

# Banking & Financial Services

## POLICY REPORT

### Incentivizing Credit Rating Agencies under the Issuer Pay Model Through a Mandatory Compensation Competition<sup>1</sup>

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Credit rating agencies assign credit ratings to bond issues and issuers. Most public bonds carry a credit rating. Credit ratings impact the price at which bonds are issued in their primary market and traded in secondary markets, and the assessment of risk in the portfolios of investors. These factors are directly linked to the regulation of bond investors such as banks, broker-dealers, insurers, investment funds, and other financial institutions.

Although rating agencies are some of the most important institutions of the global capital markets, they have long been criticized for poor performance. Most recently, they failed to rate accurately structured finance instruments during the years leading up to the financial crisis of 2008–2009. The systematic overrating of complex structured finance securities inflated valuations and investor demand, reduced the perception of risk, and permitted wholesale investments in

de facto junk bonds by regulated financial institutions. The financial crisis would not have occurred had rating agencies performed properly.<sup>2</sup> Rating agencies are important monitors of the global financial industry.

Reform of the industry is one of the most important unresolved agendas of post-financial crisis market regulation. Congress, the Securities and Exchange Commission (SEC), the securities industry, and scholars are actively scrutinizing the problem. Proposals include promoting more competition among rating agencies, imposing greater civil liability, changing rating agency compensation structures from issuer-pay to user-pay models, and substituting credit ratings with market metrics. For reasons explained in earlier articles, these reform proposals are problematic and are most likely infeasible.<sup>3</sup>

The key problem in the industry is compensation and incentives, which is recognized in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The statute requires studies of “alternative means for compensating nationally recognized statistical rating organizations that would create incentives for accurate credit ratings.”<sup>4</sup> In singling out compensation for study, Congress correctly recognized the link among compensation, incentive, and quality of credit ratings. But there has been no feasible reform

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proposal. Fixing the problem requires positively linking compensation and incentive.

A solution does not require a fundamental reconfiguration of the industry or regulation. The status quo of the much-maligned industrial organization can be maintained as a baseline reality. Rating agencies can still play vital roles in the regulation of financial institutions and investment portfolios. A solution can still continue the existence of a highly concentrated market and accept the much-criticized issuer-pay model. From the perspective of regulatory feasibility, the simplest path forward requires the least amount of structural change to large, complex institutions and capital markets. This contrarian approach counterintuitively leads to the most effective reform.

The basic problem is this: industry concentration coupled with the issuer-pay model reduces the incentive to compete and perform. Because incentive is the condition necessary to induce competition, the problem can be fixed by implementing a structured compensation scheme overlaid onto the issuer-pay model. The simplest solution is to establish a mandatory pay-for-performance compensation scheme in which a fixed percentage of accrued revenue is ceded to fund a performance bonus. At periodic intervals, the regulator should award the bonus to the best performing rating agency for the period on a winner-take-all basis. Proper incentive is achieved through mandatory participation in a compensation competition. This idea of pay-for-performance requires minimal regulatory intrusion into the industry. The proposal benefits from simplicity, administrability, and economic feasibility. It can fundamentally reform the industry with minimal disruption, even though the rating agencies themselves may not warm to the idea of competing harder and risking accrued revenue.

### **Poor Performance and Its Causes**

Systemic poor performance of rating agencies poses deep problems of public policy and economics. Rating agencies played key roles in creating the bubbly condition leading to the financial crisis of 2008–2009. There is a consensus narrative. Rating agencies systematically overrated highly speculative structured finance securities, backed by residential mortgages. The results were catastrophic. By 2010, more than 90 percent of the subprime mortgage-backed securities issued between

2006 and 2007 with triple-A ratings had been downgraded to junk bonds by Moody's and S&P.<sup>5</sup> In 2006, Moody's assigned triple-A ratings on 30 mortgage-related securities per day, and 83 percent of these securities were ultimately downgraded.<sup>6</sup> Rating agencies engaged in egregiously lax and irresponsible business practices, and systematically failed to do proper due diligence. If rating agencies had rated these securities as junk bonds, the financial crisis would not have occurred. Investor demand would have collapsed due to regulatory restrictions on investments, and the securitization pipeline fueling the housing bubble would have been broken.

The problems of the credit rating industry have many causes. Commentators have identified the following major factors, which have been generally accepted as a model of the problem.

