CreditSights

Rating Agency Legislation: Great Boost for Competition

Date Published: 03 Oct 2006, 11:33

- In a surprisingly rapid process down the home stretch, the partisan vote of the House gave way to the rapid delivery and bipartisan approval of a Senate bill and then a quick ride to reconcile with the House and then to the White House and the President's signature.
- The near 5 years of the post-Enron ratings agency scrutiny comes to a close and now the hard part begins for the strategic and private equity players looking at the space and the wannabe boutiques.
- Strategic players, private equity, and analysts and product specialists of a more entrepreneurial bent can now get busy.

It was a contentious process over almost 5 years that started in earnest after Enron, but the reform of the credit rating agency industry finally got a great lift this past Friday when the President signed into law the Credit Rating Agency Reform Act of 2006. The legislation overcame intensive backroom lobbying, veiled threats by the incumbents of invoking constitutional challenges, a surprisingly (arguably ridiculously) partisan path taken in the House during the home stretch (short version: sponsored by a young, up-and-coming GOP Congressman from Pennsylvania and the ranking Democrat on the House committee was a Democrat from Pennsylvania, etc. etc. fill in the blanks), and more than a little turf sensitivities across Congress and the SEC to drive home the first real change in this critical sector since the 70's. Despite some 11th hour concessions to the incumbent duopoly and the next tier of current NRSRO players, the legislation makes some critical strides in the evolution of the credit ratings business.

The rating agencies even came out in support of the final version (that means the bus was leaving and they had to get on), but they managed to call in a few markers to add a few more speed bumps to the pace of market entry. There is still somewhat of a quiet effort to derail quantitative models even though they are approved under this bill, and it does not take much imagination to figure out which of the incumbent agencies has the biggest axe there. The irony is that as hard as the bill was to punch home, it was not overly ambitious in terms of what it was trying to do other than to promote competition. The fact that the two dominant strategic players will remain part of de facto duopoly for the intermediate term regardless of the bill is what made their bitter opposition all so absurd in the end. Over time they will face meaningful competition, but it will not be in this credit cycle. The market has to start somewhere, however, and 5 years and 10 years goes by very quickly in the securities business and the global credit markets are growing by leaps and bounds. That means opportunity and steady growth for those that look to enter, and which can now do so with a more rational regulatory path and set of timelines that the bill delivers.

The bill as crafted achieves a number of very reasonable goals, with some of the notable features as follows:

- **Embraces the basic principles of competition**- The legislation opens up a clear path of entry for qualified organizations that have an interest in pursuing business opportunities in the credit ratings business. They can build business plans without facing the uncertainty of being cast adrift in an indefinite SEC review process that has stalled past market entry for too many. Those in the ratings business to date (in some cases for many years) in the US and in the Euro and Asian markets will be able to more logically and rationally plan under this framework. The need to plan for purposes of committing resources is a fundamental business reality that the incumbents saw, and the established players hoped to keep the process inexact to dissuade capital from entering the space. They lost on that one. Hopefully the powers that be in Washington will keep an eye on the incumbents for any anticompetitive behavior as new players look to fast-track this process and will watch the backroom lobbying to undermine future applicants. Competition will be a reality, however, one way or the other. The real impact may be 5 years away or more, but it beats the much longer and uncertain time frame the entrenched interests were pushing for. **Entrants now need to choose between the issuer model, the subscriber model, or hybrid versions of the two**. They need to garner human resources, financial resources, intellectual capital, and get busy.

