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Executive Comment:

An Examination Of How Investor Needs Are Served By Various Ratings Business Models: Ensuring Analytical Independence And Preventing Conflicts Of Interest At Credit Rating Firms

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Credit rating organizations have served investors and the markets well for over 90 years, but, regrettably, ratings on U. S. housing-related structured securities in recent years have not, generally speaking, performed as well as intended. Subsequently, ratings firms have made many changes and are working with regulators and policymakers around the world to help restore confidence in the credit markets and stimulate recovery.

This is vital work because, as the U.K.'s Financial Services Authority (FSA) stated in March, 2009, one of the reasons ratings firms play a valuable role is that it is impossible for all but the very largest investing institutions to perform independent analysis of a large number of issuing institutions and myriad debt securities.

And in April, 2009, the G-20 group of nations called for globally consistent standards, building on International Organization of Securities Commissions (IOSCO) proposals to put appropriate structures and procedures in place to manage conflicts and reinforce analytical independence and quality.

Numerous business models are either in place or being discussed. This paper examines the advantages and disadvantages that three of these models present. Standard & Poor's believes that market participants should be free to choose from a number of business models while regulations and processes are put in place to ensure that potential conflicts are effectively managed. The fundamental goal of all ratings firms should be to continue to strengthen their respective business models, particularly in the areas of transparency, quality of performance and prevention of conflicts of interest.

The Purpose Of Ratings

Ratings exist first and foremost to provide investors with an independent view of creditworthiness and are one among many important tools for investors. Standard & Poor's constantly seeks to better understand the needs of investors where credit ratings are concerned. In recent months we have met with a range of institutional and individual investors, hedge funds, pension funds, policymakers, and regulators, and we asked them: "What do investors want from ratings firms?" In addition to wanting analytical independence, they are nearly unanimous in their desire for the following six requirements:

1. Transparent and efficient markets, whereby all public ratings are available to all investors, large and small, without charge and at the same time.

2. A process for arriving at ratings opinions that is free from conflicts of interest and independent of issuers, investors, and governments through regulated oversight of policies, processes, and procedures and robust competition.

3. High-quality ratings based on sound, consistently applied methodologies that take into account real-world trends.

4. Broad and consistent coverage of a wide range of securities and asset classes to facilitate access to capital across multiple regions and by new or smaller enterprises.

5. Ongoing scrutiny to ensure that a rated security will be surveilled over time and upgraded or downgraded if appropriate and in a timely manner.

6. Freedom to choose rating opinions from multiple sources, along with additional benchmarks addressing issues besides the likelihood of default.

With these requirements as background, Standard & Poor's has examined the advantages and disadvantages of several business models:

- The Subscriber-Fee Model, in which certain investors such as hedge funds and financial companies would contract and pay for ratings reports and receive them on a nonpublic, proprietary basis.
- The Government Utility Model, in which a ratings organization is run or directed by a government and may be funded by investors, subscribers, or a public tax on issuance or outstanding debt. This tax or fee pool would then be subdivided and assigned to ratings firms performing credit analysis on specific issues and issuers.
- The Issuer-Fee Model, in which the issuer organizations pay fees to a rating firm as part of the process of issuing a security in the marketplace.

We have found that each model brings with it distinct advantages and disadvantages, and that all three models have to manage potential conflicts of interest, as one would expect. The key is to be aware of these pressures and to have regulations and procedures in place that preserve the integrity of ratings in a manner similar to the way in which other sectors have addressed conflicts. Newspapers, for example, may sell advertising space to the same people and organizations about whom they report--in much the same way that some rating organizations receive fees from the issuers whose credit instruments they rate.

There is a natural tension between the interests of subscribers (who are mostly investors) versus the interests of issuers. Generally, subscribers, such as hedge funds and large financial institutions, might prefer lower initial ratings on high-quality securities to improve their returns, while issuers prefer high ratings to reduce financing costs. It is not for the rating firm to take sides but rather to provide an unbiased opinion of the likelihood that an obligation will be repaid on time and in full.

With the expressed interests of investors in mind, this paper will examine the three business models and assess how well they foster these goals in the marketplace. For ease of reading, we have summarized and prioritized the top investor goals as:

- Transparency;
- Prevention of conflicts;
- Quality;
- Coverage;
- Scrutiny; and
- Choice.

