

April 9, 2009

## **A Fresh Approach to the Rating Agency Function**

We are writing as individual citizens with experience relevant to the operation of the capital markets and to the functions of investment research in both the equity and fixed income markets. We believe that well-functioning credit markets are essential to the allocation of capital and resources in our economy, and to the functioning of the capital markets in general.

One reason that credit markets became, and have remained fragile, is the lack of credibility of ratings provided by the traditional agencies. Market participants are unsure how to value many debt securities because the ratings shorthand they have come to rely on has inaccurately described current expected outcomes. The problem is acute in the market for structured finance products, where bonds that were rated AAA/Aaa would seem to be failing in their promise to have “an extremely strong capacity to meet their financial commitments.” And it has spilled over so that credit perceptions of financial institutions are suspect, both because the institutions hold a large volume of securities backed by these same structured finance products, and because the agencies’ overall assessments of financial institutions are perceived to have been reactive rather than anticipatory.

The framework in which the traditional ratings agencies operate does not promote quality because the “customer” of the ratings agencies is not the primary user of the product, the investor, but instead, the original issuer of the bonds.

One of the stated objectives of the Credit Rating Agency Reform Act of 2006 was to “improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.” Long-lasting improvements in the functioning of the credit markets require that this objective be realized. To effectively oversee the agencies, the primary regulator should put in place the building blocks for accountability, transparency and competition. We believe that the objective can best be achieved if:

1. Investors pay for the research and ratings which underpin the valuation of bonds that they purchase and hold.
2. Rating agencies are held accountable both by the markets, and by contract, for the quality of their work.

This is a major shift.

## **Observations Regarding the Current Market Environment**

1. Fixed income markets (investors and intermediaries) have come to rely heavily on credit ratings.
2. Market conventions have increasingly encouraged a focus on ratings shorthand rather than the full body of credit research which underlies the summary ratings.
3. Structured products have been created with collateral that is diversified by geography and product type to reduce the risk of the pool. In many cases the collateral includes interests in other securitized pools. This diversity of collateral often makes evaluation of the securities difficult. The absence of full and continuing disclosure regarding the loans underlying such securities exacerbates the difficulty that professional and individual investors face in completing thorough credit analyses.
4. Credit infrastructure within many financial institutions and investment organizations has atrophied as securitized fixed income markets have evolved. The number of personnel assigned to evaluate credit and the investment in training such personnel has failed to keep pace with the growth in complicated securities which require analysis. In addition, as securitization has evolved, investors with no direct linkage to borrowers, and often at a significant distance (both geographically and commercially) have become significant creditors. Yet these investors often do not have access to information that would be required to fully assess credit. Instead of doing thorough, independent credit work, these investors rely on published ratings to both screen and assess securities.
5. Nationally Recognized Statistical Rating Organizations (NRSRO's) are in a unique position to conduct credit research. They routinely enter into confidentiality agreements which provide them with proprietary information regarding the credit prospects of the issuer. In addition, NRSRO's are exempt from Regulation FD, which gives them the ability to gather new in-depth information about the state of an issuer, unavailable to other investors in the marketplace.
6. NRSRO ratings have become "hardwired" in a vast spectrum of rules, regulations, and investment guidelines. These rules affect capital requirements, disclosure requirements, portfolio construction, and a host of other activities undertaken by banks, broker-dealers, corporations and other issuers, pension funds, insurance companies, professional money managers and others. Investors have strongly voiced their desire to maintain these rules.
7. The markets acknowledge daily the importance of credit ratings. There is ample empirical evidence that rated securities trade at higher values than unrated securities.

