Reform of Rating Agencies

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Rating Agencies, Securitisation and Market Collapses

•Credit rating agencies were at the heart of the rise of securitisation, and securitised assets were at the heart of the Subprime problems. Plainly these agencies are slated for major reforms.

•During the last few decades, securitisation has become a primary channel for enlarging financial markets and transferring credit risk from lenders to investors. Outstanding issues of privately securitized assets peaked worldwide at just under $12 trillion in 2008

•Transferring risk undermines incentives to perform due diligence at virtually every stage in the securitisation process. Evident shortfalls of care and diligence in the origination, rating, and securitisation of mortgages have led to a collapse in the prices of securitisations related to subprime mortgages, alt-A mortgages and other leveraged loans

•Suddenness and extent of price decline has undermined confidence in the *reliability and integrity of the ratings process* for asset-backed securities, and has reduced prices and credit flows in every market in which investors count on ratings firms to ascertain the quality of debt.

•Restoring market confidence in the rating agencies paves the way for restoring the overall investor confidence. New rules are called for to ensure that the rating models and methodologies used by the agencies are sound and transparent, that there a proper review processes in place, and that conflicts of interests policies are adhered to.

REFORM OF STATISTICAL RATINGS Organisations

Strengthen the securitisation process by changing the incentives under which Statistical Ratings Organisations (SROs) operate.

Three types of improvements

1. Improve SRO incentives by increasing the transparency of their modeling practices and holding their managements accountable for negligent ratings errors.
2. Remove incorporation of SRO ratings in securities and banking regulations issued by governmental entities. By outsourcing public authority to private firms, this practice intensifies the conflicts of interest that SRO personnel must resolve
3. Acknowledge differences in the degree of leverage that is imbedded in different issues of securitized debt. Recommendation that SROs be required to state an express margin for error in their ratings for every tranche of securitized instruments.

HISTORY OF SROs

•Bond markets functioned internationally for 300 years before the first rating organisations appeared in the US. An active corporate bond market, largely in debt issued by railroad companies, emerged in the middle of the 19th century in the US more than half a century before the first SRO opened for business.

•Building a reputation for accuracy is critical to the success of any SRO. Ratings firms prospered to the extent that their predictions of the probability of default proved reliable after the fact. Over time, the accumulation of reputational capital by successful SROs made entry difficult for new SROs. The result is that two or three SROs have dominated the market for credit ratings, and did so long before the SEC began to designate particular SROs as Nationally Recognized Statistical Rating Organisations (NRSROs) in the 1970s.

•In the early 1930s, incentives for SROs to produce reliable information for investors were complicated by introducing ratings into the regulatory process. Regulators of banks, insurance companies and pension funds began to use ratings to limit the riskiness of the assets held by regulated entities. Regulators set two kinds of rules: rules that restrict the extent to which a firm can hold assets that fall below investment-grade (or higher than investment grade for money market funds), and rules that link capital requirements to the ratings on individual securities, with lower capital charges for high-rated securities

SRO History and Industrial Organisation

•The spread of photocopying technology facilitated unauthorized reproduction of SRO rating manuals, which undermined the traditional user-pays revenue model. SROs responded by shifting to a business plan in which the issuer pays for their services. This plan intensified SRO conflicts of interest with issuers.

•Income from rating structured debt began to increase sharply and account for almost half of the revenues of the three dominant firms.

•A further weakness inherent in issuer-pays arrangements is that they undercut SRO incentives to monitor and downgrade securities in the post-issuance market.

•Not until 1975 did the SEC confront the problem of how to determine whether a particular SRO could be relied upon to provide ratings of sufficiently high quality that they could be used in the regulatory process. The SEC's solution to this problem was to certify particular SROs as meeting sufficiently high standards to be designated by the SEC as an NRSRO.

•The NRSRO designation strengthened the market power of the dominant three incumbent firms: Moody's, Fitch, and Standard & Poors. In turn, the oligopolistic position these firms enjoy reduces their incentives to compete in ratings methods and procedures.

•Regulators could enhance competition among SROs by more vigorous application of antitrust policy

Evaluation of the SEC's Proposals for Reform, June 2008

Purpose of SEC proposals is to foster increased transparency, accountability, and competition in the credit rating industry for the benefit of investors.