Transparency

The single greatest contributor to trust and credibility is transparency. If investors understand how a rating firm developed its opinion--what models it used, what assumptions it factored--they can make their own decisions about whether they believe in its analytical independence and soundness. Because distribution of ratings in the subscriber-fee model is necessarily limited to subscribers, exclusive use of this model is likely to result in a significant decline in the overall volume of information available to the marketplace because the ratings opinions would not be available to the general investing public. Furthermore, if a ratings firm decided to downgrade a company and made that information available only to its paying clients, potentially market-moving information would not be readily available to other investors, thereby increasing information asymmetry and market inefficiency.

A government utility model would create maximum transparency in that ratings would be made available to the marketplace free of charge. However, this would require all governments to be equally transparent about criteria and assumptions.

Historically, the issuer-fee model has fostered the greatest levels of transparency. The issuer-fee model enables organizations that employ it to make ratings--which in the case of Standard & Poor's includes the overwhelming majority of debt obligations and preferred stock issues publicly traded in the U.S., and a large percentage of the debt issued in Europe and Asia--widely available to the market and public, free of charge, in real time. The quantity and easy accessibility of this information create a level playing field and a common basis and language for analyzing risk across a wide range of asset classes--and for comparing rating firm performance across sectors.

It is interesting to note that until the 1970s, virtually all ratings firms used the subscriber-fee model. But in the wake of several notable defaults, including Penn Central Railroad, the marketplace demanded more transparency for all participants in the bond market--transparency that could best be provided through the adoption of the issuer-fee business model, which allows ratings to be provided to all investors for free. As we have learned from recent experience, education of the marketplace is necessary to avoid potential misuse of ratings.

Prevention Of Conflicts

The potential for conflicts of interest becomes a concern in any business model where money changes hands. We have often heard that it may be in the interest of issuers to achieve high ratings in order to reduce the cost of borrowing capital, but it is in the interest of investors (who constitute most subscribers) that high quality securities have lower initial ratings as that can yield higher returns. In the subscriber model, it is possible to envision a small number of large investors representing enough of a "bloc" to attempt to wield significant influence over the ratings process. In fact, in certain types of structured securities, a small group of investors often purchases the entire offering.

Would a government utility model be any better than the private sector in managing conflicts? Does the elimination of the profit motive eliminate all potential for a conflict of interest? With these questions in mind, some have suggested the restructuring of ratings firms into government utilities funded by fees or taxes on investors. Of course, governments--as issuer, investor, and overall governor and regulator of the economy--can possess their own interest in ratings decisions. Governments, for example, have a natural interest in protecting or stimulating the growth of issuer companies with an important role in the national economy.

As a theoretical example, consider the recent downgrades in the financial markets of firms that have received bailout funds. If the government were involved in the selection of a ratings firm to opine on these firms, might the public utility have an incentive to design criteria and methodologies to meet government approval, rather than exercise independent judgment? And in the case of sovereign ratings, what would it take to convince any market participant of the objectivity of a government that would find itself in the untenable position of effectively rating itself?

Still others have questioned the independence of the issuer-fee model, in which the institutions issuing the debt pay fees for the ratings based upon the complexity and volume of analysis performed. It's important to note that new regulations requiring higher levels of transparency about rating methodologies, models, and performance should allay concerns about conflicts of interest in the issuer fee model. In addition, the widespread dissemination and use of ratings under the issuer-fee model have facilitated the raising of capital and the stimulation of economic growth--as well as broad market scrutiny of ratings--for three decades. Clearly, ratings of some recently issued structured securities have not performed well, but ratings firms have made important changes to strengthen their analytical independence--and must continue to make them.

The size and scope of the potential for conflicts of interest are further complicated because many issuers--from insurance companies and municipalities to corporations, large and small--are also active investors, meaning that those seeking ratings may also be using ratings as a tool in their own investment analysis. It thus turns out that issuers themselves have a major interest in a system that is fair and unbiased, both as a rated entity and as a debt investor.

With sound regulatory oversight and robust internal controls, every business model can effectively manage potential conflicts of interest.

