Commentary on Round Table sponsored by the SEC on Tuesday 14 May 2013.

My name is Richard Hainsworth and I founded and currently serve as the President of RusRating, an independent rating agency accredited by the Russian Ministry of Finance. Together with Bjon Saenger (a member of the German Bundestag), we organised a European round table on ratings in February of this year. The Berlin Round Table brought together politicians, regulators, credit rating agencies and ratings users. Together with Dagong Global Credit Ratings Co (China) and Egan-Jones Credit Ratings Co (a US NRSRO), RusRating is involved in the creation of a new global rating agency in Hong Kong called UCRG.

I watched the webcast of the Round Table on ratings live, and whilst the panellists touched on a number of interesting issues, several significant elements need to be highlighted.

The focus of the Round Table was on the business models of credit rating agencies and it is possible that the some of my following comments appear to be off-topic. Nevertheless, without clearly characterising certain fundamental principles, legislators and regulators may be drawn by the debate and a focus on secondary problems into actions that are even more detrimental to the economy than the problems they hope to address.

a) Ratings, not rating levels, are a public good

Where studies find evidence for dangers when credit ratings are embedded in regulations, it is in fact embedded rating **levels** that cause the problem. Credit ratings are issued along a spectrum, from bad to good. It is far too tempting for a regulator to choose just one specific rating (for example an "investor grade" rating) and then declare that companies or securities with ratings above "investment grade" will be granted privileged treatment. The presence in legislation of a single rating level inevitably over time skews the distribution of credit ratings over the whole scale: poor ratings do not get published, pressure is exerted on agencies to "bump over the threshold" marginally worse ratings, and there is lessened incentive to aspire to excellent ratings. In other words, the choice of a single rating level ignores the existence of all the other ratings and diminishes the value to the market of other levels of creditworthiness.

Another problem caused by specifying rating grades in laws or regulations is that in times of stress, rating grades will fall. If the rating grade of a security falls below the regulatory limit, then holders of that asset are forced to sell it, triggering even more stress and a downward chain reaction.

Conclusion: It is bad to embed specific rating grades into regulations.

In some national jurisdictions around the world, credit ratings are mandated by law or the market. In such jurisdictions, all large and important companies and all issues have ratings. If a company or issue does NOT have a rating, then there are questions asked about the quality of the issuer. In other jurisdictions, ratings are not mandated and in these countries issuers have credit ratings only if they wish to demonstrate some quality standard. Most companies in such countries, including good creditworthy companies, see no need to spend money on a credit rating.

Where credit ratings are common, the level of market transparency is higher than in markets where there is no need for credit ratings. When credit ratings are generally available, investors have a higher level of information. Credit ratings, although paid for by issuers, become a public good to be consumed by all investors. The increase in transparency allows small investors, who do not have the resources to conduct their own due diligence, to invest in diverse companies via public stock exchanges.

The only way to move a market from ratings-poor to ratings-rich is by government intervention. This occurred, almost by chance, in the USA in the 1960s. "By chance" because the NRSRO designation was established and "investment grade" ratings on certain securities were required in order to resolve company-level regulatory issues and not in order to create a public good for the benefit of the entire capital market.

If the need for a credit rating is removed from the regulatory regime (note "credit rating" and not a "specific rating grade"), there is a possibility that issuers will stop seeking credit ratings altogether. The wholesale removal of credit ratings from USA regulation may destroy a source of important information and diminish the transparency and liquidity of the USA capital markets.

The solution here is simple: all appropriate regulations should refer to the existence of one or more credit ratings, but no mention should be made of any specific rating grade.

There is a clear and obvious link between the mandated requirement to get a credit rating (not an “investment grade rating”) and the business model of a credit rating agency. If credit ratings are not mandated, then the business models of all credit rating agencies become marginal.

My company was founded in a jurisdiction without mandated credit ratings and existed purely on the investor-pays model. However, even in an environment of extreme information asymmetry, which theoretically should be most advantageous for an investor-pays credit rating agency, the business model is marginally profitable. The costs of high quality analysts, substantial information trapping and high-profile marketing are not easily balanced by the revenues from a product that is essentially a prestige symbol and an information source that has a limited set of users. Information products are the first to be cut during a downturn in the business cycle, so we lost subscribers since the global crisis. As soon as there is a regulatory or market requirement for universal credit ratings, a rating agency reaps considerable economies of scale. My company is beginning to see this change in the business model as regulators in our jurisdiction have recognised that credit ratings as a public good are valuable.

The issuer-pays model does indeed create conflicts of interest. However, the issuer-pays model creates an environment in which the market gains access to a public good. Whilst it is important to address problems which are inevitable in any system, it would be detrimental to destroy the system completely if the system generates overall or long-term benefits. We contend credit ratings provide long-term benefits.

The business model foreseen by the Franken amendment recognises the public-good value of credit ratings and attempts to create a publicly administered mechanism to finance the public good. All business models have their flaws. Some of the flaws in the Franken system can be seen now, but it is not possible to know whether they are more or less pernicious than the current system until the new system has been instituted and can be seen in operation.

By the same token, it is not possible to determine categorically that the Franken model would **not** be better than what currently exists. The most sensible action would be to set up the Franken system in parallel with the existing system and to see how it develops. Admittedly, the most sensible course is not always possible in the real world.