1. First proposal seeks to mitigate conflicts of interest, enhance disclosures, and improve internal policies and business practices at SROs.
2. Second proposal would require NRSROs to differentiate the ratings on structured products from those that they issue on traditional bonds and loans, and perhaps to provide a timely and relevant accompanying narrative.
3. Third proposal would nearly eliminate the role of ratings in SEC regulations

Conflicts of interest, disclosure, and improve business practices

In the important areas of disclosure and incentive conflicts, the SEC's first proposal would require SROs to:

•Publish all ratings and subsequent re-ratings in ways that facilitate comparisons of SRO performance in a timely manner. Disclosures would include performance statistics for spans of 1, 3, and 10 years within each rating category.

•Disclose all information used to determine ratings for structured products

•Explain how frequently credit ratings are reviewed, whether different models are used for ratings surveillance than for setting an initial rating, and whether, when changes are made in an SRO's models and procedures, they are applied retroactively to existing ratings.

•The SEC or Congress might also impose disclosure requirements on issuers. Every US issuer of securitised claims could be required to provide a monthly balance sheet and income statement for each and every securitisation structure it creates, even if the securities are to be marketed offshore.

Differentiating structured products from traditional bonds and loans

•The SEC’s second proposal seeks to differentiate ratings on securitisations in the future from those on ordinary bonds. Because of their imbedded leverage, securitised instruments may have a much deeper downside loss exposure than ordinary bonds.

•Because imbedded leverage and downside margins for error grow larger when claims on an underlying asset pool are tranched and retranched, SROs should be required to express ratings on securitised debt in a two-dimensional fashion (i.e., with an accompanying estimate of their particular margin for error).

Eliminate ratings' role in SEC regulations

The SEC's third proposal addresses its practice of basing rules and reporting procedures on NRSRO ratings.

•Use of NRSRO ratings in supervision simultaneously outsources some of the regulatory authority's political accountability to profit-making firms and appears to confer an official seal of approval on their methods that might reduce the willingness of other parties to undertake due diligence and invest in securities analysis. The SEC proposes to remove references to NRSRO ratings from virtually all of its rules and protocols.

First, the prudence of investment decisions must ultimately be evaluated in a portfolio context and cannot be assured by constraining the credit quality of individual assets an institution holds, regardless of how accurate the SRO ratings might be. Second, depriving SRO ratings of regulatory consequences will remove a major source of pressure for ratings inflation. Third, in the absence of SEC mandates, managers and directors can and will subject the prudence of their decision making to review by a much wider array of outside monitors.

Quasi-safe-harbour provisions that provide firms, managers and directors some protection from liability for adverse outcomes is more problematic.

EU Commission SRO reform proposals

The European Commission has proposed new rules:

•Rating agencies would have to register with European supervisors (as they already have to in the US). Supervisors would not be able to interfere with the rating decisions.

•Agencies should be banned from doing advisory work.

•Disclose how they make their ratings and would not be allowed to rate a security if they did not have sufficiently reliable information to do so properly.

•Rating agencies would have to have at least 3 independent directors on their boards.

•Internal reviews of rating quality would be required and annual transparency reports would have to be published.

