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COMPETITION AMONG CREDIT RATING AGENCIES

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Abstract

The purpose of this paper is to analyze the credit rating industry, while providing specific emphasis on competition and inherent conflicts of interest that exist within the industry. The first section of the paper defines credit ratings and describes key elements of the ratings process. This is followed by a discussion of the history of the credit rating industry, highlighted by the origins of the three major firms: Standard and Poor’s, Moody’s Investors Service and Fitch Ratings. The creation of the Nationally Recognized Statistical Rating Organization (NRSRO) designation is a significant event in the history of the credit markets and the topic is introduced as a separate section from the industry history. The Credit Rating Agency Reform Act of 2006 describes recent changes to the NRSRO designation status, and other regulatory changes to the industry. The current industry environment section speaks mainly about changes in industry since the 1970s that have created the modern credit rating system in place, as well as information related to the three prominent firms in the industry. The two possible substitutes to credit ratings, bond insurance and credit spreads, are discussed after the industry environment. This is followed by an analysis of the conflicts of interest that are inherent in the credit rating process and current business model, mainly the disconnect between investor and issuer demands. This is followed by a section describing the dual ratings norm. The final sections draws conclusions based on information presented in previous sections and examines the industry’s future.
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Credit Rating Definition and Process

Credit ratings have been a vital element of efficient capital markets for over 100 years. By analyzing the credit worthiness and overall financial position of entities issuing debt, credit rating agencies (CRAs) help eliminate the asymmetric information problem in the credit markets and lower the investigation and research costs faced by borrowers. Well-functioning rating agencies also bring more participants into the capital markets by giving investors a reliable estimate of default probability and providing issuers with information regarding the appropriate return investors require for a specific debt issuance. Efficiency in the capital markets is greatly enhanced when credit rating agencies perform these two primary functions thoroughly and independently of influence from market participants or other conflicts of interest.

The actual product the credit rating agencies bring to the market is an opinion of the credit quality of a specific debt issuance of an entity. This opinion is expressed as a letter rating. The two major credit rating firms, The Moody’s Corporation and Standard and Poor’s (a division of The McGraw-Hill Companies), use ratings systems that employ nine and ten different rating categories respectively. From lowest to highest default risk, these ratings range from AAA/Aaa to C/D (S&P/Moody’s). Ratings of C/D represent bonds that are either fully or partially in default. Each rating can also have modifiers attached, such as a +/- (S&P) or numerical value of 1,2 or 3 (Moody’s), that are used to illustrate the issuer’s relative standing within the rating category (See “Appendix ONE-Rating Category Descriptions” for rating definitions for S&P and Moody’s). Ratings can either be short or long term, based on what is considered short or long term issuances in the firm’s market. Although the ratings process varies depending on the agency and type of entity being rated, ratings are formulated using proprietary financial information provided to the rating agency by the issuer, as well as other information and opinions related to the company, industry and a variety of macroeconomic factors. After the initial issuance of the credit rating, ratings are continuously monitored by the CRA to reflect new information that comes to the marketplace. As part of the monitoring process, specific ratings can be put on positive or negative
watchlists or reviews by an agency (“Moody’s”). This tells the marketplace a ratings upgrade or downgrade may be necessary in the near term and identifies specific risks that caused the rating to be put on watch and which may cause the eventual rating upgrade or downgrade.

A credit rating is an expression of the creditworthiness of an issuer, and is meant to indicate the probability an issuer will default on all or a portion of a debt issuance. Ratings are based on a large variety of factors that differ depending on the type of debt instrument being issued, the length of time to maturity, the industry of the issuer, regulatory environment and the market the debt product is being issued in. Rating agencies analyze many aspects of the current financial strength and historical performance of the issuer when performing the due diligence involved with a rating. Because of the discrepancies that exist between rating methodologies for different products, industries and markets, it is difficult to cite specific metrics or figures that apply to all rating processes. Moody’s “Universal” Approach to Credit Analysis cites a long-term focus, global consistency, cash flow predictability, sector-specific analysis and more when describing some of the basic principles of its ratings approach (“Ratings Approach”). In general, the analysis of current financial strength focuses on factors such as entity’s overall value, the risk strategy and position, industry regulatory environment, and steadiness of earnings and cash flows. Fundamental financial analysis of liquidity, asset quality, and profitability are also essential to the ratings process.

