Giulia Rognoni

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A Look into Conflicts of Interest

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INTRODUCTION

The recent credit crisis has shoved credit rating agencies into the spotlight, especially regarding the ratings of new and "exotic" structured finance products. Hearings and meetings have been held by institutional entities to discuss about this problem and various initiatives have been undertaken in order to restore confidence in the rating agencies. Interestingly, numerous discussions have revolved around the conflict of interest inherent in the rating agencies' business model and the possibility they have to exploit it.

Many scholars[1], as well as rating agencies themselves, argue that these agencies have no incentive to exploit conflicts of interest since their reputation for providing good quality information about securities is the source of their wealth. However, nowadays, the informational value of credit ratings seems to have plunged since they have been incorporated into regulations and contracts, creating a demand for ratings that is not directly tied to their quality.

The scope of this research is to study whether reputable and well-established credit rating agencies can build up a margin, or a "quality scope", which allows them to remain unaffected by a lowered quality of the service provided and to indulge in exploiting the conflict of interest by giving their customers, i.e. the issuers, unduly high ratings. This study will also suggest a rationalisation of the latest amendments and amendment proposals to the existing legislation governing credit rating agencies aimed at improving oversight and regulation of these agencies. Finally, the traditional freedom of speech defence, granted by the First Amendment, will also be examined so to determine whether the stricter approach recently adopted

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[1] Among others: Husisian G. (1990). What Standard of Care Should Govern the World's Shortest Editorials? An Analysis of Bond Rating Agency Liability. *Cornwell Law Review, 75:* 411.
Choi S. (1998). Market Lessons for Gatekeepers. *Northwestern University Law Review, 92:* 916.
Fisch, J. (2004). Rating the Raters: Reflections on Proposals for Regulatory Reform of the Rating Agencies. *UC David Business Law Journal, 5(3).*
Hill, C.A. (2004). Regulating the Rating Agencies. *Washington University Law Quarterly, 82:* 43.
Dittrich, F. (2007). The Credit Rating Industry: Competition and Regulation. Working Paper. University of Cologne, Department of Economics. Hereinafter "Dittrich (2007), The Credit Rating Industry"

by Courts could effectively improve the conduct of rating agencies.

Part I of this research will describe the role credit rating agencies have played in the recent financial crisis. In particular, some examples will clearly show that an atmosphere of laxity has permeated these agencies, which seem to have given in to issuers' request for lavish ratings.

Part II will illustrate the functioning of credit rating agencies, their business model and the main theories dealing with the problem of (potential) conflicts of interest: the reputational capital view and the regulatory licence view.

Part III presents instead an economic model that supports the reputational capital view and thus the idea that rating agencies have no incentive to exploit conflicts of interest. This conclusion will be reverted by redefining and adding some variables so to take into consideration the regulatory function of credit rating agencies.

Finally, part IV illustrates the latest reforms and proposals to change the legislation governing credit rating agencies. The last paragraphs will be devoted to those reforms that aim at promoting rating agencies' accountability and, in particular, to a new interpretation of the US Constitution First Amendment, which has traditionally granted rating agencies the freedom of speech right.

Part I

THE ROLE OF CREDIT RATING AGENCIES IN THE RECENT FINANCIAL CRISIS

Credit rating agencies provide evaluations of the likelihood that obligations will be repaid. These evaluations, the ratings, are typically requested and paid for by the issuer or originator of the financial instrument in question and are made available to the public for free. With respect to the present economic crisis, it appears that the major rating agencies have not just failed to give an early warning to investors, but they have also played a role in the most extensive and expensive financial calamity of the last decades. It is a fact that, while there are other players in this crisis, none of them has held a special responsibility as being a gatekeeper or to serve as a defence to prevent the crisis from being systemic and going global as rating agencies were supposed to do.

The crisis has also shed some light on the relationship between credit rating agencies and structured finance products, which represent one of the most relevant developments in finance in the past twenty-five years. The problem lies in the fact that securitised products have become more complicated over time and now the rating agencies have been blamed for the poor assessment of the default risk of these products.

In October 2008, in front of the Committee on Oversight and Government Reform have been held four hearings on the financial crisis, the third of which has been devoted to role of credit rating agencies. As Sean J. Egan, Managing Director of Egan-Jones Rating Co., declared, "a string of structured finance securities all have failed or nearly failed to a great extent because of inaccurate, unsound ratings"[2]. As it appears from this hearing, the major rating agencies have badly missed the impact on sub prime mortgages of declining house prices and deteriorating

[2] Testimony of Sean J. Egan before the U.S. House of Representatives Committee on Government Oversight and Reform (22 October 2008). Committee Holds Hearing on the credit Rating Agencies and the Financial Crisis. Hereinafter "22 October 2008, Testimony of Sean J. Egan"

underwriting standards. Sub prime residential mortgage backed securities (RMBS) with initially high ratings found their way into nearly every corner of the financial system, including collateralised debt obligations (CDOs), structured investment vehicles (SIVs), insurers and banks. Many of these institutions and vehicles bought sub prime-related securities, allocated capital and extended credit because of the trust they had in the strength of assessment of the major rating agencies.