8. The economic model that supports the rating agencies does not create adequate incentives for the creation of high quality, reliable work. There are no direct economic consequences for poor credit research or a rating which fails to predict an event of default, because the payer, the issuer, is not harmed in either event.
9. Ratings are treated as a public good. Any investor can access the rating assigned to a particular bond without paying for the services of a particular rating agency. The ability to freely access and use a rating creates the benefit of providing everyone with equal information. However, the “free” nature of the ratings comes at a significant cost in that it severs the economic linkages between those who rely on ratings and those who provide them.
10. The rating agencies are not held legally accountable for the quality of their work. Since there is no contractual relationship between those who rely on ratings (investors) and the providers of ratings, there is no legal recourse. The agencies have, to date, escaped accountability for the quality of their ratings in the courts. They have successfully argued that their ratings/opinions are subject to protection under the First Amendment.
11. Current payment mechanisms encourage the rating agencies to place greater emphasis on a credit at the time of its initial rating and less emphasis on updating that analysis. (Since the issuer is most interested in the rating upon issuance of the bond, the agencies charge one fee initially and one fee (usually less) for the maintenance of that rating.) Yet defaults almost never happen immediately following a new issue, and from a holder’s perspective, changes in credit quality are as or more important than credit quality at the time of original issuance.
12. Many “free riders” have emerged—financial institutions, corporations and partnerships often now use credit ratings and changes in ratings as a reference to determine events of default, and changes in terms of private contracts such as credit derivatives, leases, partnership agreements, and collateral arrangements. Yet the providers of ratings receive no compensation for the value added by ratings in these situations.

### **Alternative Economic Models**

As a practical matter, credit ratings have become embedded in the capital markets infrastructure for good reason—the task of performing credit research is an activity that lends itself to scale economies. The markets have sought to avoid duplicating work that can be reasonably outsourced to a credible group of providers who, conceptually, are capable of gathering information, performing analysis, developing judgments and articulating their conclusions in a succinct way. However, the outsourcing model breaks down when the providers are chosen, evaluated and compensated by a party whose interests are not aligned (and, in fact, are often in conflict) with the primary users—investors and other asset owners, and the rule makers who seek to help protect their interests.

A model whereby credit research and summary ratings are paid for by investors rather than issuers would be superior to the current model. Under such a model the user making the purchase decision would tend to focus explicitly on the quality of the good/service received and its relevance throughout the holding period.

Some subscription models for credit research and summary ratings have begun to emerge. These experiments appear to be adding constructively to the menu of choices available for purchasing credit research. However, the current system makes it difficult for providers to be paid based on value-added, both because they have to compete with the “free” ratings provided by the traditional issuers, and because it is difficult for them to discover and monitor how extensively their intellectual property is being deployed. Typically, these providers charge fees based on a number of users, with some reference to an organization’s overall assets under management.

Ideally, an investor-pay model would be directly linked to value-added. . Specifically, the provider would charge some number of basis points for a specific security times the value of that security purchased or held to reflect the value added by the rating. Historically (in a paper-based environment) a system like this would have been impossible to administer. In today’s environment the technology exists to develop and implement such a system fairly easily.

We can envision several potential payment mechanisms that would be consistent with this framework.

In one alternative, investors who purchased new securities would enter into a standard contract for rating agency services. “Initial” rating fees would be deducted from proceeds of a new issue and directed to the Rating Agencies by the buyer/owner of the bonds, not the issuer. Investors would “designate” their pro rata portion of the fees to one or more agencies (with the pro rata portion designated by each investor based on the amount of the bond issue that investor purchased). Any licensed rating agency would be eligible to rate a bond and the issuer would be required to provide all interested rating agencies with the information to rate their securities. Maintenance rating fees would be paid by the issuer along with its coupon/amortization payments. These rating fees would also be allocated to individual rating agencies based on investor preferences. The payments would be held by an administrator and then released to the rating agency based on the quarterly feedback of the bondholders (including those who buy bonds during the quarter and those who are continuous holders). When the debt is repaid (or repurchased by the issuer) a final rating fee would be paid in conjunction with the retirement of the bond. Again these fees would be allocated to individual rating agencies based on explicit investor feedback or “designations” of the fee pool proportionate to the investors’ holdings of the bonds. The mechanics of this model (which we refer to as the “Designation Model”) are described in Appendix I.

