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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)

	Moody's Ratings	Bond Yield-Implied Ratings
Rating changes	25%	91%
Large rating changes (more than 2 notches)	7%	43%
Rating reversals	1%	76%
Avg number of rating changes over 12 months for issuers that experience rating changes	1.2	4.5

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