As financial markets have grown more complex, rating agencies have entered into the exotic business of rating securities backed by pools of residential mortgages and, by doing so, their role has grown in importance. New financial inventions, such as securities and CDOs backed by risky sub prime loans, have started to flood the market and the job of the rating agencies consisted of turning risky mortgages into investments suitable for investors who, in turn, would know nothing about the underlying loans, neither who owns the property nor what is his or her income. Once hundreds of mortgages were bundled into a single security, no investor had access to information regarding the underlying assets, but, since the security had a rating, the investor could forget about the mortgages. Thanks to this new mechanism, no longer did mortgage banks had to wait decades to get their money back from homeowners as they sold their loans into securitised pools and wrote new loans at a much quicker pace. Moreover, the mortgage volume surged, topping $2.5 trillion in 2006 and, at the same time, many more mortgages were issued to risky sub prime borrowers and almost all of those sub prime loans ended up in securitised pools, whose investors relied on a credit rating. Thus the agencies became the *de facto* watchdog over the mortgage industry as they set the credit standards that determined which loans could be repackaged and, ultimately, which borrowers would qualify.

1.1. The Securitisation Process: Towards the Crisis

To appreciate the role the rating agencies have played in the crisis and in particular in the residential mortgage market, it is necessary to understand the securitisation process. An RMBS consists of a pool of individual mortgage loans and, depending on the type of mortgage product underlying a given security, the pool could consist of 1,000 to 25,000 loans. Rating agencies do not have access to the individual loan files and they hardly communicate with the borrowers or try to verify the information they provided in their loan applications.

It should be emphasised that not only investors were having problems understanding these new, very complex instruments, but also that the analysts of rating agencies were not given enough information so to make an accurate assessment of their credit risk. In the years preceding the financial crisis, the situation in the structured finance segment seems to have gone out of control. In this respect, the National Community Reinvestment Coalition (NCRC), an association of community-based organisations that promotes access to basic banking services, has filed a letter of complaint to the Securities and Exchange Commission (SEC) stating that "[Fitch, Moody's and Standard & Poor's] should have had access to loan files, underwriting standards and loan product information so that they could each conduct their own due diligence for fraud and/or poor underwriting. All three NRSROs acknowledged they did not review this information"[3].

There are many instances mentioned in front of the Committee on Oversight and Government Reform during the hearing on the role of credit rating agencies that appear to be particularly interesting. These anecdotes help get a feeling of the lack of control over the rating process as well as of the gap between the job the analysts were supposed to be doing and what they were actually doing.

The first case in point is an exchange of e-mails that took place in March 2001 between Frank L. Raiter, who was, in those days, the Managing Director and Head

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[3] National Community Reinvestment Coalition (8 April 2008). NCRC complaint to SEC against Fitch, Moody's and Standard and Poor's calls for investigation of rating agencies. Hereinafter "8 April 2008, NCRC complaint"

of Residential Mortgage Backed Securities Ratings at Standard & Poor's, and Richard Gugliada, the Standard & Poor's executive in charge of those ratings. In an e-mail, Mr Raiter asked for collateral tapes, i.e. information on the loans that were in the pool he was analysing so to assess the value of the underlying mortgages. If this seems a very sensible request, the answer he received appears to be less reasonable. In his reply Mr Gugliada wrote: "Any request for loan level tapes is TOTALLY UNREASONABLE!!! Most investors don't have it and can't provide it. Nevertheless we MUST produce a credit estimate"[4]. The second, equally revealing, event is an exchange of instant messages between two Standard & Poor's officials of the Structured Finance Division in New York City that took place on the afternoon of 5th April 2007:

"[…]

Official one: By the way, that deal is ridiculous.

Official two: I know, right, model definitely does not capture half the risk.

Official one: We should not be rating it.

Official two: We rate every deal. It could be structured by cows, and we would rate it.

[…]"[5]

These two episodes clearly show that analysts were asked to give a rating in spite of the fact that they did not have the back up material and, consequently, that they were not in a position to give a sound credit rating. There appears to be a breakdown between the people that were trying to maximise the profits and the people, the analysts, that were trying to do their job properly, unfortunately it seems that those with profit motives won. In fact, this situation can only be explained if we think that the rating agencies are paid by issuers and act to their advantage, but it seems unreasonable if we believe that these companies have the investors' best interests at heart.