A second alternative model would require all “users” of credit ratings to enter into a contract and pay for the services of a NRSRO which would supply such a rating (“User Pay Model”). A “user” would be defined as any entity that included a rated security, loan or contract as an element of its assets or liabilities as recorded in an audited financial

statement. Users would include holders of long or short positions in a fixed income instrument, as well as parties who refer to a credit rating in contractual commitments (i.e. as parties to a lease) or who are parties to derivative products that rely on rated securities or entities. A user would be required to pay for ratings services supplied during each period in which it booked the related asset or liability. The implementation of this system would look to the auditing process for assurance of payment to the credit rating agency. Any entity that required audited financial statements where the rated instrument or covenant was included among the assets or liabilities would be required to demonstrate to the auditors that the holder had paid for the rating services. No audit opinion would be issued until the auditor was satisfied that the rating agencies had been properly compensated. This alternative could be cumbersome to implement. It would require the close cooperation of the auditing community and the Public Company Auditing Oversight Board (PCAOB).

A third alternative might combine features of the two described above. While the first alternative is relatively easy to implement, some market participants have suggested that it may substitute one set of conflicts for another. For instance, current holders of bonds might have some incentive to reward an agency which upgraded or maintained a high rating even in the face of a deteriorating credit. We believe this objection is overwhelmed by several factors<sup>1</sup>, but one way to eliminate the concern is to expand the group permitted to designate from the fee pool to include investors from the “short-side” of the market. Once the credit derivatives market is formalized, it might well make sense to deduct additional rating fees directly from payments associated with such derivatives, and to allow the counterparties to such transactions to be part of the designation mechanism associated with the Designation Model. This approach would incorporate some of the advantages of the User Pay Model, that is, the capturing of rents associated with benefits currently enjoyed by certain free riders.

Each of these models has strengths and weaknesses. Implementing them requires the resolution of many details. Our purpose in outlining them is to stimulate discussion of their relative merits so that an optimal model can be developed.

Importantly, any of these alternative models would encourage rating agencies to prepare unsolicited ratings, because each agency could be ensured of receiving compensation for its ratings, provided some group of investors found them useful enough to allocate to the provider a portion of the fees they designate or pay. We believe that competition amongst agencies would therefore be enhanced.

---

(1) Among the factors that address this objection are: (a) Most large owners of bonds who would be designating material amounts of fees continuously buy and sell securities. Ideally, they would like securities they were selling rated highly relative to credit quality, and securities they were buying rated below their credit quality. We do not believe they could induce a rating agency to support this arrangement from a practical point of view. Even the largest bond owners would quickly realize the impossibility of using the payment mechanism to enforce desired ratings. Instead, most large holders would recognize the value of allocating fees for the best credit work and service and would award fees associated with a specific bond issue based on the overall quality of service received from each agency. (b) Within an organization that holds bonds, at least some constituencies (typically senior management, the Board, or the compliance unit) would be likely to support fair ratings over inflated ratings, whereas within an issuer, there is no constituency which has an incentive to reward anything other than the highest possible rating.

These models would also encourage rating agencies to enter into direct dialogue with investors to understand their needs, and to tailor product quality to meet those needs. We believe that this “feedback loop,” which is limited today, would incent the agencies to continuously improve their methodologies and analytical tools to be of value to the most sophisticated investors. As a consequence, the feedback loop would improve the work product for the benefit of all who rely on rating agency services.

Finally, each of these models contemplates the development of a contractual relationship between investors and the agencies themselves. It is our view that the creation of this relationship would permit those who pay for the ratings to have some legal recourse to the agencies. More specifically, our thought is that the contract would provide the payer with the right to recover fees paid if the provider were found negligent in the preparation of its credit research and associated ratings. While this feature would not permit the payer to recover the potential value it might have at risk in connection with its holdings, it would have the benefit of holding the agencies legally accountable for diligence in approaching their work.

### **Implications**

The models described above are intended to improve the quality of available credit research for a capital market that has become increasingly dependent on a centralized and “official” source of credit evaluation.