- *Conflict of Interest.* Rating agencies are said to have an inherent conflict of interest arising from the issuer-pay fee structure.<sup>7</sup> The issuer pays the fee for the credit rating service, rather than the bond investor or a subscriber to rating information. Issuers and investment bankers can “shop” for ratings, and this competition for business can compromise the objectivity of rating agencies.<sup>8</sup>
- *Lack of Competition.* Rating agencies do not compete so much as coexist in a profitable market.<sup>9</sup> The market is heavily concentrated with Moody's and S&P dominating the market as a duopoly plus Fitch as a major player. This “duopoly plus” state reduces competitiveness. Competition is further muted by the industry custom of obtaining multiple ratings from two or more rating agencies. Most new bond issues carry multiple ratings.<sup>10</sup>
- *Ineffectiveness of Reputation Capital.* Reputation capital may ensure a certain level of quality, but it does not incentivize performance well when there is not a competitive market. Only the three duopoly plus firms are large enough to meet the aggregate demand of the bond market. The profitability of the major rating agencies is primarily a function of market environment and investors' appetite for fixed-income securities, which dictate the demand for rating services.
- *Regulatory Barriers.* Regulatory barriers protect rating agencies from competitors. Fearing fly-by-night rating agencies, the SEC has parsimoniously

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granted regulatory status. At the same time, financial regulators require institutional investors and broker-dealers to obtain credit ratings for debt securities in their investment portfolios. This regulatory requirement is difficult to substitute, making credit ratings necessary to the architecture of investment regulation. These regulatory barriers have frozen out new competitors, stifled competition among rating agencies, and diminished the importance of reputation capital.

- *Natural Barriers.* Large rating agencies provide broad coverage of an enormous credit market, and systematize credit information. This information platform is important to investors and regulators. There is a positive network effect to size and scale, that is, the benefit of having the broad spectrum of bonds and issuers in the very large credit market be rated under presumably a common methodology. Newer and smaller rating agencies lack this broad capability.
- *Complexity of Modern Finance.* For much of their history, rating agencies analyzed plain vanilla corporate bonds. Structured finance securities such as mortgage-backed securities and collateralized debt obligations are much more complicated in structure and valuation. Credit analysis has become more difficult as financial markets, and securities instruments have become more complex.
- *Implicit Collusion with Investors.* A “sinister danger”<sup>11</sup> is that investors also implicitly wanted overrated securities during the credit rating bubble. Inflated credit ratings permitted regulated investors and portfolios to invest in risky securities that were expected to produce greater yields. They gave greater discretion to pursue profitable yields than regulation would have otherwise allowed.

This litany of causal factors shows that the industrial organization of the credit rating industry is uniquely problematic. Rating agencies are not optimally organized to provide the highest quality credit ratings, and the problem has been difficult to solve. A major problem has been the inadequate link between compensation and proper incentive. The effectiveness of a reputation market as a bond on performance is questionable at best. The lack of robust competition and proper bonding of performance will continue to undermine the quality of credit ratings even as rating agencies continue to play an important role in an increasingly complex capital market.

## Compensation Competition as the Solution

In regulating the credit rating industry, the goal of regulation should be to create the *necessary conditions* to stimulate robust competition where currently the market does not work well due to cozy cooperative relationships among nominal competitors. Proper incentive is the condition precedent to robust, positive competition. The basic problem is not the lack of strong competition *per se*. Competition can be good or bad. A competitive race to the bottom in a frenzy for business engagements would be a bad thing. Strong competition is good only if it incentivizes a race to excel. Competition is not the end, but the means.

Any reform measure must solve the incentive problem. There is not a strong incentive to improve the quality of credit ratings when the market is concentrated among a few competitors whose business interests are well protected by regulatory licenses, natural barriers of entry, and the benefits of market share—a nicely profitable arrangement for rating agencies.

The inevitable outcome of a concentrated industry need not be poor quality ratings. The problem is that all three major firms consistently and concurrently win because the engagement of one is not done to the exclusion of the others and usually involves an engagement of the others as well. From a game theory perspective, the firms stand more in a cooperative posture with each other than in a competitive one because they are essentially partner monopolists. Regulatory reform must change the game from a win-win to a win-lose outcome to impart the proper incentive.

Mandating a pay-for-performance compensation scheme would foster vigorous competition among Moody’s, S&P, and Fitch. I assume that firms do not like to lose when forced to compete for profit. This assumption is empirically sound. A pay-for-performance scheme does not naturally arise due to the unique aspects of the industry. Easy profits and regulatory rents undermine competitiveness and suppress the incentive to excel. Reform must create the condition for competition through pay-for-performance incentives.

