OICV-IOSCO
30th Annual Conference
2005, Colombo–Sri Lanka

Plenary 1

The Regulation of Credit Rating Agencies

Mr. John Rutherford

Chairman and Chief Executive Officer of
Moody's Corporation, United States of America

6 April 2005

30th Annual Meeting of the

International Organization of Securities Commissions

Panel on

The Regulation of Rating Agencies

Colombo, Sri Lanka
6 April 2005

Statement of

John Rutherford, Jr., Chairman and CEO, Moody's Corporation

Moody's Investors Service

30th Annual Meeting of the International Organization of Securities Commissions Panel on the Regulation of Rating Agencies

Colombo, Sri Lanka
6 April 2005

Statement of

John Rutherford, Jr., Chairman and CEO, Moody's Corporation

Good afternoon, I am John Rutherford, Chairman and Chief Executive Officer of Moody's Corporation, the parent company of the credit rating agency, Moody's Investors Service and the quantitative credit assessment company, Moody's KMV. On behalf of my colleagues at Moody's I thank the organizers of the 30th Annual Conference of IOSCO for the invitation to participate in the rating agency panel. I, along with my co-panelists, have been asked to consider and discuss with you our views on whether additional regulatory measures relating to credit rating agencies are necessary or warranted.

I. A Background Perspective on the Last few Years

Before I discuss Moody's views about implementing and augmenting the existing regulatory framework, let me give you my perspective on the last few years. Since 2001 there have been a number of very large bond defaults, including Argentina, Enron, WorldCom and Parmalat. These defaults had important negative effects on the savings of many individuals in a number of countries. As a result securities regulatory and other financial authorities have conducted extensive assessments of disclosure and whether market participants, including bankers and brokers, accounting firms, lawyers and rating agencies, have acted properly and fulfilled the roles expected of them. At the same time, Moody's was attempting to learn from our own performance in these and other situations and examining what attributes the market wants in our ratings and how we can better meet market needs.

As the IOSCO Technical Committee has stated in the Code of Conduct Fundamentals for Credit Rating Agencies, which I will refer to as the “Code, “[Rating agency] activities are not always well understood by investors and issuers alike."[1] In my view the work done recently by both public authorities and the rating agencies has led to a much better understanding of the role of rating agencies, the meaning and desirable attributes of ratings and how rating agencies should behave in order to fulfill their role in the market.

A. Conclusions from Examinations of Rating Agencies

I'd like now to share with you some of the general conclusions from both the authorities' and our own examinations.

First: The Role of Rating Agencies: Again quoting from the Code, "[Rating agencies] typically opine on the credit risk of issuers of securities and their financial obligations. ... [Rating agencies] can play a useful role in helping investors and others sift through... information and analyze the credit risks they face when lending to a particular borrower or when purchasing an issuer's debt and debt-like securities."[2] So the role of rating agencies is essentially to be an information intermediary. From Moody's standpoint our ratings and credit research are used by issuers, financial intermediaries, counterparties to financial and commercial contracts, and investors (both owners of funds and investment managers). We perceive that each type of user may have somewhat different objectives in their use of ratings and that our job is to strike an appropriate balance between the objectives of different users. Finally, the proper role of rating agencies also includes publishing research, data and models related to credit, while avoiding improper selective disclosure.

Second: The Nature of Ratings: Again quoting from the Code, "[A] credit rating" is an opinion regarding... creditworthiness... expressed using an established and defined ranking system …[C]redit ratings are not recommendations to purchase, sell, or hold any security."[3] Ratings agencies have been very clear that ratings do not consider many matters of importance to investors and should not be used as investment recommendations.

---

[1] Code of Conduct Fundamentals for Credit Rating Agencies, the Technical Committee of the International Organization of Securities Commissioners, December 2004, p. 1

[2] *Id.*.

[3] *Id.*., p. 3.

Third: Desirable Attributes of Rating Agency Ratings: Based on our discussions with the users of our rating agency ratings, they want comprehensive coverage to allow for comparison in the investment decision process. If coverage is sufficient, the primary desirable attributes of ratings are (i) accuracy, and (ii) relative stability.

