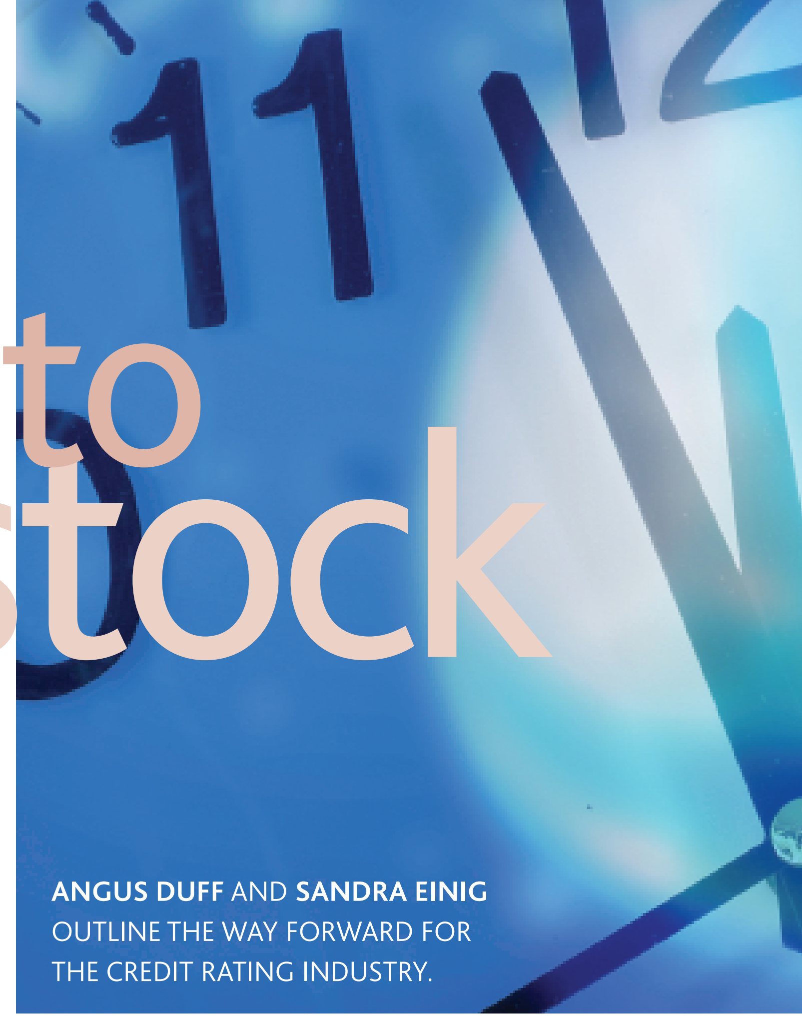


Time to take stock

ANGUS DUFF AND **SANDRA EINIG**
OUTLINE THE WAY FORWARD FOR THE CREDIT RATING INDUSTRY.

As a result of the US sub-prime mortgage crisis and the subsequent run on UK high street bank Northern Rock, the credit rating agencies have come under fierce criticism from the international financial community, regulatory bodies and politicians. Such criticism is hardly new. Commentators questioned the inability of the agencies to predict events such as the 1997 Asian financial crisis or the corporate failures in the early part of this century. For example, the three major agencies – Moody's, Standard & Poor's (S&P) and Fitch – all gave Enron an investment-grade rating until days before the US energy giant collapsed.

THE VALUE OF RATING AGENCIES The agencies provide an independent assessment of the credit quality of a client company's debt security. When the issuer commissions or solicits the rating, the agencies are given privileged access to senior management and other confidential information sources. Combined with the agencies' independence, this makes their opinions of interest to the investment community, and gives smaller investors access to high-quality analysis. The agencies act as gatekeepers to capital markets, with the ratings process facilitating the fair pricing of securities.

RAPID GROWTH AND CONTINUED DEVELOPMENT The credit rating industry has undergone significant change in the last few years. Examples include:

- rapid growth (see *Figure 1*) is driven by the development of the structured finance ratings market, and other ancillary services to corporate ratings;
- the introduction of agency self-regulation through the IOSCO (International Organization of Securities Commissions), ACT, AFP (Association of Financial Professionals) and AFTE (Association Française des Trésoriers d'Entreprise) codes of conduct;
- the introduction of formal regulation in the US; and
- the recognition of more nationally recognised statistical rating organisations: from three in 2001 to seven in 2007.