## The Proposal

My proposal assumes that the industrial structure and practices remain the same. It does not depend on

eliminating the issuer-pay model. The amount of fees, payment forms, and other transactional considerations remain private matters. But rating agencies should be made to bond their performance. To accomplish this, we do not need a heavy-handed regulatory intrusion, only a marginal adjustment to the issuer-pay model. The pay-for-performance scheme entails the creation of a mandatory performance bonus. It is a hybrid public-private compensation scheme. For the portion of the revenue not ceded, the compensation scheme would be determined by private actors, but the ceded revenue would constitute a publicly administered compensation plan.

To start, we limit participation to Moody's, S&P, and Fitch. The three rating agencies would submit a small portion of their revenue to fund a bonus pool of deferred compensation, an incentive bonus. For illustrative purposes, let's assume a bonus pool based on 5 percent of accrued revenue. At regular intervals, the performance of each agency would be statistically evaluated by an independent agency based upon regulatory disclosure requirements that for the most part are already in place.<sup>12</sup> Regulatory oversight would be limited to independent confirmation of performance. Upon evaluation, the best performer is identified and the incentive bonus would be awarded on a winner-take-all basis.

The contribution must be based on a fixed percentage of revenue, and not on a common flat contribution. A fixed contribution does not work because the amount has relative value to each firm, and thus incentives and financial effects are not symmetric. The contribution must be a fixed percentage of revenue, which would result in different contribution amounts by each firm. This rule creates a technical problem: how do we equitably and symmetrically allocate the bonus in light of the different contributions made?

The scheme should permit different levels of contribution in a three-way game, but always maintain a 1-to-1 payout ratio. There is a simple solution to the problem. The condition is met only when there are two concurrently played sub-games within the larger competition. The "main game" would involve a three-way competition with the bonus amount calculated as three times the contribution of the smallest player. The "side game" would involve a two-way competition with the bonus amount calculated as the contribution in excess

of the main-game allocation. Since the side game would be between the two larger players only, the ceded revenue is capped at the revenue contribution of the second largest player. In a multiplayer game, these rules maintain a 1-to-1 payout ratio as to all players, thus maintaining fairness and symmetry of economic stakes.

An example illustrates how the proposed rules work. Assume that 5 percent of revenue for *S*, *M*, and *F* are 120, 100, and 50. Because *S* is the largest player, it can only contribute 100, which is the contribution of the second largest player, *M*. The smallest player, *F*, contributes 50. The total bonus pool is 250. The allocation is based on the following rules: the winner in the main game among *S*, *M*, and *F* gets 150; the winner in the side game between *S* and *M* gets 100. If *S* or *M* wins outright against all competitors, it would win the main and side games and thus collect 250. If *F* wins the main game, it would get 150, but since *F* did not contribute to the side game it is precluded from this game. There would still be a side game between *S* and *M*, who have staked additional funds, for the 100.

We can apply these simple allocation rules to a compensation competition among Moody's, S&P, and Fitch. Suppose firms *S*, *M*, and *F* earn these revenues:  $S(s)$ ,  $M(m)$ , and  $F(f)$  where  $s > m > f$ . Since *S* earns the most revenue of the three players, it needs to contribute only  $m$ , the contribution of the second largest player. In each competition period, the payoffs and losses can be generalized as follows:

**Table 1: Model of Payouts**

		Players		
		<i>S</i> or <i>M</i>	<i>F</i>	
Payoff	Main	Win	$2m + f$	$3f$
		Loss (when <i>S</i> or <i>M</i> wins)	$-m$	$-f$
	Side	Net Win/Loss	$2m - 2f$	not applicable

There would always be a three-way "main game" in which *M*, *S*, and *F* compete for these stakes: (1) if *F* wins, three times its contribution; or (2) if *M* or *S* wins, the entire bonus pool. If *F* wins the main game, there would always be a "side game" between *M* and *S* for the

contributions they made into the bonus pool in excess of *F*'s bonus.

The side game can yield a net win or a net loss, depending on the size of *F*'s contribution relative to those of *M* and *S*. Losing the main game but winning the side game may result in a net gain if *F*'s contribution is much smaller. However, if the three competitors are similar sizes, winning the side game may result in a net loss.

For example, assume that the ceded revenues are  $S = 100$ ,  $M = 100$ ,  $F = 40$  (thus, the total bonus pool is 240), and that *F* wins the main game and *S* wins the side game. The results would be:

	<i>S</i>	<i>M</i>	<i>F</i>
Awards	120	0	120
Ceded revenue	-100	-100	-40
Net gain / loss	+20	-100	+80

Since the side-game allocation between *S* and *M* is large enough to offset the loss of ceded revenue, *S* is a net winner even though it lost the main game.