There are a few litmus tests for success.

First, any viable new model must be embraced by the institutional investment community. It is important that the largest, most sophisticated holders of bonds express willingness to pay for or direct payment for credit ratings. Based on relevant precedents in the equity market, we believe that investors could and would implement the necessary processes to implement the investor Designation Model. They would measure the contribution of the rating agencies to their investment results and communicate those views to the appropriate administrator to allow payments to be made appropriately. The second alternative, or User Pay Model, would likely trigger a stronger reaction from investors since they might perceive user fees to be a new expense of holding securities or entering into contractual relationships. To implement this alternative, it would be necessary to persuade the community that its interests were best served by shifting the model to one meant to be of long-run benefit to all investors.

A second litmus test for a new model is whether it attracts new capital into the credit research space. Many market participants have expressed frustration with the current providers of credit research and ratings. A fresh workable model would have the benefit of attracting additional talent to the industry and buttressing the overall credit infrastructure available to the capital markets. It is likely that the models outlined here would impact the existing credit research/ratings providers and cause them to modify their practices and enhance the quality of their products. It also might attract researchers

who would specialize in specific markets or types of bonds, and make it easier for them to start viable businesses that would add to the competitive dynamic in the marketplace.

A third test is whether the new model enhances the credibility of ratings and inspires public confidence. An advantage of the models we have described is that their implementation requires substantial changes to the way the agencies currently conduct their business, and collaboration by many market constituents. The implementation of these models provides an opportunity to educate investors and the public regarding what has gone wrong to date, and how this major shift would help right the situation.

The introduction of a new compensation model naturally would require regulatory support. The Roundtable discussion sponsored by the U.S. Securities and Exchange Commission could well be a starting point for vetting these ideas with leading market participants. Importantly, the model should be fostered and promulgated worldwide. Naturally, it would be helpful if the U.S. regulatory community were willing to lead the way. Importantly, we believe these changes would align the economic incentives of the rating agencies with the relevant policy and regulatory objectives.

At the moment, U.S. regulators have an exceptional opportunity to begin experimenting with techniques designed to foster accountability, transparency and competition in the credit rating agency industry. Both the Term Asset-Backed Securities Loan Facility (“TALF”) and the Public-Private Investment Funds (“PPIF”) contemplate that securities to be financed are or may be rated by NRSRO’s. As these new securities are developed, it could make sense to begin to introduce or encourage several improvements to the new issue process including:

- Providing more fulsome initial and ongoing disclosure regarding new issue securities to both the agencies and investors
- Constructing or reconfiguring pools in a way that facilitates deep credit research by the agencies and by investors themselves
- Experimenting with an investor-pay model for compensating the rating agencies

The models we have outlined are not the only approaches that could be developed to align incentives amongst the agencies and the investors who rely on their work product. We can imagine other ways to approach the issue as well. We have crafted this paper to start a dialogue amongst industry participants around some specific ideas so that a workable methodology can be developed and implemented to improve oversight of the credit rating agencies and enhance the efficiency and effectiveness of the capital markets.

