Plenary 2

Regulating Credit Rating Agencies

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IOSCO High Level Principles for Rating Agencies

- Reduce asymmetry of information
- Independent from political or economic pressures & manage conflicts of interest
- Disclosure and transparency
- Protection of non-public information
  - Only use such information to inform public ratings; no selective disclosure
What Are Credit Ratings?

- Probabilistic opinions about the future
  - The relative likelihood of an issuer to meet its debt repayment obligations

- Not statements of historical fact

- Serving a public good
  - Predictive content in the aggregate
  - Communicated broadly to the investing public

- Contributing to market efficiency and investor protection
Necessary Attributes of Credit Rating Agencies: *Predictive Content*

- Impossible for ratings to be judged “correct” or “incorrect” on a case-by-case basis
  - Rating opinions are analogous to actuarial opinions in this regard

- If Moody's could know the future, we would only have two ratings:
  - "will default" or
  - "will pay"

- Moody’s rating system provides a rank ordering of relative creditworthiness
  - 21 rating categories,
  - Further refined by Watchlists and Outlooks
Necessary Attributes of Credit Rating Agencies: Independence

- Rating actions are sometimes unpopular or controversial
  - Opinions on powerful and prestigious entities

- Investor trust demands independence and objectivity (and predictive capability)

- Regulatory measures must support rating agency independence:
  - From other rating agencies
  - From issuers, investors, intermediaries, and
  - From governments (in their capacity as issuers of debt or as agents for nationally important debt issuers).
Ratings and Credit Volatility

- Some market participants assert that credit ratings cause, or increase, volatility in credit sensitive markets
  - “Pro-cyclicality”
- If true, do ratings require greater governmental scrutiny and regulatory oversight?
- “Pro-cyclicality” – what does it mean?
Ratings and the Credit “Cycle”

- Are rating actions statistically correlated with the credit cycle? (Yes)
- Do rating actions cause or amplify the credit cycle? (No)
- Do rating actions exacerbate credit problems of individual companies? (Sometimes)
Managing Moody's Bond Rating System

- **Accuracy**
  - Correlation of ratings with subsequent credit performance – e.g. the extent to which issuers with lower ratings default at a higher rate than issuers with higher ratings

- **Stability**
  - Frequency and magnitude of rating changes
## Average Annual Volatility Statistics

(as a percentage of issuers; 1999-2002)

<table>
<thead>
<tr>
<th>Category</th>
<th>Moody's Ratings</th>
<th>Bond Yield-Implied Ratings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rating changes</td>
<td>25%</td>
<td>91%</td>
</tr>
<tr>
<td>Large rating changes (more than 2 notches)</td>
<td>7%</td>
<td>43%</td>
</tr>
<tr>
<td>Rating reversals</td>
<td>1%</td>
<td>76%</td>
</tr>
<tr>
<td>Avg number of rating changes over 12 months for issuers that experience rating changes</td>
<td>1.2</td>
<td>4.5</td>
</tr>
</tbody>
</table>
Overall, Stabilizing Impact

- Ratings are much more stable than market-based credit measures

- From the peak to trough of a typical cycle
  - Average Moody's rating changes less than a single notch
    - An implied credit spread change of ~20 basis points for an investment-grade borrower.
  - Investment-grade credit spreads
    - Vary as much as 200 basis points

- Moderating force
  - Reducing credit spread volatility.
Should Ratings Be Even More Stable?

- Potentially a more powerful counterbalance to market overreactions

  *But...*

- If too slow to change
  - Criticized as lagging indicators of credit risk
  - May inadvertently cause:
    - False sense of security; or
    - Shift market reliance to more volatile credit signals, increasing rather than reducing market volatility.
Why Ratings Sometimes Increase Problems for Companies

- Convey new information about company's fundamental credit risk
  - Or confirm other market signals

- Investors may reflexively pull back from downgraded issuers,
  - Based on assumption that others will do the same.

- “Rating triggers" may cause automatic changes in a borrower's cost of funding.
Policy Reactions?

- Rating agencies should be as transparent as possible
- Disclosure of ratings (and other forms of financial conditions) as "triggers" is important
- Ratings should not be treated as buy, sell or hold recommendations
- Diversity and independence in the credit opinions should be encouraged