Now, assume that the ceded revenues are  $S = 100$ ,  $M = 100$ ,  $F = 80$  (thus, the total bonus pool is 280), and again *F* wins the main game and *S* wins the side game. The results would be:

	<i>S</i>	<i>M</i>	<i>F</i>
Awards	40	0	240
Ceded revenue	-100	-100	-80
Net gain / loss	-60	-100	+160

Here, even after winning the side game, *S* is a net loser because *F* has won most of the bonus pool by winning the main game. Thus, the side game is meaningful to the two losers of the main game, and the winner can either net a gain or mitigate a loss, depending on the smaller competitor's contribution of ceded revenue.

Under the above rules, all three rating agencies will always have "skin in the game." The game is perfect from the perspective of symmetric incentives and equities among players of disparate wealth contributions. Importantly, the competition is zero sum and the "awards" are self-funded.

### Financial Effects

The creation of a bonus pool raises an important question: What is the financial effect of the proposal? The financial analysis goes to the issue of economic and business feasibility, which in turn is relevant to legal feasibility as well. In the above discussion, I use an illustrative bonus amount of 5 percent. The financial effects of this compensation competition will not materially affect the companies' operations.

If either Moody's or S&P were to continually lose the competition to the other such that it would incur a perpetual loss of 5 percent of ceded revenue, there would be a loss of equity value reflecting lost profitability. In a robust competition, however, no firm will always win or lose. The actual range of potential valuation effects will be marginal.

It is unlikely that we would see a substantial net loss in value for two reasons. First, the 5 percent is always ceded, which means that the mandatory contribution reduces revenue but does not add variance to a firm's financial results. The ceded revenue is a fixed obligation like overhead expense. Second, exposure to risk from the competition can be reduced to zero through perfect hedging. A shareholder needs to buy one share each in the three firms of the duopoly plus to fully invest in the credit rating sector. This investment strategy perfectly diversifies the unique risk of each firm with respect to the bonus. In other words, a diversified investor would assume no greater volatility of earnings or cash flow due to the zero-sum nature of the compensation game. Thus, there is no significant loss of value from the proposal.

The next question is whether the 5 percent figure is feasible as a business proposition. The answer is clearly "yes." A review of the financial performances of Moody's and S&P shows that there is substantial room to impose a mandatory contribution. Table 4 shows the 2012 revenue, operating profit, and operating margin of Moody's, S&P, Goldman Sachs, Accenture,

Lazard, and FTI Consulting. These firms operate in different industry sectors, but they provide significant professional advisory services. Goldman Sachs is a leading investment bank, and Accenture, Lazard, and FTI are leading advisory businesses. Table 4 provides financial data on these companies as compared to Moody's and S&P.

**Table 4: Comparison of Financial Data**

FY2012 (\$ million)	Revenue	Operating Profit	Margin
Moody's	1,958	947	48.4%
S&P	2,034	849	41.7%
Goldman Sachs	34,163	11,207	32.80%
Accenture	29,778	3,872	13.0%
Lazard	1,912	124	6.5%
FTI Consulting	1,577	169	10.7%

Moody's and S&P have high operating profit margins compared to other leading firms shown in Table 4. Keep in mind that the above firms are different businesses, but the different levels of financial performance are stark. A ceding rate of 5 percent would have significant impact on any business (of course), but the important takeaway is that, on the whole, the rating agencies would not be financially threatened in any way. If the operating profits of advisory services are the benchmark (7 percent to 13 percent), the rating agencies could cede as much as 25 percent of revenue and still be within the range of financial feasibility. The proposed competition would have a small impact on margins and financial operations, but as the analysis also shows, the rating agencies would have substantial economic incentive to win the game because 5 percent ceded revenue is still a lot of money at stake.

### Implementation Issues and Objections Coordination and Collusion

In light of the duopoly plus industry structure, one concern may be whether rating agencies would implicitly coordinate or collude. The three rating agencies may be tempted to take a "one for you, one for me" collusive approach to the bonus payment. Forced competition requires greater effort and quite probably greater investments that reduce profit. In a zero-sum game, the desire to maintain the status quo and signal détente would be great. This is not a serious concern.

