

Treasury Markets Association  
Education Programme

# **The Credit Rating War**

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# What Is Credit Rating

- A credit rating is the opinion as of a specific date on the credit worthiness of an obligor (i.e. issuer or borrower) in general or with a debt security with respect to a particular financial obligation (i.e. debt issue or loan).
- Credit ratings are provided by credit rating agencies (CRA).
- CRA were not regulated until 2006 in USA and 2010 in Europe.

# Role and Function of Credit Rating Agency

- Credit rating is an important component of the debt market.
- Credit rating helps the debt market effective and efficient in evaluating and assessing credit risk, pricing debt, benchmarking issue and creating a liquid secondary market.

# Principles of Credit Rating Service

- Integrity
- Independence
- Creditability
- Objectivity
- Quality

# The “Big Three” Credit Rating Agencies

- The “Big Three” CRA are: *Moody’s, Standard & Poor’s and Fitch.*
- Moody’s and Standard & Poor’s are American companies, and Fitch is American and European after a couple of merger and take over (Fitch, IBCA, Duff & Phelps, Thomson Bank Watch).
- The “Big Three” have a history of nearly 100 years, dominating the international credit rating market by capturing about 90% market share.

# Failure of the “Big Three”

- The “Big Three” were seriously criticized by debt market participants, regulators and politicians on their failed performance with respect to their inflated credit rating and conflict-ridden rating process that play a significant role in exacerbating the “2008 Financial Tsunami”.
- The “Big Three” have been facing critics and attacks from the market and their competitors.

# Misdeeds of The “Big Three”

- Inflating credit rating
- Ignoring massive and rapid deterioration in the credit worthiness of subprime mortgages in the USA
- Concerning market share more than the CRA principles
- Loosening internal control
- Conflict of interest in the rating process
- Low degree of transparency in rating methodology
- No verification of information received from the rated entity and the public
- Slow to revise rating or down grade issue
- Tendency to converging over time on a common rating
- Loss of the “Goal-keeper” role (de facto regulatory licensing power)

# Conflicts of Interest

- Conflicts of interest is the main cause of the failure of the “Big Three”
- Conflicts of interest embeds in both
  - “ Issuer-pay ” business model
  - “ Subscriber-pay” business model



# Types of Conflicts of Interest (1)

- Conflicts of interest at the analyst level:
  - \* ownership of securities of rated entities;
  - \* employment position or directorship at a rated entity;
  - \* business relationship beyond ordinary course of business or special personnel relationship;
  - \* receipt of gifts from rated entity
  - \* the determination of analysis' compensations based on rating fees

# Types of Conflicts of Interest (2)

- Conflicts of interest at the rating agency level:
  - \* affiliated underwriter or issuer;
  - \* ancillary services to rated entities.

# The “Issuer-pay” Business Model

- The “Issuer-pay” business model was introduced in the late 1960s by the “Big Three”. Before that, was the “subscriber-pay” business model (or called the “investor-pay” business model).
- The “Big Three” could not survive on the “subscriber-pay” business model due to insufficient fees received from the genuine subscribers.
- In the “issuer-pay” business model, issuer pays an initial fee for entity rating or issue rating and the relevant annual fees.

# Advantages of “Issuer-pay” Business Model

- CRA can access to unpublicized information from the rated entity, therefore the latter’s credit strength can be more accurately reflected in the rating.
- The public can receive credit rating results from the CRA at the same time, therefore the issue can be distributed to a wider spectrum of investors.

# Disadvantages of “Issuer-pay” Business Model

- An CRA afraid of losing out clients may tend to inflate credit rating in a heightened competition among CRAs.
- Investment banks may press CRAs to assign higher ratings on the issues they arranged as an issuer tend to listen to the issue arranger’s recommendation of appointing CRAs.
- Conflicts of interest.

# “Subscriber-pay” Business Model

- “Subscriber-pay” business model had been used since the inception of the Big Three in the early 20<sup>th</sup> century until late 1960s.
- The subscribers, namely, investor, bank, researcher and academic, paid to receive credit rating and report from the CRA.

# Advantages of “Subscriber-pay” Business Model

- CRAs receive no or little pressure from the issuer or investment banks on the credit rating results.
- Internal pressure to credit analysts from CRA management with respect to market share can be reduced substantially.

# Disadvantages of “Subscriber-pay” Business Model

- A subscriber may privately send CRA’s credit rating report to other entities such that the CRA cannot receive sufficient subscription fees to maintain the daily operation.
- Issuer may not be co-operative in providing information to the “subscriber-pay” CRA.
- Credit rating result cannot reach to all interested investors who are not the CRA’s subscribers, hence, narrowing the distribution spectrum of securities in the market.
- Conflicts of interest.