-Mayree Clark  
-Andrew Jones

### **Mechanics of Designation Model**

#### ***At Issuance:***

- 1) Issuer decides to issue a bond and engages underwriters.
- 2) Issuer and underwriter determine whether or not a bond issuance should be rated by a National Recognized Statistical Rating Organization (“NRSRO”).
- 3) Assuming that a rating is desired, underwriters determine the market rate for rating services (the “Rating Fee”) through a discussion with the rating agencies. This fee would be expressed in basis points as a percentage of the face amount of the issue. If the underwriter was also the issuer (which is often the case with structured products, an independent underwriter might be asked to orchestrate the discovery of the market rate for rating services).
- 4) All rating agencies would be notified by the issuer or underwriter of the upcoming bond issuance and associated Rating Fee. Agencies then would decide whether to participate in rating the bonds and would notify the issuer or the underwriter.
- 5) Interested rating agencies would receive the issuer information and participate in due diligence sessions necessary to rate the securities.
- 6) Rating agencies would issue their ratings and potential investors would review any and all ratings.
- 7) Bonds would be issued and rating fees would be held in escrow in a pool of fees (“Initial Fee Pool”).
- 8) Investors who purchased securities would enter into a standard contract for rating agency services and designate which agencies should be compensated for the quality of their work (the “Rating Designation”). Investors would receive votes ratable to their share of the issuance.
- 9) All Rating Designations then would be tallied, determining how the Fee Pool should be split among the rating agencies. If a holder did not designate a rating agency(s), that holder’s designations would be assumed to be in the same proportion as the holders who did designate an agency.
- 10) Initial Fee Pool would be paid to the agencies based on each agency’s share of Rating Designations.

#### ***Thereafter:***

- 11) Issuers would make maintenance rating payments when they pay coupon payments. For zero coupon bonds, maintenance payments would be made annually.
- 12) Maintenance payments would be pooled.

- 13) A system would be in place to allow investors to review the quality of the work of the rating agencies and designate which agencies should be compensated for the quality of their work. Investors' designations would be ratable to their share of the issuance (potentially along with a mechanism to incorporate the views of investors with a short position in the instrument).
- 14) Quarterly, the administrator of the pool of maintenance payments would pay the rating agencies based on designations received from investors. At the end of each year, the administrator would reconcile the account and allocate all remaining, undesignated Rating Fees to the rating agencies rating the issue.
- 15) Upon retirement or repurchase, a final pool of fees would be allocated to the rating agencies based on designations provided by investors receiving payments. Rating agencies would be paid for maintenance and debt retirement if and only if coupon payments are made and the bonds were successfully retired. In most circumstances, if an issuer defaulted, the agencies would not receive any payment.

**Mayree Clark**

Mayree Clark is a member of the Investment Committee of Aetos Capital Asia. She joined AEA Holdings, former parent of Aetos Capital, as a Partner and member of its Executive Committee in 2005. Her work in connection with the rating agencies is independent of Aetos, and has been undertaken as a service to the community.

Ms. Clark was affiliated with Morgan Stanley from 1981 to 2005. She served in mergers and acquisitions, corporate finance, debt capital markets and real estate during the early years of her career there. She was a pioneer in the area of securitization, leading several initiatives associated with commercial mortgages and fixed income securities, and the team which developed the UPREIT structure. Ms. Clark spent two years as deputy to the chairman, president and CEO of Morgan Stanley. She became Global Research Director in 1994 and led that effort to preeminence until 2001, when she was asked to lead the firm's global private wealth management activities. She served as non-executive chairman of Morgan Stanley Capital International (MSCI) from 2000 to 2005.

Ms. Clark did her undergraduate work at the University of Southern California and received her MBA from the Stanford University Graduate School of Business. She is currently a director of the Stanford Management Company (which is responsible for the University's \$15 billion endowment) and was a Director of Commonfund from 1996-2004.

Ms. Clark recently contributed to *Financial Reform: A Framework for Financial Stability*, published in January 2009 by the Group of Thirty.

**Andrew Jones**

Drew Jones is a senior investment professional with approximately 20 years experience in the financial services business. His work in connection with the rating agencies has been undertaken as a public service.

Drew's investment background includes 18 years at Morgan Stanley. Drew was an Associate Director of Research at Morgan Stanley from 2000-2007. He was responsible for 10 of the 13 research sector and macro teams and managed both equity and fixed income analysts. Before joining the research management team, Drew was a ranked securities analyst, focused on the Real Estate Investment Trust (REIT) market and an acquisitions officer for the Morgan Stanley Real Estate Funds. He began his career at Morgan Stanley as an investment banker in the real estate group. Most recently, Drew served as a product specialist and risk manager for an Asian securities hedge fund.

Drew received his MBA from the J.L. Kellogg Graduate School of Management, with a concentration in finance, and his BA in Economics from Northwestern University.