At the firm level, tacit coordination may appear possible due to the limited number of competitors, but as a practical matter such a feat would be difficult to execute. The situation here is not akin to price fixing in which only a few decisions by a few actors would be needed to coordinate with other firms. In a rating agency, such centralized decisionmaking does not exist. Each rating agency has more than a thousand credit analysts and supervisors, and each rating requires a credit committee of various compositions of analysts, all of whom would presumably be exercising independent judgments on many thousands of bond issues and monitoring of outstanding issues. Coordinating collusion cannot occur absent an explicitly illegal, broadly disseminated (thus easily discoverable) edict from the executive suite or the boardroom.

Even if there is an illicit conspiracy to undermine the competition from the top, such top-down coordination cannot work when there are thousands of decision points in each firm that must then be coordinated with those of several other firms. Coordinating performance and statistical outcomes, many of which are subject to uncertainty and market forces, would be practically infeasible. A misstep in any coordinated action would quickly unravel a coalition. A collusive agreement among three players would be highly unstable, and would likely devolve into active competition once the pattern of "one for you, one for me" is broken due to cheating, miscalculation, or some exogenous factor leading to unintended or unexpected outcomes.

### Standard for Performance Assessments

A pay-for-performance scheme requires performance standards. There are questions as to the metric to be measured, the method for measurement, and the timing of measurement and compensation. How does an agency determine "the winner"? I do not offer or advocate a specific assessment protocol. The purpose of this article is to present the conceptual framework for reform. However, I suggest that the problem of performance measurement is neither insurmountable nor paramount.

The assessment criteria must be based on accuracy and not on downward deviations of issues from ratings. The focus should not be on how many issues were over-rated since it would impose a bias toward underrated securities. The magnitude of the error should count but not directionality. Timeliness is also an important

consideration. It does the investor no good for a rating agency to downgrade the debt of a company on the eve of bankruptcy. Thus, directional correctness and timeliness are the two most important factors in formulating the assessment criteria.

The evaluating criteria must cover performance along all asset classes including difficult-to-rate structured finance instruments. This requirement would not open up the possibility of gaming by the rating agencies through calculated changes in the business mix. The mathematics of profitability precludes gaming the business mix because the ceded revenue is only a small portion of the fees earned. In concrete terms, a rating agency would be unlikely to give up 95 percent of a highly profitable business line to enhance its chances of winning the 5 percent bonus pool, particularly since complex instruments such as structured finance bonds generate significantly higher profit margins.

Competent experts would be required to propose a statistical method to measure the quality of performance. Such experts are numerous in the academy and the financial profession. The SEC could also solicit the three largest rating agencies as well as various constituents of the capital market, including bond investors, to provide proposed rules and comments on the question of assessment. The standard could be as simple as providing a universal standard of the probability of default per each rating, and an assessment could be made based on deviations from the defined standard as weighted by the number of issues and time. Much of the data analysis can be performed with the use of technology and algorithms.

Although the assessment should be primarily based on quantitative measures, the SEC could add qualitative factors toward a weighted scorecard of best performance. Such factors can include compliance with rules and regulations, independent assessments of governance, management of conflict of interest, and quality of internal controls, all of which were issues addressed in both the Credit Rating Agency Reform Act of 2006 and the Dodd–Frank Act and implemented in SEC rules.

Can data analysis reveal “the winner”? Yes, because there is an enormous volume of statistical data. Table 5 shows data on outstanding credit ratings reported by nationally recognized statistical rating organizations (NRSROs) to the SEC in 2011:<sup>13</sup>

**Table 5: Data on Outstanding Ratings as of 2011**

	S&P	Moody’s	Fitch	Other NRSROs	Total
Financial institutions	54,000	61,581	61,550	32,207	209,338
Insurance companies	8200	4540	1657	5391	19,788
Corporate issuers	44,500	30,285	13,385	11,116	99,286
Asset backed securities	117,900	101,546	64,535	18,480	302,461
Government issuers	965,900	841,235	363,897	14,694	2,185,726
Total	1,190,500	1,039,187	505,024	81,888	2,816,599

Because there are so many outstanding, maturing, and defaulting issues at any given time, there is an enormous volume of data from which we can cull reasonable inferences on performance. The industry custom of multiple ratings makes the statistical analysis easier. There is great overlap among the top three agencies. For instance, from 1976 to 2006, 62,496 new domestic issuances of non-convertible debt were rated, and of these 98.2 percent were multiple rated: 67.3 percent by two rating agencies and 30.8 percent by all three agencies.<sup>14</sup> As another example, in a representative sample of 2,514 corporate bonds outstanding at the end of March 1997, Moody’s had ratings on 92.5 percent and S&P 90.7 percent.<sup>15</sup> There would be no problem in gathering a dataset based on issues expiring and defaulting within defined periods of time from which periodic quality assessments could be performed.