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[4] E-mail from Richard Gugliada to Frank Raiter (20 March 2001, 12:12 PM). PINSTRIPE CDO: RMBS Credit estimates Request follow-up. Emphasis in the original

[5] Instant message exchange between two unidentified Standard & Poor's officials on the topic of a mortgage-backed security deal (5 April 2007)

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Moving on, the rating process could be split in two distinct operations, namely the credit rating analysis of individual mortgages and the review of the documents governing the servicing of the loans and the payments to investors of securities. The first process, which can be considered as the assignment of the rating, serves the purpose of determining the expected default probabilities on each loan and the loss that would occur in the event of a default. These probabilities will then establish the expected loss for the whole pool and determine the amount of triple-A bonds that can be issued against the pool. The loss estimate determines the equity needed to support the bond and that it is intended to protect the triple-A bonds from experiencing any losses. Afterwards, the credit rating agency assigns an analyst to evaluate the package, subject to review by a committee.

It should be noted that rating's analysts not only had to work with a substantial lack of information, as described above, but they also had not much time to produce a rating. An example of this situation could be found in an article appeared on the New York Times of 26th April 2007. The author writes: "In the frenetic, deal-happy climate of 2006, the Moody's analyst had only a single day to process the credit data [of a security that comprised] 2,393 mortgages with a total face value of $430 million"[6]. It is clear that there is no way that one could do an effective job of rating a portfolio that large in just one day. What the analysts were really evaluating were the bonds issued by a special purpose vehicle (SPV) created to buy and stock the mortgages. At this point, the rating agencies just wanted to make sure that the inflow of mortgage payments could cover the outgoing payments to bondholders. For their part, investment banks just needed a triple-A rating, without which the deal would not have been profitable. The creation of such highly rated securities was made possible by the fact that the SPV would issue different classes of bonds. The highest-rated bonds would have priority on the cash received from mortgage holders until they were fully paid, then the next tier of bonds, then the next and so on. The bonds at the bottom would pay the highest interest rate, but if homeowners defaulted, they would also absorb the first losses.

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[6] Lowenstein, R. (27 April 2008). Triple-A failure. *New York Times Magazine*. Hereinafter "27 April 2008, Triple-A failure"

Mortgage-backed securities were not the end of this business. They were, in fact, building blocks for even more exotic vehicles known as CDO's, which were financed with similar bonds and the credit-rating agencies' role was just as central. The difference is that RMBS are first-order derivatives, as their assets include real mortgages owned by actual homeowners, while CDO's buy bonds that are backed by mortgages and thus miscalculations that are damaging at the level of RMBS become devastating at the CDO's level. A related problem lies in the fact that credit rating agencies were using statistical models to assess CDO's, relying on historical patterns of default. This assumes that the past would remain relevant in an era in which the mortgage industry was turning into a wildly speculative business. As Stephen W. Joynt, President and Chief Executive Officer of Fitch, declared: "We did not foresee the magnitude or the velocity or the decline in the US housing market nor the dramatic shift in borrower behavior brought on by changing practices in the market, nor did we appreciate the extent of shoddy mortgage origination practices and fraud in the 2005 and 2007 period. These dynamics were magnified in the CDO market [...] As we have learned, building complex highly tranched securities on historical default probabilities does not always provide enough cushion for extraordinarily variable performance"[7].

In this chaotic context, a triple-A rating became the stamp for approval that the investment was safe. Investors might have not been able to fully understand the securitisation process, but they did know what a triple-A meant and market participants have heavily relied on the rating agencies for, at least, three reasons. First, sub prime RMBS and their by-products offer little transparency around the composition and characteristics of the underlying loan collateral. Detailed loan-by-loan data are not available to potential investors that, therefore, cannot base their investment decisions on information that would allow them to clearly understand the quality of the loan pool. Second, the complexity of the securitisation process requires extremely sophisticated systems and technical competence to properly

[7] Testimony of Stephen W. Joynt before the U.S. House of Representatives Committee on Government Oversight and Reform (22 October 2008). Committee Holds Hearing on the credit Rating Agencies and the Financial Crisis

assess the risk at the tranche level. Finally, rating agencies had a reputation, earned over nearly a century, of being honest arbiters of risk.

