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<u>Plenary 2</u>

Regulating Credit Rating Agencies

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Conflicts of interest in the rating industry

- arise from issuer (-based) compensation
- issuer compensation partly justified by the public-good nature of ratings information
- problem likely to be more serious in markets where
  . the number of issuers is small and their size is relatively large
  . Competition is weak , and
  . the regulatory barrier to entry is high

To lessen the conflict of interest problem

- encourage entry of firms relying on investor subscription
  . examples in credit rating, equity analysis, and corporate governance rating
- provide incentives to firms whose revenues come mainly from investors
  . requirements for regulatory recognition may be shortened
- firms should not provide consulting services to their rating customers (cooling-off period required as in Korea)

To lessen the conflict of interest problem (cont'd)

- encourage annual formal rating by the investment industry
  of rating agencies (as in Korea)
  . quantitative rating(cumulative default rates, migration
    rates, etc.)
  . qualitative rating(consistency of rating policies,
    timeliness of rating changes, reputation, etc.)
  · results to be publicized by detailed reports, conferences, etc.

On disclosure of rating information

- requiring disclosure of too much information undermines the basis of investor-based compensation
- Regulation FD should be applied to information given to rating agencies
  - · exceptions for certain types of confidential information
  - · require rating agencies not to use confidential information in services other than ratings per se
- ratings information of all agencies should be available through a centralized web-site(as in Korea)

Issues pertaining to Korea

- Entry into the credit rating business requires permission (no separate procedure for regulatory recognition)
  - “one size fits all” type of regulation deters specialized entrants
  - likely to prevent entry by firms with investor subscription business models(firms that need not be recognized)
  - industry structure(oligopoly or not) should be determined by market competition(facilitate differentiation by reputation)
  - entry should be free; recognition based on rating process, performance, and conflict management

Issues pertaining to Korea (cont'd)

- unsolicited ratings considered too risky
  - · civil liability as well as criminal penalty feared
    (need to amend the SEA and Act on Credit Information)
  - · makes it difficult for new entrants to develop reputation
- unsolicited rating helps prevent rating shopping
- agencies required to publish detailed rating opinion
  - · reduces room to obtain compensation from investors
- FSC's authority to do direct, ongoing oversight will,
  if actively exercised, jeopardize independence