The final credit rating issued to a particular debt product has an enormous impact in the marketplace. Ratings act as starting points for investors to price risk in the capital markets. Each rating category has specific default percentages associated with it based on historical data. Investors demand newly issued products have relatively the same risk profile associated with them as products given the same rating in the past. This consistency allows the market to set the price of the debt product to closely match yields on similarly rated products in the past. While many investors perform their own research on the credit worthiness of different issuers, rating agencies have unique access to proprietary information other investors do not. In addition to non-public information, analysts from the rating agency establish
relationships with employees at various management levels of the organization issuing debt. This additional insight and first-hand exposure to the client gives credit ratings their substantial weight in the pricing process for nearly all debt instruments, and a wide variety of other products, issued in the capital markets around the world.
Industry History

To understand the current credit rating industry, it is important to understand the industry’s history. Throughout the 19th century, the US capital markets were dominated by the railroad industry, as this was among the most profitable and capital intensive businesses at that time. Because capital markets remained in their infancy, and regulation was almost not existent, the availability and transparency of corporate records was extremely limited. This began to change when Henry Poor and his son began publishing the Manual of the Railroads of the United States in 1868, with annual updates thereafter (“History of Standard and Poor’s”). This was among the first published works that provided investors with financial information for investment purposes. John Moody and Alfred Best expanded on Poor’s idea when they published Moody’s Manual of Industrial and Miscellaneous Securities and Best’s Insurance Reports in 1900 (“Moody’s History” and “Best”). Moody focused on increasing the number of firms and industries for which financial data was kept and tracked year to year, while Best focused on providing a variety of in depth information on the insurance industry. Another early entrant into the credit rating agency market was the Fitch Publishing Company, founded in 1913. It began with two main publications “Fitch Bond Book” and “Fitch Stock and Bond Manual” (“History of Fitch Ratings”). The practice of providing a letter rating describing the financial strength of a company was started by Moody in 1909, and was later adopted by both Standard Statistics and Poor’s Publishing Company before their merger to become Standard and Poor’s Corporation in 1941. Fitch Publishing Company introduced its AAA to D ratings scale in 1924. Starting in the early 1900s, the number of institutions and products for which agencies issued ratings steadily rose. Today, agencies issue credit ratings for public corporations, municipalities, state and federal governments, non-profit organizations, as well as a wide variety of structured finance products.

Important changes in the history of the rating industry occurred during the 1970s. Previously, CRA revenues came from selling ratings and investment information to investors. However, the spread
of photocopying and other technologies made it easy for individuals to share purchased information, hurting industry revenues. To combat this, the rating agencies began charging issuers fees for credit ratings. Issuers were willing to pay these fees because credit ratings are valuable in the marketplace as they instill confidence in a company’s financial strength and allow debt to be issued at a lower yield, and therefore lower cost to the company. However, receiving fees from issuers for ratings created a significant conflict of interest for agencies. The investment community demands rating agencies provide the most truthful and accurate analysis of a company’s financial strength and risks associated with it, while the issuer wants the highest possible rating in order to be able to issue its debt at a lower yield. If the rating a company receives is lower than what it expected, a strong incentive exists for the company to take its business to another accredited rating institution. The new rating agency also has a strong incentive to provide the company with a higher rating, which would induce future business from the new client. This creates a dangerous situation in that what the market desires from ratings agencies is in direct conflict with what the client desires. Because of this change, a much greater incentive was created for agencies to provide artificially higher ratings. This conflict is especially apparent when dealing with clients that provide the largest sources of revenue to the rating agencies, mainly financial institutions that demand ratings on a wide variety of structured products on a frequent basis. Losing a client such as this is significantly more detrimental to the agency from a revenue standpoint than losing a client who issues long-term debt on an annual or semi-annual basis.
Nationally Recognized Statistical Rating Organizations