1.2. Consequences of the Crisis on Structured Finance Products

Evidence of falling home values began to emerge in late 2006. Yet, there was no appreciable change in rating standards reflecting this reality. Market reactions forced a halt to new securitisation in the summer of 2007 and the first downgrades of sub prime linked securities occurred in June 2007. Events have come to a head in 2008 and are mirrored in the default studies of structured finance products published by the rating agencies. A striking evidence of the situation can be found in the analysis of the activity of triple-A structured finance products.
Looking at the data provided by Fitch[8] it is easy to see that the impairment rate[9] across its global structured finance ratings reached the 16.8 per cent in 2008, substantially higher than the 2.6 per cent rate of 2007. In particular, the impairment rate of AAA global structured finance products reached the 0.97 per cent and the 7.62 per cent of these products have been downgraded to non-investment grade (BB or lower). These results are even more impressive when compared with the 1991-2008 average annual rate of impairment and of downgrades to non-investment grade, respectively of 0.16 per cent and 1.28 per cent. The RMBS sector, under heavy stress in 2008, has registered an impairment rate of 1.40 per cent across its AAA products and the 9.76 per cent of AAA RMBS have been downgraded to speculative grade. The annual average in these two categories in the years 1991-2008 has been respectively of 0.17 per cent and 1.24 per cent. Finally, the CDO sector continued to experience elevated levels of negative rating performance in 2008. At the investment-grade level, 13.96 per cent of tranches rated AAA were downgraded to non-investment grade and the impairment rate soared to the 1.33 per cent, where the corresponding 1991-2008 annual averages were 3.74 per cent and 0.38 per cent.

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[8] It has been decided to use Fitch's data because they are more easily available compared to those of the other main rating agencies.
Fitch Ratings (17 March 2009). Fitch Ratings Global Structured Finance 2008 Transition and Default Study. Credit Market Research

[9] For the 2008 Transition and Default Study, Fitch expanded its definition of default in structured finance to include bonds in payment default (the traditional definition of default) and distressed bonds downgraded to CC or C, where the risk of default is highly certain. Using this new definition, Fitch calculated the impairment rate of its structured finance products.

As regards the lagged response of rating agencies, we might well ask ourselves why did it take so long for them to recognise the problem. A report of the President's Working Group on Financial Markets held that "credit rating agencies contributed significantly to the recent turmoil by underestimating the credit risk of sub prime RMBS and other structured products"[10]. Moreover, the NCRC stated that "the rating agencies knowingly issued false and inflated ratings backed by the problematic high-cost loans that have created a financial nightmare for millions of families across the country whose homes have been lost to foreclosure or are now in jeopardy of foreclosure..."[11] Because rating agencies are paid by the same companies that issue the bonds that they rate, these agencies suffer from "an inherent conflict that created one of the worst financial crisis this country has ever faced"[12].

[10] President's Working Group on Financial Markets (March 2008). Policy Statement on Financial Market developments

[11] 8 April 2008, NCRC complaint

[12] 8 April 2008, NCRC complaint

1.3. Conflicts of Interest Emerge During the Crisis

Different exponents of the world of finance have found that the problem of conflicts of interest might play a relevant role in the business of rating agencies. Arthur Levitt, the former chairman of the Securities and Exchange Commission, maintained that "credit-rating agencies suffer from a conflict of interest, perceived and apparent, that may have distorted their judgment, especially when it came to complex structured financial products."[13] Frank Partnoy, George E. Barrett Professor of Law and Finance and Director of the Center on Corporate and Securities Law at the University of San Diego, has written extensively about the credit-rating industry, affirming that this conflict is a serious problem.

Jerome S. Fons, who has been Moody's Managing Director, Credit Policy, until August 2007, suggests that a large part of the blame can be placed on the intrinsic conflict of interest found in the issuer-pays business model. As a matter of fact, until the 1970s, rating agencies, well aware of the conflicts posed by this business model, did not accept payments from rated bond issuers and by doing so, they built up their reputation for independence. In particular, Moody's often refused to meet with the rated entities and it was said to be very difficult to deal with the company. Then, beginning in the mid-1990s, management undertook a concerted effort to make the firm more issuer-friendly, since issuers largely paid for the bills. In this way, the focus of the company shifted from protecting the investors to being a market-driven organisation, while stock options and other incentives started to raise the possibility of large payoffs.

Another side of the problem of conflicting interests has been underlined, among others, by Mr Egan, who stated that "issuers paid huge amounts to these rating companies for not just significant rating fees but, in many cases, very significant consulting fees for advising the issuers on how to structure the bonds to achieve maximum triple-A ratings. This egregious conflict of interests may be the single greatest cause of the present global economic crisis"[14].

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[13] Arthur Levitt in 27 April 2008, Triple-A failure

[14] 22 October 2008, Testimony of Sean J. Egan

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