Quality

When applied to ratings, the words "quality standards" can take on many definitions, from the evaluation of the robustness of analytics to the consistency with which those analytics are applied to the transition, or change, of ratings over time. Much of the recent criticism directed at ratings firms stems from the natural actions that can occur as a firm reassesses, over time, ratings on existing securities. Ratings are designed to change if any combination of factors including, for example, the overall state of the economy, and in the case of mortgage securities, the housing market, changes. In a tough economic environment, companies and individuals alike can experience difficulties in meeting their obligations, and rating downgrades are often the result. This is in spite of the ratings firms' best efforts to anticipate the severity of a downturn and account for it in the ratings. Therefore, moving from one business model to another would not mean that the ratings on securities would never be reassessed and subsequently upgraded or downgraded throughout their term.

There is a debate as to how to judge the quality of ratings that the subscriber-fee model produces when the results of the analytics of that model are not generally made public. This model has generally been used by firms that can create a product at a price that can be supported by a relatively small audience of subscribers who can afford the private fees.

In the mid-1970s there was a historic shift away from the subscriber-fee model as the demand for more high-quality corporate, municipal, and structured ratings grew rapidly and required larger staffs, global offices, and other resources to support this increased ratings output.

The government utility model is not one that has been widely employed to date. There is no doubt that the time, talent, and energy necessary to launch such an effort would be considerable. However, with appropriate investment over many years, quality may be achieved. It would require the dedication of a tremendous amount of public resources and time, with governments required to be involved substantively in hundreds of thousands of ratings each year, requiring thousands of analysts to rate trillions of dollars worth of debt. For reference, in 2008 alone, Standard & Poor's issued or changed more than 1.1 million ratings. An important question is whether all governments would make similar commitments. And were they to do so, how would they manage the substantial, detrimental market effects due to the length of time necessary to develop the analytical systems, personnel, and infrastructure to adequately service the market with a high-quality product?

Firms employing the issuer-fee model devote considerable resources to publishing high-quality ratings with established criteria for all major ratings segments (municipalities, corporations, sovereign nations, etc.) and have a long-term track record of success and a global footprint with broad market coverage. As an example of the results for one such firm, Appendix 1 outlines the default and transition studies for Standard & Poor's over the past five years in all major rating segments. In the area of structured securities, as noted above, we are implementing enhanced analytics to raise investor confidence in the quality of ratings.

Coverage

A key requirement for investors is broad ratings coverage of many issues and issuers in multiple asset classes, coverage that is based on robust methodologies and analytics that are consistently applied across asset classes and over time. This three-dimensional grid of depth and breadth of coverage over time presents numerous challenges, even for the largest, most sophisticated and well-funded ratings providers.

A subscriber-fee model often focuses on established entities or sectors, placing unique barriers in the way of new entrants seeking financing in the capital markets. As stated earlier, it was the desire of investors for greater diversity of bond offerings that helped prompt some rating organizations, including Standard & Poor's, to shift in the 1970s from a subscriber-fee model to an issuer-fee model.

History has demonstrated the ways in which investor desire has driven dramatic changes in the way markets are serviced. For example, in the wake of the equity research scandal on Wall Street in 2001, securities firms dropped research coverage of hundreds of smaller companies and concentrated their resources on large, liquid securities favored by large institutional investors. Many small to mid-cap companies found that liquidity in their stocks was severely reduced as research coverage and dissemination of information and independent analysis about the marketplace dried up. The provider in the subscriber-fee model has an incentive to provide a rating only when a paying customer demands it. Should the customer no longer request the rating, coverage of that security or issuer could be discontinued. As investor appetite shifts from country to country, the changing needs of the limited subscriber base may not match the overriding goal of the marketplace for consistent information across asset classes, regions, and time. This model in many respects serves to complement or fill in the gaps or niche desires of defined constituencies.

Although the goal would be for the government utility to provide maximum coverage, there is also a question of whether, for example, non-U.S. issuers would accept a U.S. government-sponsored rating, or whether a public utility in one country would have any mandate to rate securities in another country. In addition, if global coverage and consistency could not be achieved via a government-sponsored vehicle, the goal of using ratings as a common credit tool on an international scale would be defeated. Different governments have different interests and would likely conduct themselves differently with respect to ratings organizations. If different governments analyzed the same issue or issuer differently, could the markets lose clarity and consistency as to the relevance of a given rating to a particular debt offering on a global basis? Would an 'A' rating issued in Sweden be the same as an 'A' rating in Japan or the U.S.? Aside from the cost, would a public-utility model slow down the process of issuing securities, resulting in costly market inefficiencies or inhibiting access to capital?