Aside from beginning the practice of charging issuers for ratings, the 1970s brought an additional change to the credit rating industry. In 1975, the Securities and Exchange Commission (SEC) introduced the term “Nationally Recognized Statistical Rating Organization” (NRSRO) as part of amendments to the broker-dealer net capital rule (“Ratings Agencies”). The new rule dealt with calculating net capital requirements and mandatory percentage deductions, known as “haircuts”, to proprietary holdings of broker-dealers based on the underlying risk of different classes of securities being held. The amendment creates applicable haircuts for different investment classes based on ratings provided by NRSROs. To become an NRSRO, a firm must request a no-action letter from the SEC. The Commission then reviews the firm’s rating methodology, financial and managerial viability, policies for maintaining impartial ratings, position in the marketplace and a variety of other factors. The original three designated NRSROs in 1975 were Standard and Poor’s, Moody’s Investors Service and Fitch Ratings. The SEC had identified 11 NRSROs between 1975 and the time of the Credit Rating Agency Reform Act of 2006, which altered the process for becoming an NRSRO, but through consolidation only five remained at the time of the Act’s passage: Standard and Poor’s, Moody’s Investors Service, Fitch Ratings, A.M. Best Company, and DBRS Limited (“Role”). As of September 2008, a total of ten firms were registered with the SEC as official NRSROs (For a list of these firms see Appendix TWO – 9/25/2008 List of NRSROs). Although the original establishment of the NRSRO concept was to help regulate broker-dealer capital requirements, the concept’s use has grown tremendously since then. By 2003, “In the U.S., credit ratings referenced in at least 8 federal statutes, 47 federal regulations, and more than 100 state-level acts and regulations” (“Covitz”).

The Security and Exchange Commission’s creation of the NRSRO established a significant regulatory barrier to entry to the credit rating business. Prior to the Credit Rating Agency Reform Act of 2006, the SEC process for attaining NRSRO status was difficult, long, and opaque. For example, the SEC’s 2003 concept release states, “The single most important criterion is that the rating agency is widely
accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings” (“Rating”). This presents a significant problem for entrants to the market because it is nearly impossible to become a widely accepted issuer of ratings without NRSRO status, which isn’t granted until the agency becomes widely accepted in the marketplace, an obvious catch-22. The lack of feedback provided by the SEC regarding the status of applications prior to the Reform Act also presented significant problems for NRSRO applicants. Applications often took years to review, with no updates given during the process. SEC officials were routinely unwilling to answer applicants’ questions or requests, often providing no guidance or basis for denying a firm NRSRO status (“Egan”). This left many smaller rating agencies frustrated, while applications lay dormant in the SEC pipeline.
Credit Rating Agency Reform Act of 2006

On September 29th 2006, the United States Senate passed the Credit Rating Agency Reform Act of 2006 ("S.3850"). President Bush signed the bill into law the following Monday, October 2nd accompanied by Richard Shelby, Senator from Alabama, then Chairman of the Senate Banking Committee and sponsor of the legislation and Michael Fitzpatrick, Representative from Bucks County, Pennsylvania who originally introduced the legislation in the House of Representatives under the name “The Credit Rating Agency Duopoly Relief Act”. The legislation states it is an Act:

“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.” (S. 3850).

The purpose of the Credit Rating Agency Reform Act of 2006 was to address many of the issues that had grown around the Nationally Recognized Statistical Rating Organization designation after its creation in the 1970s. Many regulators perceived rating agencies as failing to detect enormous financial problems at firms that eventually underwent high-profile bankruptcies, including WorldCom, Tyco and Enron. One method thought to decrease the likelihood of something like this happening again was to increase competition in the industry, which was dominated globally by Moody’s and Standard and Poor’s (and to a much lesser extent, Fitch Ratings). Promoting competition evolved into one of the main objectives of the Act as seen in many of its provisions.

The new industry regulation drastically clarified and streamlined the SEC registration process to become an NRSRO. All firms wishing to obtain NRSRO status are required to register with the SEC under the new rules, including firms previously designated with NRSRO status. The SEC is granted increased authority to oversee NRSRO firms, while prohibiting the SEC from regulating the actual procedures and methods used to determine credit quality ratings. Firms with at least three years of ratings experience are eligible to apply for NRSRO status. The new requirements ask firms to include a large variety of information in their application. Two of the most important items are a list of the 20 largest issuers that use the applicants rating services and certifications from at least ten qualified institutional
buyers that have used the firm’s ratings for the three most recent years (“S. 3850 Summary”). The Act forces each NRSRO firm to establish written procedures designed to both prevent the misuse of nonpublic information provided to the firm by an issuer and to manage the various conflicts of interest that exist within the business model (inherent conflicts of interest at CRAs will be further discussed in subsequent section). Firms granted NRSRO status are required to annually certify application documents (excluding qualified institutional buyer certifications) and document any material changes that occurred during the period.

