The Rating Reform Papers - In Search of the Missing Pedestal

Economies of (Ratings) Scales, Part 1

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"*Guildenstern*: We only know what we're told, and that's little enough. And for all we know it isn't even true.

Player: For all anyone knows, nothing is. Everything has to be taken on trust; truth is only that which is taken to be true. It's the currency of living. There may be nothing behind it, but it doesn't make any difference so long as it is honoured. One acts on assumptions. What do you assume?"

- From Tom Stoppard's *Rozencrantz and Guildenstern are Dead*

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The susceptibility of securitization to abuse by poorly incentivized parties is a topic we have covered before; but we have yet to examine the several incentive misalignments that are apparent throughout the securitization vehicle. We are abounding with conflicts of interest while informational asymmetries, resulting in various forms of moral hazard, proliferate.

Economy-wide, we have realized that we need to encourage, if not force, the investor to perform necessary levels of due diligence both pre and post investing in complex securities. We need to impose adequate safe-guards on these vehicles to ensure that they are not mismanaged, and that managers are incentivized to manage across the capital structures, in the spirit of the deals. We also ought to encourage regulator responsibility, and permit them the authority necessary to "step in sooner" – to act before the problems become insurmountable.

And most importantly, we realize the need to incentivize the rating agencies to be accurate, or disincentivize them from being inaccurate.[1] This is no mean feat: given their exemption from legal liability, and absent any sufficient reputational risk that would jeopardize their government-mandated oligopoly, how can we discourage rating agencies from rating anything and everything in their search for market share?

[1] Standard & Poor's president Deven Sharma recently contended in a *WSJ* opinion piece that S&P's ratings "should now be more stable, comparable and transparent than before." Notably, Mr. Sharma didn't use the word *accurate*: we have yet to incentivize the rating agencies to be more accurate. http://online.wsj.com/article/SB10001424052748703959804575006694196038802.html

Measurability, Comparability and Reputational Risk

Today's paper approaches the second of these risks: reputational risk. As it currently stands, each rating agency rates each asset according to its own methodology, and ranks it according to its own scale. Given that each scale differs in distribution and meaning, the ability for any investor to compare the performance of two rating agencies is substantially muted – somewhat akin to comparing apples to oranges. Absent scale-wise comparability, an investor has no way of measuring the accuracy of each rating agency's methodological approach; and the rating agencies are limited in the ways they can build a reputation for being more accurate.

Our financial structure is in the rather unfortunate position of having its risk capital requirements, economy-wide, centered solely on credit ratings.[2] Under this burdensome scenario, it becomes increasingly necessary that each rating have the same meaning. Right now, we have no quantifiable metric for whether a AA default probability rating from S&P is better justified, for a certain security, than a Aa2 expected loss rating from Moody's. In sum, the alternative to creating a comparable rating scale is to continue with a plethora of meaningless scales, and to encourage each rating agency to create a more appropriate, or optimal, ratings scale distribution that meets the demands of its users. Having a common ratings scale mitigates against these superfluities – and many we have yet to mention.

A Common Scale

The Credit Rating Agency Reform Act of 2006 restricts the Securities and Exchange Commission, or any State or political subdivision thereof, from regulating the "substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings." But it does not prevent the creation of a single, common scale against which all NRSROs' ratings can be mapped.

The central ratings scale is crucial for many reasons:

1. it will promote investor due diligence,[3] as investors will be better able to compare the historical ratings performance of each rating agency;
2. it will encourage consistency as to the interpretation of the ratings and their meanings, which enhances liquidity;
3. it will create an environment in which the rating agencies can build their reputation,[4] based on quantifiable, measurable performance;
4. it will allow for a consistent application of regulatory capital, discouraging regulatory arbitrage, while not impinging on the rating agencies' ability to apply their own methodologies in the analysis; and
5. it will better enable regulators to oversee and monitor the performance of the rating agencies.

The existence of reputational risk encourages improved standards, which lead to accuracy. It also creates a form of regulation. In many ways the rating agencies already report this information: for example, even though Moody's has an expected loss approach – versus, say, S&P's default probability approach – it already provides an issuer-level default probability estimate that accompanies many of its expected loss ratings. With

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[2] See for example http://files.ots.treas.gov/25307.pdf.

[3] This is a key goal of the International Organization of Securities Commission. See *Good Practices in Relation to Investment Managers´ Due Diligence When Investing in Structured Finance Instruments,* at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD300.pdf.

[4] A reputation-based system, such as that of research equity analysts and newspaper publishers, may be more consistent with the rating agencies' opinion-based model, than is the current forum which is increasingly rules-based, as is cogently argued by Arturo Cifuentes' in the *Financial Times*: http://www.ft.com/cms/s/0/56467d90-9cd8-11de-ab58-00144feabdc0.html?nclick_check=1.

this in mind, we do not anticipate that the adaptation of a universal scale will create a substantial incremental expense.

Coup de Grâce

Currently, each rating agency measures its own performance, which is not dissimilar to hedge funds marking their own portfolios and calculating their own returns – the key metric upon which hedge funds compete for new capital and investor trust.

The creation of a single ratings scale against which each rating agency can express its opinions will enhance the consistency, measurability and transparency of the otherwise opaque and difficult-to-regulate rating agency environment. The implementation of the common scale based on a common metric will, finally, establish a more structured framework in which credit ratings will become more meaningful, and under which the integrity of the ratings process can be improved. Together, these objectives will increase investor confidence in credit ratings, which promotes liquidity.

Our economy, as it currently exists, is heavily reliant on the independence of rating agencies, and deeply dependent on their performance. We have the option available to measure their performance. Why choose to rely solely on blind faith?

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This opinion piece constitutes one article in a series of articles on rating agency reform, entitled "In Search of the Missing Pedestal." Articles written under this series can be found at http:/ratingsreform.wordpress.com.

Prior papers in this series include:
"Gaming" the Ratings System, or the Observer Effect (January 8, 2010); *Assuming Responsibility, or What You Will* (January 14, 2010); and *A Centralized Solution* (January 22, 2010).