Accuracy: Much work has been done to understand what accuracy means in a rating system, how it can be measured, and how the accuracy of two different rating systems can be compared. Accuracy means predictive power and calibration.

The predictive power of a rating system is its ability to distinguish between defaulters and non-defaulters over various time horizons. From an overall investor protection perspective, good performance in distinguishing between defaulters and non-defaulters is much more important for large credits than for small credits. From the issuers' perspective, however, smaller issuers will have as great an interest in good ratings performance as large issuers. As a consequence, Moody's measures predictive performance both in dollars (or equivalent) of rated debt and by number of rated entities.

Calibration means that default rates by rating category will remain within historic levels. Generally default rates by rating category increase in more difficult credit conditions and decline in improving conditions; without formality this is called "through the credit cycle". Generally, rating agencies endeavor to have the same mean default rates by rating category through multiple credit cycles.

Stability: Market participants favor stability in rating agency ratings. Less stable ratings could lead to higher costs for borrowers. From investors' perspectives, changes in agency ratings, particularly over the investment / non-investment grade boundary, can cause portfolio revision costs because of portfolio governance rules. As a result of these costs both issuers and investors strongly favor more stable ratings over more volatile ratings even though more volatile ratings may be more accurate, especially at the one and two year time horizons. I should note that Moody's offers both types of ratings from the rating agency and our quantitative unit, Moody's KMV.

Moody's makes publicly available on a quarterly basis a scorecard on our measures of accuracy and stability for our agency ratings. This information supplements the default and rating transition studies that we and other leading rating agencies publish regularly.

Fourth: Lessons from the Recent Defaults: Moody's has attempted to learn from the defaults in the 2001-2002 period and undertaken initiatives to improve our processes in manufacturing, so to speak, our ratings and credit research. Large failures since 2001 resulted from fundamental macroeconomic imbalances, in the case of Argentina, and both simple and very complex financial frauds, in the cases of WorldCom, Parmalat and Enron. For the largest issuers we have undertaken to improve our credit rating processes with liquidity risk assessments, financial reporting assessments, risk transference analysis for companies with special purpose vehicles, risk management assessments for financial institutions, and corporate governance assessments. We have hired teams of accounting and corporate governance specialists. We have substantially increased the size of our credit policy staff, which is charged with developing and ensuring consistent application of our credit rating methodologies and analyzing the performance of our ratings, and put in place a professional development program for our analysts. While we believe that these initiatives will improve the quality of our ratings, we do not believe that it is our role, or within our capacity, systematically to detect financial fraud, and our ratings may not be accurate when fraud is involved.

Fifth: Standards for Rating Agency Behavior: The IOSCO Technical Committee has now successfully defined standards for rating agency behavior in the Code. While my description is not organized the same way as in the Code, the Code sets forth standards:

1. To promote quality ratings;
2. For transparency and timeliness of ratings;
3. For avoidance, and/or proper management and disclosure, of conflicts of interest;
4. For treatment of confidential information; and

5. For legal compliance at both the rating agency entity and rating agency

employee level.

So in the last few years, good progress has been made in improving global understanding and consensus on the proper role of rating agencies, the meaning and elements of value in ratings, improved process in manufacturing ratings, and standards for rating agency behavior.

II. The IOSCO Code and Implementing and Augmenting the Regulatory Framework

Now let me address the primary subject of this panel, the IOSCO Code and implementing and augmenting the existing regulatory framework. The IOSCO Code sets forth standards of appropriate behavior for rating agencies that the market has endorsed and to which Moody's has committed support. Quoting the Secretary-General of IOSCO,

> "[The Code]... represents a significant and positive development in ensuring increased transparency and disclosure of information by rating agencies. Central to the code is the disclosure mechanism whereby agencies publish their own code of conduct and explain any areas in which they do not fulfill the requirements of the IOSCO code. The result is a market-driven compliance mechanism and ... a victory for investor protection."[4]

Our commitment to the IOSCO Code is based primarily on Moody's fundamental commitment to be a useful and responsible participant in the global capital markets and our understanding that such participants should support and uphold global standards. In our own self-interest we also believe that greater transparency around what we do and how we do it will further enhance our reputation and issuers' and investors' confidence in our product.