Aside from altering the registration process for firms to be granted NRSRO status, Congress attempted to diminish the importance of the designation for regulatory purposes. References to the NRSRO status was removed from many Congressional Acts, such as the amended Investment Advisers Act of 1940. Other references were altered to downplay the importance of the NRSRO status. The remaining references, such as the Higher Education Act of 1965 and the Housing and Community Development Act of 1992, were altered to reflect the new provisions (“S. 3850 Summary”). During testimony and debate over the Reform Act, experts on the credit quality assessment business, including certain Congressman and Senators, had expressed concerns over the enormous growth of the use of NRSRO designation in state and federal statutes and regulations. Each reference was seen as reinforcing the regulatory barrier to entry created by the NRSRO designation by increasing the designation’s importance and providing NRSRO firms with additional business derived by regulatory requirements. The removal and amendments of this reference from various acts reflects Congress’s acceptance of this reality.

The Credit Rating Agency Reform Act of 2006 mentions specific abusive practices requiring additional regulatory guidance. Alleged abusive practices included sending companies unsolicited ratings with a bill to solicit business by inferring artificially high ratings, downgrading or threatening to downgrade a credit rating on asset-backed securities unless the firm rates a substantial portion of the underlying assets (a practice called “notching”) and influencing ratings based on the purchase of other
products and services. The first set of rules published by the SEC with its new authority to oversee CRAs came in June 2007. These rules related to recordkeeping, financial reporting, conflicts of interest, abusive practices and other issues outlined in the Reform Act passed one year prior. A second set of rules was released by the SEC in February 2009, which placed increased focus on alleviating conflicts of interest and improving the transparency of the ratings process (“Moody’s Corporation”). Much of the oversight was derived based on the SEC’s nearly year-long review of the three major credit rating agencies. This analysis identified significant weaknesses in ratings procedures, which the new rules were designed to combat. Chairman of the SEC at the time, Christopher Cox summed up the investigation and creation of the rules after their release by stating:

“These comprehensive rules touch every aspect of the credit rating process – from conflicts of interest to publication of ratings methodologies, to disclosures of ratings track records. The SEC’s examinations of credit rating agencies uncovered serious deficiencies that these rules will address, so that investors and markets will have better information to guide investment decisions.” (Shepard).

The new rules impose stricter guidelines on rating agencies, create additional required disclosures and prohibit agencies from performing certain actions related to the credit rating process and their customers. Conflicts of interest are addressed in the legislation in several ways. Rating agency firms are prohibited from providing additional services for companies that contract for ratings (“Summary”).

Ratings agencies typically offer a range of credit and investment related products aside from credit ratings, including often more lucrative consulting services. Much like the Sarbanes-Oxley Act of 2002 which prohibited accounting firms from offering certain consulting and other services to their audit clients, the new credit rating agency rules attempt to separate a CRAs credit rating client base from clients that it contracts on a more advocacy base. Interestingly, both the Sarbanes-Oxley Act of 2002 and Credit Rating Agency Reform Act of 2006, along with subsequent rating agency rules and guidelines, were enacted at least in part as a reaction to high-profile bankruptcies and fraud at WorldCom, Tyco and Enron. Other conflicts of interest arising from the way a CRA is paid for issuing and monitoring a rating
or group of ratings, or from potential independence between employees of the rating agency and the issuer, are either prohibited, or require significant disclosures or review procedures by the rating firm.

In an effort to more closely monitor fees, the new rules require each rating report issued by a firm to disclose fees paid by the issuer for a specific rating, along with the aggregate fees paid to the rating agency during the past two years (“Summary”). Additional disclosures are also required when a ratings report is issued such as an assessment of data reliability, sensitivity of ratings to changes in assumptions and other conditions, default probability, a ratings history for each product receiving a rating and any preliminary ratings activities performed by the CRA that were provided to the issuer. The latter is designed to combat “ratings shopping”, where issuers receive private ratings from several rating agencies in order to either choose the best one, or use them as leverage over another firm to induce a higher rating. To manage the new policies, each credit rating agency is required to appoint a chief compliance officer (CCO) who reports directly to the board of directors or the senior official at the firm (“Summary”). The CCO will be responsible for compliance with relevant regulation and the establishment of proper internal controls and procedures at their firm to ensure rules are being followed accordingly.
Current Industry Environment