The compensation competition is a repeat game, occurring at regular intervals. It could be based on only the bond or debt issues expiring or defaulting during that period. These issues would be examined against the performance of the issue, initial rating assigned, and changes in rating. Each rating agency would be evaluated on the performance of the entire portfolio of expired and defaulting issues against the objective performance standards set for each credit rating.

Perhaps the most serious criticism of the proposal is what may be called the perfectionist’s challenge: the argument that any statistical analysis, however sophisticated, would not be capable of determining the “true winner.” There would be too many technical difficulties, such as problems of data sampling, fluidity of credit ratings over

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time, different portfolios of covered bond issues, and numerous other factors that make identifying the best performer imperfect at best. If one were inclined to oppose the idea of a compensation competition, there would be many objections based on imperfections. A fair response to this criticism might be, “*le mieux est l’ennemi du bien*” (“the best is the enemy of the good”).<sup>16</sup> We should not let the lack of perfection get in the way of implementing something that is a net good.

Epistemological certainty is not needed to implement the policy objective. The standard for assessment should be reasonably fitted to the objective so that, like any performance bonus, the risk of arbitrariness is mitigated. Potential errors do not undermine the policy goal. If there is objective application of a rational standard, we expect that any “errors” would average out for each player. Since the compensation game is a classic repeat-play game, the mathematical expectation from an imperfect standard would be zero. In the long run, the risk of error is diversified away.

Errors are simply a part of the real world, including the legal process. One accepts that any standard of evaluation may be imperfect and thus subject to criticism. Virtually the entire panorama of human endeavors and observations is subject to imperfect evaluations and subjective probability assessments. Many types of evaluative processes are far less quantitatively driven than the proposal here and subject to the discretion of individual judgment: just to name a few, the typical performance evaluations of employees including those of CEOs, tenure reviews of academics, strategic considerations in business planning, medical evaluations, and judgments in civil trials. We seek reasonable outcomes based on objective application of a rational standard of evaluation.

“Who is the winner?” is the penultimate question. The ultimate inquiry is “Are the players incentivized?” From this perspective, a perfect assessment standard is not needed to serve this policy end. If a rational standard is applied objectively, the rating agencies subject to a performance evaluation will be incentivized to produce accurate credit ratings for the purpose of winning the competition. That there is some uncertainty in the process would produce more incentive to win by a clearer margin. Any potential for “errors” may actually benefit the desired end. Thus, the policy objective is served when the standard of evaluation is sufficiently connected

to the criterion of accuracy, though perfect accuracy is not needed.

### **Dodd–Frank’s Regulatory Foundation**

The proposal requires that a regulator collect the ceded revenue, assess performance, and award the bonus. Regulation must create an agency body to oversee the program, and must mandate rating agencies to collect and maintain data on performance. In this respect, the regulatory foundation necessary to implement the proposal has already been laid, which makes the implementation of the proposal easier and more feasible.

The Dodd–Frank Act mandates the regulatory framework necessary to collect, maintain, and report data on performance. The rating agencies must provide ratings based on a common system of ratings, including the designation of alphanumeric ratings and the criteria applicable to each rating. The rating agencies already use similar rating symbols. Section 938 of the Dodd–Frank Act, titled “Universal Ratings Symbols,” requires the SEC to implement rules and procedures that

- (1) [A]ssess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument;
- (2) [C]learly define and disclose the meaning of any symbol used by the [NRSRO] to denote a credit rating; and
- (3) [A]pply any symbol described in paragraph (2) in a manner that is consistent for all types of securities and money market instruments for which the symbol is used.<sup>17</sup>

There will be a universal standard against which the performance of rating agencies can be judged and assessed. The statute also imposes a regulatory reporting and disclosure structure, which has been partially implemented through SEC rules.<sup>18</sup> If additional rules are required to produce a set of statistical disclosures, this can be done through the auspices of the Dodd–Frank Act’s mandate.