The issuer-fee model facilitates the highest level of coverage. In the case of Standard & Poor's, our ratings cover the overwhelming majority of debt obligations and preferred stock publicly issued and traded in the U. S., and we have issued ratings on debt securities in more than 100 countries. The issuer-fee model also allows new entrants to the capital markets with which investors may not be familiar to obtain a rating in connection with efforts to raise capital--resulting in more ratings on more securities to the benefit of the market as a whole. And it enables Standard & Poor's to publish a large volume of non-rating-related research on a wide range of subjects to the marketplace at no charge. Overall in 2008, Standard & Poor's Ratings Services published more than 35,000 credit analyses, more than 7,200 commentaries (of which 152 were criteria articles), and more than 16,700 media releases. We also believe that all ratings firms should adopt a single, global ratings scale across all regions and asset classes, as Standard & Poor's has done. On a global scale, we intend for an 'A' rating that we issue on a corporate security in the U.S. to reflect a similar default likelihood as for an 'A' rated corporate security issued in other countries.

Scrutiny

Ongoing surveillance and market scrutiny provide an important check on rating firms regardless of their business model. Because access to data and analysis generated by the subscriber-fee model would be restricted to those who are actually subscribers, the amount of transparency and market scrutiny would be far more limited. The result would be two tiers of investors--the very large institutions that can afford to pay for ratings reports and those that cannot. At the same time, subscribers faced with a cost burden might choose to subscribe to only one ratings firm, limiting investors' ability to compare ratings or assess a firm's long-term performance against its competitors--an important quality check.

Presumably, the government utility model would be subject to the same type and degree of scrutiny that ratings firms receive today and will continue to receive under regulation enacted in the future. However, would the credibility of ratings be diminished if the market felt that a government was providing less rigorous scrutiny or if the public utility were seen as having no other alternative than to stay in a government's good graces?

With the passage of the Credit Rating Agency Reform Act of 2006, the U.S. Congress gave the Securities & Exchange Commission (SEC) oversight of registered credit rating firms. As a result, Standard & Poor's and others are subject to periodic examinations by the SEC. In addition, since our ratings and long-term ratings performance are made available to the public, we are under significant, ongoing scrutiny by the marketplace.

Choice

Investors want choice, and we agree that it best serves the marketplace to provide access to multiple business models as long as appropriate regulatory oversight is in place to ensure analytical independence and freedom from potential conflicts of interest. The detriment to the marketplace of sanctioning only one business model would be significant.

If, for example, the industry moved exclusively to a subscriber-fee model, how would investors around the world gain access to the full coverage they currently receive from ratings firms employing the issuer-fee model? Only the large players able to pay for research would have access to it.

On the other hand, if the industry adopted only the issuer-fee model, investors who are willing to pay for research that would be made available exclusively to them would no longer have that option. And in the case of a government utility model, would the burden of creating a new entity that would be capable of managing the enormous volume of ratings issued each year in a timely manner create a significant cost burden that might be difficult to offset without higher fees than are currently charged now? Would this also potentially lead to myriad conflicting government models around the world?

Conclusion

In the end, the market will decide which business models work best and are sustainable over time. From our own experience in rating bonds and bond issuers for nearly 90 years, we feel that, regardless of which model a ratings firm adopts, its transparency, methodologies, timeliness, integrity and record of performance are ultimately the hallmarks on which its reputation among investors is based.

Standard & Poor's believes that the global credit market is large and diverse enough to accommodate more than one business model. Although each presents its own potential advantages and disadvantages, we believe that with appropriate regulatory oversight, the potential conflicts can be managed. At the same time, while any model must be responsive to the interests of both issuers and investors, the investors' needs for increased information and high quality performance must take priority. For example, at Standard & Poor's we are developing actions to add a stronger investor voice in the rating process. In addition, regulation and oversight of these practices will provide investors with consistent global standards to serve their interests.

In summary, we believe that it is vital for investors and issuers alike to have confidence in ratings and ratings firms, and to have a range of options from which to select, according to their individual requirements.