Important changes and trends in the overall capital markets that began in the 1970s and 80s have essentially shaped the credit rating industry into its current form. The most significant trend in this process surrounds the increasing size and complexity of capital markets worldwide. The introduction of the retail investor to the stock market greatly increased the number and anonymity of participants in the capital markets. This increased size fueled competition among investing firms and the creation of increasingly complex trading devices and strategies. At the same time, the knowledge of the average investor relative to financial transactions and capital markets greatly decreased, and more reliance was placed on third parties for financial information. Technology began to play an increasingly important role in the capital markets, altering the investing process but also providing lucrative investment opportunities in fast growing, often high risk businesses. Globalization of the capital markets added a large number of participants to the capital markets, again increasing complexity and anonymity in the marketplace. American dominance of capital markets worldwide has spread the use of ratings-based regulation and the idea of a sovereign rating for a country by which international investors can assess the risk of national capital markets around the world. Almost all of these changes had a favorable impact on credit rating agencies by increasing the number of ratable securities being issued to the marketplace, either by increasing the size of the capital markets as a whole or by increasing its complexity and inducing demand for ratings in an effort to combat asymmetric information problems.

All of these developments have created a large, profitable industry dominated by two firms: Moody’s Corporation and Standard and Poor’s. Fitch Ratings is the only other relevant firm from a standpoint of market share. Moody’s is the only public firm of the three largest rating agencies, it is traded under the symbol MCO on the New York Stock Exchange. Standard and Poor’s was acquired by the McGraw-Hill Companies, a provider of business information and education services in 1966 (“Key”). Fitch Ratings is a division of the Fitch Group, which became a majority-owned subsidiary of Fimalac S.A., a French holding company, in 1997 after Fitch merged with IBCA Limited. By 2005, these three
companies accounted for over 90% of total industry revenue, with Moody’s and S&P accounting for roughly 80%. In 2009, Standard and Poor’s Ratings Services published more than one million ratings, including new and revised ratings, on debt totaling approximately $32 trillion (“Key”). This incredible depth and breadth means ratings produced by Standard and Poor’s and Moody’s impact the majority of financial transactions in the capital markets every single day, around the entire world.

In 2009, Standard and Poor’s earned operating revenues of $2.61 billion (“Key”), while Moody’s earned revenues of $1.80 billion, with $402 million of net income (“Moody’s Corporation”). These revenues are down sharply, about $500 million for Moody’s, due to the meltdown of the credit markets after its peak in 2007. Today, credit rating agencies generate revenues from sources beyond traditional credit rating activities. Firms have leveraged their financial expertise by offering research and information products on industries, significant developments in the credit markets, proposed and new regulation affecting the market and investment outlook. Consulting has become an increasingly important revenue source for many firms, often centered on risk management issues.
Substitute Products

Credit ratings are valuable because they instill confidence in a company’s financial strength and allow debt to be issued at a lower yield and cost to the issuer. Few products exist, if any, that provide a service identical to this, however bond insurance can have a related effect to that of a strong credit rating. Bond insurance is purchased by issuers who pay a premium to insurers in return for a guarantee to provide interest and principal repayments should the issuer fail to do so. This provides an added layer of confidence to the marketplace because should the issuer not be able to repay the debt, the insurer will step in and take responsibility for the terms of the debt. This added confidence translates to a lower required return from investors, reducing the cost of the debt issuance.

Credit ratings and bond insurance may seem to provide the same service and be viable substitutes for one another, but this is not quite the case. Bond insurers exist to guarantee the terms of a debt issuance, while credit rating agencies simply assess the probability of default for an issuer and assign that probability a rating. The bond insurers perform an internal investigation of a firm’s finances and identify a premium to charge based on their assessment of the company’s risk of default. In essence, bond insurers perform their own “rating” of an issuer’s financial strength, but take this process a step further by providing a capital guarantee and charging a premium based on their assessment. In the absence of actual credit rating agencies, it would be feasible to formulate credit ratings based on the varying premiums charged by bond insurers to issuers of debt. This system effectively replaces the current credit rating agencies with bond insurers, and does little to prevent many of the current problems with the industry to be repeated among the firms issuing bond insurance. Another problem with this approach is that the capital markets need an assessment of the insurer’s credit rating to be certain repayment of interest and principal would occur should an issuer default. Without the credit rating industry, market participants would have to do separate analysis of each bond insurer’s ability to repay interest and principal. This system, adds significant search and information costs and other inefficiencies to the capital markets, while providing no assurance the current industry problems will be solved.
A rating system using credit spreads established in the marketplace may be another possible substitute for the traditional credit rating function. A credit spread is the amount an issuer pays over the yield on a comparable maturity U.S. Treasury Bill, which is considered risk-free, quoted using basis points. The credit spread essentially determines the cost to the company of issuing a specific debt instrument to the marketplace. The magnitude of the spread mainly reflects the market-perceived risk of a particular issuer. However, varying tax considerations as well as liquidity differences play important roles in determining the credit spread for particular debt products.