Even if the Franken system were to be implemented, ratings would still need to be mandated for all market participants. If ratings were no longer required, then market participants would cease to seek or pay for ratings.

b) The near monopoly of the “Big-3”

Several times the near monopoly of the three dominant US credit rating agencies was alluded to by panel members. In particular there is the problem of "hard coding" in investment policies, particularly in State laws and in the investment policies of large institutional investors. We confirm that this phenomenon, which has now extended far beyond the borders of the USA, is a major barrier to the entry of new and small credit rating agencies. The near monopoly has a substantial impact on the business models of new and small credit rating agencies.

We also perceive that whether or not it is a conscious policy decision of the dominant credit rating agencies, their actions and behaviours do appear to be directed to the protection of their near monopoly and to the detriment of smaller players. There is, for example, no industry body for credit rating agencies (for example, the European Association of Credit Rating Agencies or the Asian

Association of Credit Rating Agencies) that lists any of the dominant agencies amongst their members. The commercial pressure to retain for oneself a monopoly is obvious and for the player involved it is rational to try to keep the monopoly (which monopolist in history has willingly forgone monopoly profits?) However, the existing massive concentration in the market for the provision of credit ratings, so that only two, at most three, credit rating agencies provide virtually all ratings has not turned out to be beneficial to the economy of the USA or to the global economy. There is therefore no solid economic argument that the near monopoly should be retained or preserved.

It is therefore, we contend, in the best interests of the US economy to diminish remnants of monopolistic influence. These same monopoly remnants create an uneven playing field and prevent smaller players from growing and proving the value of their products.

Moreover, we contend that these monopolistic remnants are not the result of a free market or of free speech and therefore free-market or free-speech arguments should not be used to defend them.

One such remnant is the hard coding of named agencies in investment policies. For example, there are many (if not the overwhelming majority of) institutional investors who have investment policies which include statements similar in form or meaning to “the <fund/account> shall not purchase securities rated lower than XXX YYY”, where XXX is one of S&P or Moody's, sometimes FitchRatings, and YYY is a particular rating grade, such as BBB-.

It is good practice to link asset allocation policies to creditworthiness assessed by a neutral third-party. It is anti-competitive and discriminatory to refer to a named company rather than to a generic category of competent providers.

Generic language referring to NRSROs accredited by the SEC should be adopted in place of specific company names.

In place of specific symbols, generic terms such as “investment grade” can be used. It would of course be better to have a number of categories, such as “speculative grades”, “acceptable grades”, “safe grades” corresponding to different parts of the credit rating spectrum. Credit rating agencies would then be able to define which of their credit rating symbols correspond to these categories, in the same way as credit rating agencies currently define which of their symbols is the “investment grade” threshold.

The SEC is in a position to provide explanation to the investment community that generic investment policies are good practice, whilst anti-competitive investment policies are bad practice.

The SEC is in a position to make investment best practices a component of ongoing regulatory oversight for a wide swathe of investment institutions and instruments.

The SEC might consider requiring a “comply or explain” rule regarding best practice for investment policies. In this way, an investment institution would need to explain to its clients and investors why it is willing to rely exclusively on a set of credit rating agencies whose performance in recent years has been subject to severe and unmitigated criticism.

Removing the remnants of monopoly practices will, we are certain, do far more to affect the business models of small rating credit rating agencies than changing the mechanism for financing ratings.

c) Credit Rating Agency Performance.

The idea that the ratings assigned by credit rating agencies should be compared to actual results is very important. Although the discussion of this topic centred around management of the Franken system, we believe it has far wider implications.

We call metrics that use actual losses or credit events related to some issuer “**ex-post** measures of creditworthiness” because they look backwards in time. This is in contrast to credit ratings, which we call “**ex-ante** measures of creditworthiness” because they are predictions of current and future creditworthiness.

Surely it is obvious that when an individual or agent makes a forecast of something (eg., the weather, inflation, baseball results, creditworthiness), we should compare the prediction with what happens, and decide whether to pay attention to that “prophet” in the future. Using our terminology, ex-ante credit ratings should be compared to ex-post measures of creditworthiness.

Panellists mentioned metrics such as “loss curves” and “fallen angels”. These are new or less common ex-post metrics; the most common ex-post metric is default frequency, namely how many companies defaulted in some previous period. Default frequencies are enticing because they can be correlated with particular rating categories and then “converted” into the default probabilities of those credit ratings. The important point here is that other ex-post measures of creditworthiness exist, not just the method of counting the number of defaulting companies in a period.

Anchoring a credit rating agency's ratings to real-world loss experience will in the medium to long term provide a barrier to rating shopping and to the slippage of ratings in quality.

The investment community and the SEC should be concerned about the prevalence of rating shopping, in other words issuers going from one rating agency to another in search of the highest rating for a new issue. Consequently, any mechanism to counteract the pressure exerted by investment bankers and issuers on credit rating agencies to give them improperly high ratings should be implemented.

What should be avoided however is a blind adherence to any one ex-post measurement technique, such as default counting. Rating agencies themselves should be encouraged or required to define how their ratings should be assessed and should provide the data on an ongoing basis to enable assessment of their performance over time.

Conclusion

In conclusion, may I take the opportunity to thank the SEC for sponsoring the Round Table and for making it possible for a wide audience to take part. I also thank the SEC for the opportunity to comment on the proceedings.

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