Implications for Other Regulators

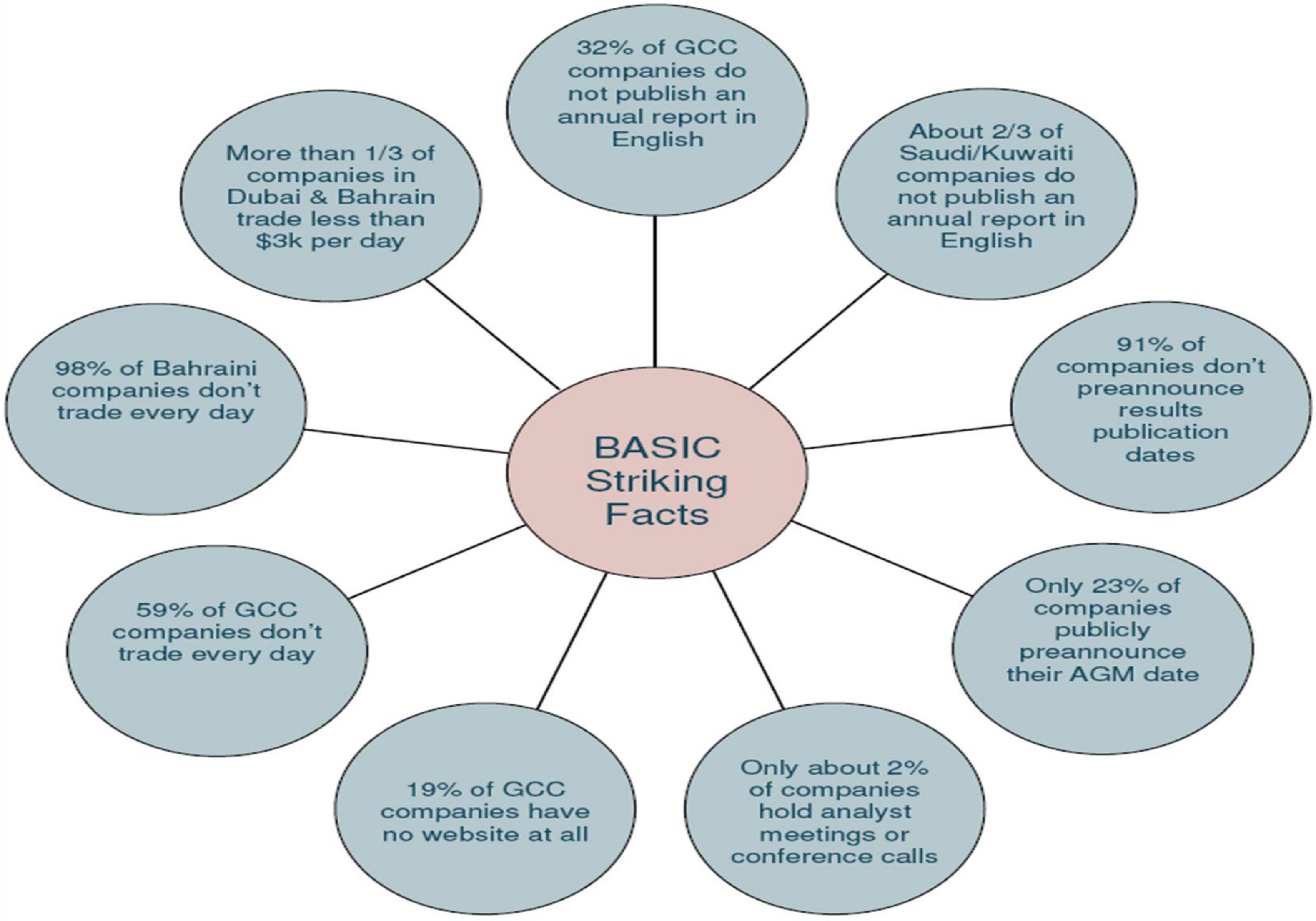
•Although new rules and enhanced supervision might induce slightly better SRO performance, it is unlikely that increased government oversight of the production of credit ratings can improve SRO performance over time and improve the performance of investment managers as effectively as market forces can.

•It is particularly important for banking regulators to reconsider their reliance on ratings decisions. By adopting Basel II, they are linking minimum capital requirements for some banks to ratings issued by whatever SROs they recognize in each individual nation.

•European Commission has proposed a registration and oversight regime that would have two features. The first charges the Committee of European Securities Regulators (CESR) with the responsibility for choosing an individual country to register, coordinate and consolidate oversight of individual SROs. The second creates a central supervisor, financed from the EU budget, to license rating organisations

•Roundtable strongly supports the SEC’s strategy which relies on greater transparency, increased competition and the abandonment of the practice of incorporating NRSRO ratings in regulatory mandates

Hawkamah-TNI Survey, August 2008



Source: TNI Investment Research

MENA/GCC Reform Measures

1. Improve statistical capacity and public dissemination of data & information
2. Establish company registrars and companies houses
3. Strengthen Transparency & Disclosure for listed companies
4. Introduce mandatory CG Codes, Guidelines and Laws and enforce them
5. Enforce anti-trust measures for SROs to combat oligopolistic structure with dominance of 3 companies; license new SROs
6. Three types of improvements
    i. Improve SRO incentives by increasing the transparency of their modeling practices and holding their managements accountable for negligent ratings errors.
    ii. Remove incorporation of SRO ratings in securities and banking regulations issued by governmental entities. By outsourcing public authority to private firms, this practice intensifies the conflicts of interest that SRO personnel must resolve
    iii. Acknowledge differences in the degree of leverage that is imbedded in different issues of securitized debt. Recommendation that SROs be required to state an express margin for error in their ratings for every tranche of securitized instruments.
7. Reconsider the role of ratings in Basel II
8. Suspend “mark to market” or “fair value accounting” until markets become functional