The use of credit spreads as a substitute for credit ratings is far from perfect. To begin with, no formal system has been proposed to Congress or another legislative body that actually translates credit spreads into ratings of default probability. But even if one was developed, credit spreads are based on market-quoted prices and are much more volatile than ratings issued by rating agencies. This has been especially apparent during many periods of the global credit crisis, during which turmoil in the credit markets has caused a near global freeze of markets for many types of securities, as well as normal borrowing and lending practices. It is uncertain where all this volatility comes from, and what information investors are employing to affect the amount of the spread. Several studies have attempted to analyze exactly how much of the credit spread is actually due to credit or default risk. Although results vary, some estimate only 20% of the credit spread is explained by expected losses from default; others believe this amount is closer to 60% or higher, yet few argue the entire credit spread can be explained by default risk alone (“Krainer”). The variety of factors other than credit quality influencing credit spreads, the ease with which spreads can be manipulated by sophisticated traders and the lack of a formal system translating credit spreads into ratings indicate the use of credit ratings as a substitute for current credit quality assessments is not feasible.
Inherent Industry Conflicts of Interest

The premise that governs much of the behavior of credit rating agencies relies on a widely accepted conflict of interest between client and investor demands that exists within the industry business model. Credit rating agencies are employed by issuers of debt to rate their respective products. To reduce issuance costs to their lowest amount, issuers demand the highest possible ratings from credit agencies. However, this is in direct conflict with what investors demand, the most accurate and objective rating the agency can provide. The issue of concern is whether or not the long run goal of a pristine firm reputation for quality and accuracy, the “reputation hypothesis”, is more important to the rating agency than the short run goal of keeping a client happy and retaining that firm’s business, what I call the “client appeasement hypothesis”.

Firms make many claims against the preferential treatment of client demands over reputational concerns. A wide variety of internal “firewalls” that separate the integrity of their employees’ work from earnings demands exist at each firm. Independent rating committees and fixed-rate fee schedules, which are designed to separate an agency’s compensation from the actual ratings process, are two of the most common of these firewalls (“Egan”). It is clear, the importance of reputation can never lead to total neglect of investor demands for truth and accuracy, but the question remains whether or not these measures are sufficient. Do client demands have a significant negative impact on ratings quality and the final products supplied to the marketplace?

A 2003 study done by Federal Reserve Board members Daniel Covitz and Paul Harrison attempts to answer this question for credit rating agencies by analyzing ratings changes from Moody’s and Standard and Poor’s and corresponding changes in bond prices leading up to a credit upgrade or downgrade (“Covitz”). The study uses monthly bond yield data from Merrill Lynch’s bond database, and calculates composite bond credit ratings using the average credit ratings from the two firms, rounded down to capture the initial ratings change. Although the study concluded ratings changes are “roughly 75% anticipated” by the bond markets, they found no evidence conflicts of interest relating to preferential
client treatment have any sort of significant impact on the ratings process (“Covitz”). The results are robust to various changes in other factors that could possibly affect market anticipation, and also persist when analyzing each of the rating agencies separately. When summarizing their findings, Covitz and Harrison state:

“The findings strongly indicate that ratings changes do not appear to be importantly influenced by rating agency conflicts of interest but, rather, suggest that rating agencies are motivated primarily by reputation-related incentives.” (Covitz)

While Covitz and Harrison’s study does an excellent job of examining the behavior of ratings agencies surrounding a rating upgrade or downgrade, it does nothing in the way of identifying whether or not initial ratings are influenced by issuers hiring the rating agency. This is the time many people believe an issuer has the strongest ability to pressure a rating agency for an artificially high rating. The relationship between the credit rating agency and the client has just begun and the rating agency wants to make a good impression on the issuer to induce future business. The rating agency employees are also the least familiar with the client’s business model, strategy in the marketplace, customer base, IT systems and other critical factors needed to properly assess an issuer’s credit quality. Unless an accurate and detailed record of every rating agency and client interaction during this time is kept, there is no guarantee the issuer did not have significant influence over the final rating issued to the marketplace.
Dual Ratings Norm