Turning to the implementation and augmentation of the existing regulatory framework, let me address the subject under four headings: (i) the concerns, (ii) special considerations if ratings are used in regulation, (iii) mechanisms to address the concerns, and (iv) the advantages of global harmonization.

---

[4] Financial Times, "*Rating agencies code is positive and practice step,*" Philippe Richard, Letter to the Editor, 7 January 2005.

<u>First: The Concerns:</u> In Moody's view there are two primary types of concerns about rating agencies. I should note that my terminology and organization is somewhat different from that used in the Code. The concerns are about: (i) the ***quality*** of the rating process; and (ii) the ***integrity*** of the rating process and compliance with laws. So we are talking about ***quality*** and ***integrity***.

Concerns about ***quality*** include number and training of staff, rigorous methodologies, timely updating of ratings and other matters.

Concerns about ***integrity*** mainly address matters such as: (i) whether the rating assigned and maintained is independent of business or other relationships and the effect of the rating on the issuer, the rating agency and others, and reflects only a pure judgment of creditworthiness, (ii) whether conflicts of interest are avoided and/or properly managed and disclosed, (iii) whether confidential information, both provided by issuers and about future rating agency actions, is properly handled, (iv) whether rating agencies exert improper pressure on issuers to purchase their services, and (iv) whether there is proper compliance with law.

<u>Second: Special Considerations if Ratings are Used in Regulation</u>: The intensity of concerns is likely to be increased as the use of ratings changes from “market access” to “regulatory use”. With market access, issuers and investors are allowed to choose ratings from among a group of private sector information providers and use the ratings as they see fit. With regulatory use there is an “outsourcing” to rating agencies of certain functions traditionally performed by regulation (or required by regulation to be performed by market participants). Not surprisingly, there is a tendency to attempt to apply higher behavioral standards on rating agencies in a regulatory use framework since the government must “designate” that a rating agency “qualifies” as an outsourcing alternative.

<u>Third: Mechanism to Address the Concerns</u>: With regard to ***quality***, we believe that regulators should encourage diversity in the credit opinions available in the market and let the credit rating agencies compete to deliver quality.[5] The two best ways for rating agencies to address quality concerns are, first, through transparency in the methodologies and processes for the assignment and maintenance of ratings; and second, through determining the statistical properties of their ratings that they consider important and publishing related analyses of their ratings on a periodic basis.

We believe that these are the best ways for rating agencies to address quality concerns for two reasons: first, different users of ratings can value different attributes of quality. Second there can be very significant differences in opinion on what produces quality in agency ratings, the differences can affect a number of important companies and, because of the relative infrequency of defaults and the multiple variables involved in ratings, the differences are often not subject to empirical determination.[6]

Under these circumstances we advocate letting the market know how the ratings perform, so the market can decide whether they want to use them and for what purpose. The proof of the pudding is in the eating, not in the making.

With respect to ***integrity***, we believe that the considerations are quite different. The credit rating process should be conducted with integrity and, stated more directly, free of corruption. If there is corruption in the rating process, national authorities should be able to apply appropriate sanctions, both to individuals and to the rating agencies.

In applying this standard, national authorities need to be aware that independent credit rating opinions can be unpopular. It is important that national authorities refrain from using their legal and regulatory powers to punish opinion that is honestly manufactured and honestly held, but unpopular. It is also important for national authorities to resist pressure from important companies or banks to intervene on their behalf with rating agencies.

---

[5] Diverse credit opinion will also promote financial stability because it is less likely that an individual opinion will cause excessive market reaction.

[6] A good example is differences of analytical approach toward German unfunded pension obligations.

National authorities should carefully consider whether they really need new legislation or regulation to address concerns about the integrity of the rating agency process, or whether existing laws and regulation are quite sufficient.[7]

This consideration should be made in the context of other attributes of the national legal system. For example, in the United States there are particularly costly aspects of private litigation. Accordingly, from a legal perspective we correctly categorize ratings, which are not a fact but a forecast of an uncertain binary event, default or non-default, as opinions. The legal consequence of this categorization is to allow us to freely express our opinions and obtain protection from civil litigation about potentially unpopular opinions under the paramount constitutional law. In our view any regime which inhibits rating agencies from issuing independent rating opinions does not serve the best interests of the market.