Appendix

Table 1

Global Corporate Cumulative Average Default Rates (1981 - 2008) (%)

	—Time horizon (years)—														
Rating	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**
AAA	0.00	0.00	0.09	0.18	0.27	0.37	0.40	0.47	0.51	0.55	0.55	0.55	0.55	0.60	0.65
AA	0.03	0.08	0.14	0.25	0.34	0.45	0.56	0.65	0.73	0.83	0.92	0.99	1.08	1.15	1.20
A	0.08	0.20	0.34	0.52	0.72	0.95	1.21	1.45	1.69	1.94	2.17	2.35	2.53	2.68	2.91
BBB	0.24	0.68	1.17	1.79	2.43	3.06	3.59	4.12	4.63	5.16	5.68	6.12	6.63	7.15	7.70
BB	0.99	2.88	5.07	7.18	9.07	10.90	12.41	13.74	15.00	16.02	16.89	17.64	18.28	18.76	19.33
B	4.51	9.87	14.43	17.97	20.58	22.67	24.46	25.93	27.17	28.41	29.54	30.50	31.45	32.32	33.14
CCC/C	25.67	34.10	39.25	42.29	44.93	46.24	47.45	48.09	49.53	50.33	51.03	51.77	52.33	52.93	52.93
Investment grade	0.12	0.33	0.57	0.88	1.19	1.51	1.80	2.07	2.34	2.62	2.87	3.08	3.30	3.52	3.76
Speculative grade	4.06	7.99	11.48	14.32	16.59	18.51	20.13	21.49	22.75	23.86	24.84	25.69	26.48	27.16	27.82

Table 1

Global Corporate Cumulative Average Default Rates (1981 - 2008) (%) (cont.)															
All rated	1.47	2.94	4.25	5.37	6.30	7.11	7.80	8.40	8.95	9.46	9.92	10.30	10.68	11.02	11.38

Sources: Standard & Poor's Global Fixed Income Research and Standard & Poor's CreditPro®.

Table 2

USPF Cumulative Average Obligor Default Rates, 1986-2008 (%)

	—Time horizon (years)—							
Rating	1	2	3	4	5	10	15	20
AAA	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
AA	0.00	0.00	0.01	0.01	0.01	0.03	0.07	0.14
A	0.00	0.01	0.02	0.02	0.03	0.06	0.11	0.19
BBB	0.01	0.04	0.08	0.13	0.17	0.29	0.37	0.37
BB	0.20	0.57	0.97	1.14	1.32	1.76	2.07	2.07
B	1.46	3.01	3.84	4.75	5.40	7.70	7.70	7.70
CCC/C	13.77	19.44	23.95	27.95	30.01	37.80	41.76	41.76
Investment Grade	0.00	0.01	0.03	0.04	0.05	0.11	0.16	0.22
Speculative Grade	1.56	2.61	3.46	4.13	4.58	6.13	6.75	6.75
All Rated	0.02	0.04	0.07	0.09	0.11	0.17	0.23	0.29

Table 3

Global SF Cumulative Default Rates (%), Conditional On Survival—1978-2008*

	—Time horizon (years)—									
Rating	1	2	3	4	5	6	7	8	9	10
AAA	0.08	0.15	0.17	0.18	0.18	0.19	0.20	0.20	0.20	0.20
AA	0.14	0.43	0.50	0.60	0.73	0.84	0.93	0.97	0.99	1.01
A	0.27	1.01	1.37	1.65	1.91	2.17	2.48	2.70	2.80	2.89
BBB	0.68	3.01	4.79	6.51	8.26	9.68	10.46	11.14	11.68	11.98
BB	2.02	5.64	8.31	9.81	11.03	12.39	13.43	13.98	14.21	14.28
B	4.64	8.84	12.36	14.65	16.66	18.42	19.77	20.86	21.62	22.01
CCC	43.80	50.63	55.11	58.40	60.58	61.80	62.04	62.37	62.79	62.79
CC	23.56	32.53	40.59	45.86	49.20	49.76	49.76	49.76	49.76	49.76
Investment-grade	0.26	0.95	1.37	1.72	2.04	2.28	2.43	2.54	2.60	2.64
Speculative-grade	6.51	10.57	13.74	15.71	17.31	18.79	19.88	20.62	21.07	21.27
All rated	1.13	2.26	3.01	3.54	3.98	4.33	4.55	4.69	4.77	4.82

*'AAA' ratings from the same transaction are treated as a single rating in the calculation of this table.