Today’s debt markets typically demand issuers purchase ratings from at least two accredited rating agencies, usually Moody’s and Standard and Poor’s. Several arguments exist that describe why the dual rating system exists. The first and most obvious reason the market desires two ratings is the additional information provided by the second rating. Studies have shown the additional information provided to the market from a second rating is small, yet the extra rating is still preferred because investors do not explicitly pay for rating cost and receive the entire benefit. Regulation is one of the more compelling arguments for the two rating norm. Certain rules restrict mutual funds and other market participants to purchasing certain products only if they have been issued two NRSRO ratings (“Dittrich”). Another related explanation involves the desired consistency of many market participants when it comes to their use of ratings. For example, to prevent rating “cherry picking”, banks are required to use the same agency’s ratings for a variety of risk assessment claims. Because many banks do business globally, they have a large incentive to choose Moody’s or Standard and Poor’s, far and away the firms with the largest global reach. A final argument on this issue, even if each of the previous arguments are only somewhat correct, at some point the number of issuances that carried two ratings became so large, investors began to demand this double scrutiny, and any new product issued with only one rating was seen as skeptical in the marketplace (“Dittrich”).

Because the work of a single credit rating agency is “checked” by the other agency rating the issue, accuracy becomes of greater importance than client demands. The two ratings norm is therefore a strong argument in favor of the reputation hypothesis. If the two agencies issue inconsistent ratings, often a third agency is hired to help clarify the rating to the marketplace. If one institution was consistently rating debt issuances higher than the other agencies, it would quickly become apparent to the marketplace and an immediate destruction of that credit rating agency’s reputation would occur. This destruction would have an enormous impact on future earnings possibilities, and would reflect a “worst case scenario” for a firm in this business.
Conclusion

The credit rating industry faces unique problems as it continues to grow and evolve with the current economic environment. The small number of dominant firms, high regulatory and reputational barriers of entry, current lack of viable substitute products and inherent conflicts of interest create an industry susceptible to client influence, lack of proper due diligence, collusion or fraud. In addition, the widespread availability of massive amounts of data on companies around the world is chipping away at the industry’s usefulness in the investment analysis process. To combat these issues, the industry must take steps to reassure the investing public that credit quality assessments are essential elements of the capital markets and that each assessment is done with the utmost regard for accuracy. Efforts to increase competition and the number of firms with a global reach must be continued. Innovative ideas to mitigate the inherent industry conflicts of interest need to be developed by key industry figures, not by government regulators, to demonstrate the industry’s willingness to address criticisms rather than relying on regulation as a primary driver for growth in the future. Firms operating in the credit rating agency industry must make a choice. They can choose to remind the public of their history and critical role in shaping the development of the capital markets and the investing process and promise to continue this evolution despite current disapproval and concern. Or, firms can choose to do nothing and accept increased regulation, watching as their importance diminishes in the face of a more dynamic, fast-paced modern economy.
Bibliography


Appendix ONE – Ratings Category Descriptions

Moody's Long-Term Rating Definitions:

Aaa
Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.

Aa
Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.

A
Obligations rated A are considered upper-medium grade and are subject to low credit risk.

Baa
Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.

Ba
Obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk.

B
Obligations rated B are considered speculative and are subject to high credit risk.

Caa
Obligations rated Caa are judged to be of poor standing and are subject to very high credit risk.

Ca
Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.

C
Obligations rated C are the lowest rated class of bonds and are typically in default, with little prospect for recovery of principal or interest.

Note: Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.

(Requires log in)
Appendix ONE (cont.) – Ratings Category Descriptions

Standard and Poor’s Ratings-General Meanings

The general meaning of our credit rating opinions is summarized below.
‘AAA’—Extremely strong capacity to meet financial commitments. Highest Rating.
‘AA’—Very strong capacity to meet financial commitments.
‘A’—Strong capacity to meet financial commitments, but somewhat susceptible to adverse
economic conditions and changes in circumstances.
‘BBB’—Adequate capacity to meet financial commitments, but more subject to adverse
economic conditions.
‘BBB-’—Considered lowest investment grade by market participants.
‘BB+’—Considered highest speculative grade by market participants.
‘BB’—Less vulnerable in the near-term but faces major ongoing uncertainties to adverse
business, financial and economic conditions.
‘B’—More vulnerable to adverse business, financial and economic conditions but currently has
the capacity to meet financial commitments.
‘CCC’—Currently vulnerable and dependent on favorable business, financial and economic
conditions to meet financial commitments.
‘CC’—Currently highly vulnerable.
‘C’—Currently highly vulnerable obligations and other defined circumstances.
‘D’—Payment default on financial commitments.