With respect to an independent body or board that would evaluate performance and award the incentive bonus, the Dodd–Frank Act created a structure that



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could fill this role. Section 932 creates an Office of Credit Ratings within the SEC.<sup>19</sup> Its charge is “to promote accuracy in credit ratings issued by nationally recognized statistical rating organizations; and...to ensure that such ratings are not unduly influenced by conflicts of interest.”<sup>20</sup> The statute mandates that the staff should have knowledge and expertise in debt instruments, and that the Office of Credit Ratings should conduct annual examinations of NRSROs.<sup>21</sup> If additional expertise or input is needed, the Office of Credit Ratings could be composed of regulators, academics, and disinterested industry professionals who would be tasked with analyzing performance and making recommendations as to the award of a bonus, and could incorporate additional methods such as an industry survey of investors and other knowledgeable constituents.

The Dodd–Frank Act has enabled at least some of the process-based rules necessary to administer a pay-for-performance compensation scheme. Although not fixing the problem directly, it has enacted the regulatory precursors to fundamental reform based on greater positive competition and correctly aligned incentives to perform.

### **Political Reality of Regulation**

The economic and administrative feasibility of the proposal here is well within the realm of practical possibility. More than the potential for collusion or the difficulties of performance metric, the political reality of effective regulation is the chief impediment to reform of the credit rating industry. In any regulation affecting corporate and Wall Street interests, there is always the reality of political feasibility. Although no one denies that better quality credit ratings are clearly a public good, there would be significant political opposition to effective regulation. The idea of regulatory capture has long been recognized.

The three rating agencies would oppose any attempt to put any contingencies on accrued revenue, however small. They would want to keep their rents. The proposal here means that the leading rating agencies would have to work harder and incur more costs and investments in human capital to improve the quality of their products and services. The political voices of Moody’s, S&P, and Fitch would be significant.

Other powerful voices would speak against mandated competition. Investment banks and corporate issuers,

which yield greater political clout than the three rating agencies, would be opposed as well. Issuers like over-rated bond issues because they lower their costs of borrowing. The oft-cited conflict of interest arises from the implicit threat that issuers and their investment bankers might funnel rating business to more lenient rating agencies. Investment banks would have a business interest in maintaining the status quo of this leverage. Higher rated bonds are easier to manage in the issuance process, again making the jobs of investment bankers easier. Systemically higher credit ratings can increase the overall demand for bonds because they relax the regulatory restrictions on bond investments.

Lastly, as mentioned previously, the “dirty secret”<sup>22</sup> of the problem of credit ratings is that investors also benefit from overrated bonds. This is not to suggest that bond investors like being fooled into bad investments. There is a tradeoff for some bond investors: a freer hand in pursuing greater yields on investments at the price of less accurate credit ratings.

With all this said, the political picture is not so bleak. Even as some bond investors may have conflicting interests, many institutional investors actually rely on a credit rating system that provides broad coverage of the bond market. Many institutional bond investors desire a more accurate credit rating system. Long-term players in the bond market, such as insurance companies, rely on credit ratings. The bond market needs the credit rating system, and it is quite plausible that a sufficient subset of the bond investor community wants greater accuracy in credit ratings to offset some of the countervailing political pressures.

Credit rating agencies exist because they provide a quantum of value in intermediating information in the capital markets and serve a quasi-regulatory role. If the benefits of these functions were outweighed by the costs of a continuously compromised credit rating system, the future of rating agencies would be bleak. This is a possibility recognized by the rating agencies themselves. We must be aware that there is a powerful political coalition that has a significant economic interest in maintaining the status quo, inherent flaws and costs notwithstanding.

### **Conclusion**

Credit rating agencies suffer from a lack of competition and will to perform better than other agencies, which diminishes the quality of credit ratings. If

competition in fact does not exist, regulation should induce it. Large numbers of competitors are not needed to achieve robust, positive competition. Contrary to accepted wisdom, an industry of three firms can be competitive under the right conditions. The condition for competition is created when a portion of compensation is redirected from consideration for services rendered to pay for performance. A mandatory winner-take-all bonus scheme can augment the issuer-pay model. This modest, at-the-margin change can create the necessary conditions for robust, positive competition.

A compelling rationale supports a mandated, hybrid public–private compensation scheme. Credit ratings are more than just the opinions of a private actor; they are a public good. Rating agencies enjoy a regulatory license that necessitates their service and gives them market status, and the credit rating system exists in a capital market that creates significant network externalities. Rating agencies are private firms that report to shareholders, but they also serve as public gatekeepers. The main goal of regulation should be to change the incentives by altering the relationship among rating agencies. By mandating a self-funded bonus pool, each firm is forced to post a bond on good performance and a winner-take-all tournament is created. At least with respect to the bonus, rating agencies will not be oligopolists but instead will be competitors. A change in the relationship will change behavior.