In the particular circumstances when ratings are used in regulation, it is necessary to designate the rating agencies whose ratings can be used in regulation. We also urge regulators to consider very clearly:

- what are the desirable attributes of ratings that make them suitable for use in regulation in the first place, and

- what information the designated rating agencies should provide to validate both the continuing appropriateness of the regulatory use and themselves as providers.

I suspect that most of the uses relate to historical default rates for various rating categories, particularly at the investment grade boundary, and that the information currently published by the larger rating agencies is sufficient to determine the continuing appropriateness of the use. Nevertheless, additional disclosure may be appropriate.

[7] See generally. The Committee of European Securities Regulators, “CESR’s technical advice to the European Commission on possible measures concerning credit rating agencies,” March 2005, Ref: CESR/05-139-b.

In my view, regulators implementing the Basle II new bank regulatory regime have done a particularly good job in specifying the desirable attributes of ratings and the information required to assess and confirm those attributes.

Intrusive regulation of rating agencies is emphatically not justified just because ratings are used in securities regulation. Rather, disclosure of the type that I have specified is sufficient to determine the validity of use of ratings in regulation and the capabilities of the designated providers of such ratings.

There has been discussion of audit standards and independent audits in the case of regulatory use of ratings. Generally, we do not favor audit standards related to the rating manufacturing process as a basis for judging the quality of ratings. However, it is still subject to discussion whether there may be an appropriate use of audit standards and independent audits to assist rating agencies in preserving the integrity of the rating process. Sanctions for failure of rating integrity would include withdrawing recognition, particularly if the corruption is widespread or persistent and rating agency management has not effectively addressed it.

To conclude these comments on mechanisms to address concerns, let me quote Marty Fridson, who is one of the leading independent analysts of less than investment grade bonds:

> "Politicians and bureaucrats love to impose solutions before clearly demonstrating that a problem exists. A loss to the economy is the usual result, as the added administrative costs produce no offsetting benefit."[8]

Fourth: The Advantages of Global Harmonization: Finally, we would also urge you towards a *globally* harmonized set of expectations for rating agencies. The advantages to Moody's of lower manufacturing and compliance costs are obvious. But we also believe that global harmonization will provide important advantages to issuers and investors, because it will make it easier for us to provide a more *globally* consistent product, which will be easier

[8] Martin Fridson, "*The agencies ain 't broke, don't try and fix 'em*", 4 US Credit March 2005, www.uscreditma".com.

for the users of our ratings and research understand and use. Let me give you an example to illustrate this point Moody's believes that it is able to produce more accurate and stable ratings if issuers share relevant non-public information with Moody's. If this practice is permitted in one country and forbidden in another country, we believe that the performance of Moody's ratings could differ between the two countries. You will understand that these potential differences in the performance of our ratings would be difficult for users of our ratings globally to comprehend, and this potential lack of understanding would contribute to less efficient global capital markets. Global regulators need to balance the objectives of global market efficiency against national or regional interests.

Conclusion

The examinations of financial markets and credit rating agencies which have culminated in the IOSCO Code and the current regulatory framework represent a substantial global increase in understanding about the role of rating agencies, the meaning of ratings, the elements of value in ratings and how rating agencies should behave to fulfill their role in the markets. We support the IOSCO Code and its market-driven compliance mechanisms. To address on-going concerns about quality, regulators should avoid practices that restrict entry into the rating agency industry and encourage competition among rating agencies on the basis of quality, including further disclosure of quality metrics. While numerous laws and regulations already exist to address failures in integrity or corruption in the rating process, in some states there may be some gaps that need to be filled. In the special circumstances where ratings are used in securities regulation, that use should not be the justification for intrusive regulation of rating agencies absent specific failures of integrity or evidence of corruption. Rather regulators should determine the desirable attributes of ratings that justify the use and what information the rating agencies should provide to determine the continuing appropriateness of the use and the designated rating agencies as providers.

We at Moody's believe that these orientations would best preserve the core attributes of ratings that have made them valuable to both governmental authorities as tools of public policy and to private sector users in the first place. Thank you.