

**Wait to Rate:
How To Save The Rating Agencies
(and the Capital Markets)**

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The Context

Rating agencies were material contributors to the credit crisis as their inaccurate ratings allowed for the issuance of trillions of dollars of securities and derivatives which generated trillions of dollars of losses globally

What they do well

- **Rating agencies are generally good at rating the debts of corporate issuers**

Where they have failed

- **Rating agencies overstated the ratings of structured finance securities and bond insurers like MBI, ABK, FNM, FRE and AIG**

Various proposals have been floated to address the problem. As currently proposed, we believe that none will succeed as comprehensive reform

What Are the Principal Problems?

Problems are caused by corrupting incentives at the original issuance of a security or derivative by an issuer

- ▶ **Investors** – Overly relied on ratings rather than their own due diligence and are often subject to ratings-based investment limitations
- ▶ **Issuers/Banks** – Are incentivized to get highest ratings with highest yielding (riskiest) assets
- ▶ **NRSROs** – Are conflicted by how they are paid; without high ratings, agencies do not earn fees on new issue transactions
 - “Success Fee” model leads to competition and grade inflation among NRSROs for new issuers and new product ratings

What Are the Principal Problems? (Cont'd)

Regulators and investors with ratings-based mandates have been ill-served by the NRSROs before and throughout the credit crisis

- ▶ Rating agencies have failed to meet expectations:
 - **Act as Underwriters** – in substance, have acted as part of the underwriting team for new issues
 - **Are Slow to Downgrade** – are incentivized to keep ratings stable so new issues can continue to be sold and rated
 - **Are Loath to Pass Judgment on Themselves** – did initially forbear from downgrading financial guarantors (e.g., MBI, ABK, FNM, FRE, AIG), as simultaneous downgrades would be triggered on thousands of other securities, putting NRSROs in the uncomfortable position of questioning their own prior ratings

How Do You Solve These Problems?

Our suggested rider to the Restoring American Financial Stability Act of 2010

“New Issue Ratings Moratorium. *Prior to the date 60 days after the issuance of a new fixed income security, it shall be unlawful for any NRSRO to:*

- (1) Have any contact with issuers, sponsors, servicers, trustees or underwriters of such security during such period,*
- (2) Comment publicly on, or issue ratings regarding, any such security, or*
- (3) Otherwise participate in the structuring, underwriting, offering or sale of such securities during such period.*

Notwithstanding the foregoing, NRSROs shall at all times be permitted to:

- (a) Conduct due diligence based solely on publicly available information of the issuer or otherwise related to the security in respect of future ratings for such issuer or security, and*
- (b) At all times broadly publish their ratings standards, procedures and methodologies.”*

How Do You Solve These Problems? (Cont'd)

- ▶ **Allow Non-NRSROs to Publish During New Issue Moratorium** – Firms can (1) apply to be qualified as NRSROs and be subject to the new issue ratings moratorium or (2) choose to be non-NRSROs and compete for business from investors during the moratorium on the basis of the quality of their research
 - Creates incentive for the development of an “Investor Pays” model for non-NRSRO rating agencies who will seek to fill the ratings void left by the New Issue Ratings Moratorium on NRSROs
- ▶ **Insist on NRSRO Accountability** – The SEC should be required to revoke a ratings agency’s NRSRO status if it consistently underperforms its peers
 - While the SEC currently has the power to revoke NRSRO status, it has failed to exercise that power likely because of the lack of credible alternatives to NRSROs
 - Bright line rules requiring the exercise of that power after material consistent underperformance could address the breakdown caused by the SEC’s past regulatory forbearance

Buyside analysts will develop into credible alternatives and even new NRSROs

How Do You Solve These Problems? (Cont'd)