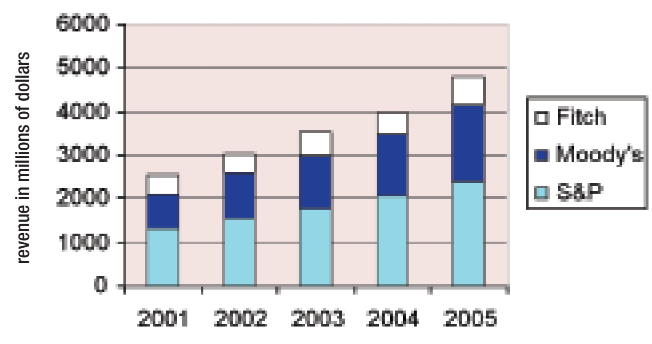
Rating agencies remain relatively under-researched as entities and an industry. In recent research published by the Institute of Chartered Accountants of Scotland (ICAS), we report the results of a series of interviews with a range of market participants, and a survey sent to 2,450 individuals representing users of rating agency services. The research developed a model of ratings quality with 14 factors, as listed in *Table 1*. The most important agency attributes for users are reputation and trust, reflecting the agencies' role as reputed intermediaries; responsiveness and service portfolio rank lowest.

THE RECOMMENDATIONS Our report makes recommendations to strengthen policy in the industry, as follows:

1 Continue down the path of self-regulation and ensure IOSCO and ACT/AFP/AFTE codes of conduct are monitored closely. Few market participants see a role for formal regulation at this stage. Formal regulation would stifle the professional judgement of rating analysts and create backward-looking number crunchers; the situation is analogous to defensive medicine, whereby a range of treatments with minimal benefits are administered to patients as a way of avoiding litigation.

2 The rating agency industry would continue to benefit from additional specialists. Although the industry is an oligopoly, investors increasingly favour more than one rating. Issuers do not necessarily engage both of the Big Two (S&P and Moody's) but may use one larger agency alongside a smaller player. Thus the development of additional high-quality niche operators would encourage competition in the industry.

Figure 1: Revenue growth of the rating agencies



Executive summary

- A recent survey, *Credit Rating Agencies: Meeting the needs of the market?*, suggested how the industry could answer its critics. Recommendations include education programmes to encourage staff recruitment and professionalisation.

3 Rating agencies need to maintain and improve their commitment to quality if growth in revenue and profitability is to be sustained. A potential problem for the agencies is the rapid and continued growth in publishing new ratings, which requires the recruitment and development of more analytic staff in a financial services labour market characterised by skill shortages. Interviewees referred to problems created by staff turnover and analysts who did not understand their (unique) business.

4 Rating agencies must find more user-friendly ways of communicating their methodologies and decision-making processes to diverse market participants. Although the agencies provide extensive coverage of their methodologies on their corporate websites, many users find this detailed information confusing. The many different types of ratings (for example, default probability and loss given default) add to the confusion. Users of ratings information have different needs and levels of understanding. It is possible that the agencies have become too sophisticated, and would do better to focus on communicating basic ratings information clearly to all?

5 Rating agencies should not let themselves be deflected by the provision of unwanted, but potentially profitable, ancillary services. Few market participants see much value in ancillary services and believe agencies should adhere to providing core ratings services. Although the agencies are quick to dismiss analogies with consulting services, it seems the market is not convinced. As ratings quality is difficult to assess, perceptions are critical.

6 Agencies should clearly identify ratings formulated without access to an issuer's management team. Issuers almost uniformly dislike unsolicited ratings. However, unsolicited ratings allow some of the smaller agencies to improve their coverage, and increase competition in an oligopolistic industry. The vast majority of information used in a rating is in the public domain. An ambiguity within the IOSCO code is the lack of a formal definition of what constitutes an unsolicited rating. From a user's perspective, the most important value added feature of a rating is the access the agency has to the non-public, qualitative information provided by the issuer.

Table 1: Ratings quality (numbers in parentheses represent how users rank that quality)

CHARACTERISTIC	DESCRIPTION
Technical Qualities	
Reputation (1)	Credibility among third parties
Shared values and norms (3)	The ethical values and organisational norms expected by market participants
Timeliness (5)	Willingness to regrade a rated security
Expertise (6)	Ability to make competent and informed decisions about default probability
Methodology (8)	Processes used to assess default probability
Independence (10)	Ability to make objective decisions about issuers
Internal processes (12)	Effective staff management processes
Relationship Qualities	
Trust (2)	Degree of trust with issuers/investors
Transparency (4)	Clarity of decision-making, and quality of communication to users
Investor orientation (7)	Ability to offer high levels of service to investors
Co-operation (9)	Effective communication with issuers/investors
Issuer orientation (11)	Ability to offer high levels of service to issuers
Responsiveness (13)	Effective relations with issuers/investors
Service portfolio (14)	Ability to offer specialised, ancillary services

7 By working closely with universities, the rating agencies could help influence finance students to consider a career in the industry. This could lead to the creation of a professional body for ratings analytical staff. Analytical work is not seen as particularly glamorous. As the agencies fulfil an important corporate governance role, this is a concern for all market participants. Other gate-keepers such as auditors and corporate lawyers have developed professions, with graduate education programmes created in partnership with universities to foster public recognition and concern for the public interest.

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The full research report is available from the Institute of Chartered Accountants of Scotland. Email research@icas.org.uk or telephone 0131 347 0237 for a copy.