Unlike other proposed reforms, this proposal does not require a fundamental transformation of the industrial organization and regulatory framework. It maintains the duopoly plus industry organization and the issuer-pay model. This contrarian perspective is the proposal's principal benefit. It is fair to say that as much as 95 percent of the status quo would be preserved.

The reform is economically feasible and administrable in a fair, coherent way. As with all reform of Wall Street, the greatest barrier to reform is the politics of regulation and the alignment of interests. In this regard, there would be a sufficient constituency of bond investors who would be interested in seeing an improvement in the quality of credit ratings as evinced by the passages of the Credit Rating Agency Reform Act of 2006 and the provisions relating to rating agencies in the Dodd–Frank Act. Although these statutes did not fundamentally change the credit rating industry, they laid the

foundation necessary to implement the reform proposal advanced in this article.

## Notes

1. This article is substantially derived from *On Duopoly and Compensation Games in the Credit Rating Industry*, 108 Nw. U. L. Rev. 85 (2013), and is a condensed version of the ideas set forth therein.
2. Fin. Crisis Inquiry Comm'n, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* xxv (2011).
3. Robert J. Rhee, "On Duopoly and Compensation Games in the Credit Rating Industry," 108 Nw. U. L. Rev. 85 (2013); Robert J. Rhee, "A Critique of Current Reform Proposals for the Credit Rating Industry (with a Comment on Future Reform)," 32 Bank. & Fin. Serv. Pol'y Rep. 14 (No. 3, March 2013).
4. Pub. L. No. 111-203, 124 Stat. 1376, 1872-1890, § 939F(b)(4).
5. Eric S. Pendergraft, "Section 933(b): Nimble Private Regulation of the Capital Market Gatekeepers," 39 Fla. St. U. L. Rev. 511, 515 (2012).
6. Financial Crisis Inquiry Report, *supra* n.1, at xxv.
7. See U.S. Sec. & Exch. Comm'n, *Annual Report on Nationally Recognized Statistical Rating Organizations* 16–17, 19 (2011).
8. Thomas J. Fitzpatrick, IV, and Chris Sagers, "Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations," 61 Admin. L. Rev. 557, 586 (2009).
9. John C. Coffee, Jr., "Ratings Reform: The Good, the Bad, and the Ugly," 1 Harv. Bus. L. Rev. 231, 231 (2011).
10. In a 1999 survey of issuers, 97.4 percent bought credit ratings from multiple rating agencies: "[a]bout three-quarters hire[d] two rating agencies and one-fifth hired three or more" rating agencies. Herwig M. Langohr & Patricia T. Langohr, *The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They Are Relevant*, 54–55 (2008).
11. See Coffee, *supra* n.8, at 259 ("[T]here is the even more sinister danger that many institutions (in particular, money market funds) wanted inflated ratings so that they could earn the higher returns from riskier securities. To hold such higher yielding securities, it was necessary for them to be able to rely on the stability of the rating and the unlikelihood of a post-issuance rating downgrade.").
12. See 17 C.F.R. § 240.17g-2 (2012) (providing for the maintenance of data and information on credit ratings and experience); *id.* § 240.17g-3 (providing for annual financial reports to SEC).
13. US Sec. & Exch. Comm'n, 2011 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization 6.
14. Langohr & Langohr, *supra* n.9, at 54.
15. *Id.*
16. M. De Voltaire, *La Bégueule, Conte Moral* A3 (Geneva 1772).
17. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 938, 124 Stat. 1375, 1885 (2010)

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18. 17 C.F.R. §§ 240.17g-2, 240.17g-3 (2012).
  19. Dodd–Frank Act § 932, 124 Stat. at 1872, 1877 (amending Section 15E of the Securities Exchange Act of 1934, now codified at 15 U.S.C. § 78o-7 (2006)).
  20. *Id.* at 1877.
  21. *Id.* Matters to be examined are whether the rating agencies conduct business in accordance with the established policies and methodologies, manage conflicts of interest, implement ethics policies, exercise internal supervisory controls, have appropriate corporate governance, and monitor the activities of credit analysts. *Id.*
  22. See Aaron Lucchetti, Kara Scannell & Craig Karmin, *SEC Aims to Rein In the Role of Ratings*, *Wall St. J.*, June 24, 2008, at C1 (“The dirty secret of some bond investors is that they simply bought securities with the highest yield for a given rating, which is why they snapped up complicated securities tied to subprime mortgages. Those securities often got high ratings but yielded more than other, more standard securities with the same rating.”)

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