Repealing NRSRO legal exemptions will mitigate undue reliance on ratings

- ▶ **Re-Thinking Reg FD** – The SEC should repeal the NRSRO exemption from fair disclosure rules that currently allow rating agencies access to issuers' material non-public information
 - Investors justified their over-reliance on ratings in large part on account of NRSRO information advantages. Repeal of the SEC's Reg FD exemption would reduce reliance premised on information asymmetries
- ▶ **Prospectus Delivery Requirements** – Each issuer that seeks an NRSRO rating should be required to include in its bond offering prospectus all information that a reasonable investor would need to form an investment decision
 - Any information that could reasonably be expected to impact ratings should be viewed – **by definition** – as material and therefore should be disclosed in prospectuses and in on-going public disclosures
 - Improved disclosure requirements would improve the accuracy of fundamental analysis and level the playing field among market participants

What Are the Impacts of Our Proposed Changes?

Old Paradigm:

- ▶ **Investors** – overly relied on ratings and performed inadequate due diligence
- ▶ **Issuers/Banks** – structured deals to minimally achieve desired ratings thresholds through negotiations with rating agencies
- ▶ **NRSROs** – monopolized ratings, became an essential participant in underwriting process which was corrupted by the success fee payment scheme
- ▶ **Investor Pay Research** – “Investor Pays” ratings model is virtually nonexistent

New Paradigm:

- ▶ **Investors** – will need to do their own due diligence and will benefit from truly independent ratings/research
- ▶ **Issuers/Banks** – ratings opinion uncertainty will force them to “under-promise and over-deliver” creating margins of safety above ratings targets
- ▶ **NRSROs** – will “*call ‘em like they see ‘em*” and will be completely removed from the structuring and underwriting process
- ▶ **Investor Pay Research** – creates opportunity for “Investor Pays” ratings and research to develop as non-NRSRO analysts will be permitted to publish pre-offering and during the blackout period

How Should Ratings Agencies Be Compensated?

- ▶ **New Fee Arrangements** – Ratings fees should be “set aside” and paid over time by issuers to NRSROs and failure to pay fees would be deemed an “Event of Default” for issuers
 - **Base Fee** – a minimum fee will be paid in quarterly increments over the life of the bond to those NRSROs that pre-commit to rate a new bond after the 60-day moratorium and to continue to update those ratings over the bond’s life
 - **Ranking Fee** – a portion of the remaining set aside will be paid in annual increments based on investor-determined annual rankings of each NRSRO
 - **Performance Fee** – the remaining set aside will be paid in annual increments to the NRSROs based on the performance of the bond relative to the ratings designated by each participating NRSRO

What Are the Impacts of Our Proposed Changes?

Old Paradigm:

- ▶ **Investors** – had no impact on NRSRO compensation
- ▶ **Issuers/Banks** – had the ability to manipulate the process through NRSRO compensation to achieve desired ratings
- ▶ **NRSROs** – received full, upfront payments which were unrelated to the ratings performance for that issue
- ▶ **Investor Pay Research** – “Investor Pays” ratings model is virtually nonexistent

New Paradigm:

- ▶ **Investors** – will help allocate ratings fees, closer to an “Investor Pays” model
- ▶ **Issuers/Banks** – will have no ability to set compensation or even choose which NRSROs will rate a bond
- ▶ **NRSROs** – will be paid over time, with a large percentage of compensation based on performance; material consistent underperformance assures loss of NRSRO status
- ▶ **Investor Pay Research** – will create market opportunity which will improve independent research for buy-side investors

Conclusion

The combination of increased buy-side due diligence coupled with mitigation of conflicts of interest and a new payment scheme can restore the integrity of ratings

- ▶ The steps toward regaining confidence are deceptively simple:
 - Exclude the NRSRO rating agencies from the initial offering and underwriting process
 - Create incentives for fundamental research and valuation analysis by investors
 - Create the market opportunity for “Investor Pays” research and ratings to develop
 - Create a payment regime that focuses on NRSRO performance and the quality of their ratings over time and aligns their interest with investors
- ▶ Failure to address fundamental flaws in the legacy ratings system is not an option