# Suggested Reform on Credit Rating after 2000

- “Do it yourself” credit analysis.
- Regulating the CRA.
- Encourage more CRAs entering the credit rating business to break the oligopoly of the “Big Three”.
- CRAs should do due diligence on the rated entity and the collaterals in case of structured issue.
- Implement the “Equal Access” rule.
- In the case of structured issue, disclose information of collaterals and cash-flow in the case of securitized issue on CRA’s website.
- Disclose credit rating methodologies on the CRA’s website.
- Rotation of credit analysts.
- Adoption of “subscriber-pay” business model.

# Reform Development – USA (1)

- US Congress enacted the “Credit Rating Agency Reform Act of 2006”.
- The Securities and Exchange Commission (“SEC”) lowered the barrier of registration for Nationally Recognized Statistically Rating Organizations (“NRSRO”) in 2006 such that more NRSROs can be made available.
- Dodd-Frank Act mandated the creation of the Office of Credit Rating (“OCR”) in June 2012 to oversight the NRSROs
- As of 31 December 2013, there were 10 NRSRO: *A.M. Best, DBRS, Egan Jones, Fitch, HR Ratings de Mexico, Japan Credit Rating, Kroll Bond Rating, Moody’s, Morningstar, Standard & Poor’s.*

# Reform Development – USA (2)

- SEC has promulgated a series of rules to:
  - (i) govern the registration procedures;
  - (ii) provide detailed disclosure as to the experience with the ratings issued by each NRSRO;
  - (iii) regulate conflicts of interest;
  - (iv) encourage competition.

# Reform Developments – Europe (1)

- International Organization of Securities Commission (“IOSCO”) developed a set of Code of Conduct to ensure the accountability of CRA in 2006.
- In June 2010, the European Commission created a pan-Europe body - the European Securities Market Authority (“ESMA”) – the supervisory authority over CRA registered in Europe.
- As of 31 December 2013, there were 22 CRA s directly or indirectly registered with, and 2 CRAs certified by, ESMA. (the list can be found by click open from the following link: <http://www.esma.europa.eu/page/List-registered-and-certified-CRAs>)

# Reform Developments – Europe (2)

- Every registered CRA must adopt the CRA Code of Conduct developed by IOSCO albeit some deviations may be allowed.
- Under the code of conduct, an CRA must avoid conflicts of interest, periodically review its rating methodologies, adopt reasonable measures to assure reliability of information relied upon its models, ensure its analysts are adequately trained and have appropriate knowledge and experience, ensure the credit rating decision process is independent and objective, ensure the clients' information is safely kept.

# Reform Development – Hong Kong

- Since 1 June 2011, all CRAs operating in Hong Kong have to registered with Hong Kong Securities and Futures Commission (“SFC”).
- As of 31 December 2013, there were 7 registered CRAs: *A.M. Best, China Chengxin, CTRISKS, Fitch, Moody’s, Pengyuan, Standard & Poor’s*.
- SFC follows the regulatory practice of ESMA and the IOSCO’s Code of Conduct for CRA, credit ratings issued by the registered CRAs in Europe and Hong Kong are in principle mutually recognized by the two regulators.

(SFC’s Code of Conduct for CRA can be found by click open the following link:

[http://www.sfc.hk/web/EN/pdf/sfcRegulatoryHandbook/EN\\_H636.pdf](http://www.sfc.hk/web/EN/pdf/sfcRegulatoryHandbook/EN_H636.pdf) )

# Reform Development - China

- There are over 70 CRAs in China operating in the domestic market, but only about 6 CRAs are nation-wide and recognized by People's Bank of China ("PBOC"), China Securities Regulatory Commission ("CSRC"), China Insurance Regulatory Commission ("CIRC") and National Development & Reform Commission ("CDRC")
- The major CRAs in China are: *China Chengxin, Dagong, Golden Credit, Lianhe, Pengyuan, Shanghai Brilliance.*
- Since 2006, China Chengxin joint ventured with Moody's and Lianhe joint ventured with Fitch.
- In 2010, an CRA called *China Credit Rating Co.* was formed by the members of National Association of Financial Market Institutional Investors ("NAFMII") through NAFMII, adopting the "investor-pay" business model. It issues ratings to securities traded in the inter-bank market.

# Small CRAs Joint-venture to Enter the International Market

- *Universal Credit Rating Group* – formed by *Dagong* of China, *Eagan Jones* of USA, *RusRating* of Russia.
- Joint venture CRA (to be named) announced to be formed by *CPR of Portugal*, *CARE Rating of India*, *GCR of South Africa*, *MARC of Malaysia*, *SR Rating of Brasil*.
- They bear the aim of breaking the oligopoly by the “Big Three”.



# Conclusion

- The aftermath of the 2008 Financial Tsunami led to the reform of the credit rating industry by the regulators.
- After their registrations, the “Big Three” CRA have reviewed their business practices and complied with the new regulations and strictly observe the CRA code of conduct.
- Unifications of some small CRAs from the emergent economies find that there is the opportunity for small CRAs to capture some portion of the market share from the “Big Three”. However, it is a long march to destination.