Note: Ratings from ‘AA’ to ‘CCC’ may be modified by the addition of a plus (+) or minus (-)
sign to show relative standing within the major rating categories.

Appendix TWO – 9/25/2008 List of NRSROs

Credit Rating Agencies—NRSROs

A credit rating agency is a firm that provides its opinion on the creditworthiness of an entity and the financial obligations (such as, bonds, preferred stock, and commercial paper) issued by an entity. Generally, credit ratings distinguish between investment grade and non-investment grade. For example, a credit rating agency may assign a "triple A" credit rating as its top "investment grade" rating for corporate bonds and a "double B" credit rating or below for "non-investment grade" or "high-yield" corporate bonds.

Credit rating agencies registered as such with the SEC are known as “Nationally Recognized Statistical Rating Organizations.” There are ten firms currently registered as NRSROs:

- A.M. Best Company, Inc.
- DBRS Ltd.
- Egan-Jones Rating Company
- Fitch, Inc.
- Japan Credit Rating Agency, Ltd.
- LACE Financial Corp.
- Moody’s Investors Service, Inc.
- Rating and Investment Information, Inc.
- Realpoint LLC
- Standard & Poor’s Ratings Services

Under the Credit Rating Agency Reform Act, an NRSRO may be registered with respect to up to five classes of credit ratings: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities; and (5) issuers of government securities, municipal securities, or securities issued by a foreign government.

To learn more about NRSROs, please visit the Division of Trading and Markets’ web page on Credit Rating Agencies. There you can find a variety of background materials, including SEC releases, transcripts of hearings and selected No-Action letters by SEC staff.

http://www.sec.gov/answers/nrsro.htm

We have provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.
Vita

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EDUCATION
The Pennsylvania State University, Schreyer Honors College             University Park, PA
B.S. Accounting, Finance concentration, Economics Minor         Expected Graduation: May 2010
Sapphire Accelerated Business Program
Study abroad program completed in Barcelona, Spain during the spring 2009 semester

HONORS
• The President’s Freshman Award                                   • The President Sparks Award
• Phi Eta Sigma National Honors Fraternity                         • Beta State Foundation Scholarship
• Beta Gamma Sigma Business Honors Society                         • Dean’s List each semester

RELEVANT EXPERIENCE
PricewaterhouseCoopers, LLP        Summer 2009
Assurance Intern – Insurance and Banking
• Developed knowledge of the PwC audit approach, including insurance specific audit
  procedures and issues
• Built internal network within the firm and on client engagements
• Worked on three separate client engagements: ACE Limited, American Life Insurance Co. and
  Philadelphia Life Insurance Co.

The Nittany Lion Fund, LLC              Summer 2008-Fall 2008
Intern, Financials Sector Co-Fund Manager, Director of Compliance
• Entirely student-run equities fund modeled after the S&P 500 with roughly 40-50 holdings
• Researched stocks and overall market and industry trends and prepared reports on fund and
  sector performance
• Monitored internal controls and other compliance requirements such as overall portfolio beta
  and % of portfolio invested
ACTIVITIES/LEADERSHIP
Beta Sigma Beta Fraternity              Fall 2006-Present

**Auditor**
- Developed and managed the undergraduate budget and the Fraternity Purchasing Agency account
- Awarded Beta State Foundation scholarship in 2007 for leading undergraduate member fundraising for the fraternity’s annual philanthropy benefiting Cure Autism Now/Autism Speaks
- Collectively received Chapter of Excellence award for third consecutive year in 2007 (award changed after 2007)

Accounting Society            Fall 2006-Fall 2009

**Active Member**
- Participated in seminars and presentations with accounting professionals on career paths and professional development skills
- Built strong relationships with club members and leadership

CURRENT RESEARCH
Competition among Credit Rating Agencies          Spring 2010

**Schreyer Senior Thesis**
- Thesis includes an analysis of the credit rating industry, with special consideration paid to competitive factors between firms and inherent conflicts of interest in the current business model

SKILLS/INTERESTS
- Proficient in Bloomberg and Microsoft Office
- Hobbies include reading, exercising, traveling and cooking