of rating agencies. For instance, the SEC (1997) claimed that the “single most important criterion is that the rating organization is nationally recognized, which means the rating organization is recognized in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings”¹⁶. Its new rule (2007) drops the concepts of reliability and credibility of ratings and only requires “that an application for registration as an NRSRO contain credit rating performance measurement statistics”¹⁷.

This shift is difficult to understand: does the Commission drop the concept of reliability and credibility in order not to give investors the “illusion” of reliability and accuracy of rating? Does the Commission drop them in order not to give investors the “illusion” that the Commission guarantees the reliability and credibility of NRSROs?¹⁸ If so, it would have been

¹⁵ In U.S. Securities and Exchange Commission (2008b), see footnote 10.

¹⁶ In U.S. Securities and Exchange Commission, 1997, “Capital Requirements for Brokers or Dealers Under the Securities and Exchange Act of 1934”, “Proposed Rule”, Release n°34-39457; File n°S7-33-97, December 17.

¹⁷ “The Commission intends to continue to consider this issue to determine the feasibility, as well as the potential benefits and limitations, of devising measurements that would allow reliable comparisons of performance between NRSROs.” In U.S. Securities and Exchange Commission, 2007, “Final Rule: Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations”, Release n°34-55857; File n°S7-04-07, June 5.

¹⁸ Does the Commission make this shift in order not to give investors the “illusion” of the equivalence of reliability and credibility between rating agencies? This concern has been already raised by some rating agencies since 1994! For example, Moody’s (1994) claimed that “the SEC appears to have created in the capital markets merely the *illusion* of equivalence among the various agencies, their ratings and their rating standards. This illusion, Moody’s believes, creates the opportunity for rating shopping (...). In addition, because of the manner in which the SEC uses NRSRO ratings in its regulations, investors may be led - fallaciously - to conclude that all NRSRO ratings of a certain level express opinions denoting equivalent levels of risk”. Numerous researches demonstrate that differences between rating agencies exist. For instance, Packer and Reynolds (1997) find