- **Allows entrants to establish timelines for capital commitment**- The process (at least in theory) will allow for a more predictable timeline to entry for new start-ups (3 years in business), a less cumbersome process for small and mid-size operators to plan expansion of their product and business lines, and most importantly for real competition the bill gives large strategic players and private equity investors greater certainty around how to enter this sector and commit capital. After all, Moody's and S&P are getting into everyone else's business in the financial media and data space from their protected enclave. Now those other major players can think about "payback" and exploiting a great business opportunity in the ratings space. Some will throw in with the incumbent NRSROs (the Hearst investment in Fitch was striking in that regard) and some will look to build global franchises from the ground up and via roll-ups. The bill as it is written more or less formally awards the incumbents a fresh head start under the 3-year requirements, but it was the best deal available to the pro-competition interests to get this legislation through. As we have detailed in past testimony (see **Senate Rating Agency Hearings: Progress Dead Ahead?** 3-7-06), the margins in the ratings are almost scary, and major strategic players will be taking a hard look. There will need to be significant building of infrastructure before that margin opportunity can be fully exploited. **Economic 101 will now *finally* be allowed to play out like it did in Chapter 1 in any college course (i.e., large profit margins attract market entry…)**

- **Avoids the red herring of "burdensome regulation"**- the duopoly and the next tier of incumbents tried every trick in the book to scare this legislation off the table (see **Rating Agency Legislation: House Vote Pending, Senate Next?** 7-11-06). The "burdensome regulation" palaver usually carries some weight, but interestingly this bill became a Republican initiative (where the regulation boogeyman usually has a shot) as time wore on and the House became GOP vs. the Democrats. It was at least nonpartisan in the Senate. The principles of competition reign supreme in the GOP camp, however, and that trumped the fear of regulation—especially given that regulation was not the issue, competition was the name of the game. **The only *regulation* that was bad was the one keeping everyone out**. The regulation rationale used by the incumbents was a lame ploy that everyone saw through quickly and the Jedi Mind Trick missed. In the end, the legislation also was crafted in a form to step around constitutional challenges to explicit regulations that looked to exploit the First Amendment for profit. In the end, this registration process is voluntary. **You can rate without being an NRSRO, but you cannot be a formal NRSRO without meeting the requirements of the bill**. Thus no First Amendment twist.

- **Gives a waiver to the incumbents** – Calling in political markers to get a legislator to vote against such an obviously beneficial, pro-efficiency and pro-competition bill would have made any legislator look like a hack, so the best option was to toss in some add-on structural favors for the duopoly. As a result, the incumbents got a waiver in the 11th hour from the registration process set forth in the legislation, underscoring their enormous political clout, but competition is still the winner. They also managed to get the QIB certification requirement tweaked to slow the entry of new firms into some categories of obligors (a requirement not foisted upon DBRS or AM Best either). Given that near term market entry was more likely to be in corporates, financial services, sovereigns, and governmental issuers, the agencies managed to squeeze in some last minute changes to slow the entry into the very lucrative asset backed and securitization markets even though there is a relatively young and rapidly growing pool of talent to tackle that market. In the end, however, that market can still be attacked by the burgeoning quantitative talent pool coming out of schools and out of the street, so that sector can still be rated immediately but just not under the NRSRO designation.

In the end, legislation is about getting the "W" in the column, and this one is a "W" for basic principles of competition and innovation. The intensive legislative push picked up the pace in the summer of 2005 with a much more aggressive bill in the House (see **CreditSights Testimony on the Credit Rating Agency Duopoly Relief Act of 2005** 11-29-05), and that bill started the debate going. The final bill put in enough barriers to placate those worried about an influx of snake-oil salesmen into the ratings business. The additional barriers the Senate layered into the bill targeted those parties who worried about "quality" issues. We could not tell who was using the scaremonger technique as a ploy to kill the bill or honestly bought into the rationale that the markets would be in jeopardy if some tree-in-the-woods analyst emailed in an inflated and unsound credit opinion. It never made sense to us since peripheral players will have no scale, no business, no analysts of note, and no clout. The final bill added some modest barriers and requirements to deal with it one way or the other (see exhibit). The duopoly and the next tier of players got thrown a bone with the exemption (the required confidential disclosure to the SEC of the top 20 clients might have been interesting when framing the new entrants against some of the more recent adds to the NRSRO ranks—such as DBRS and AM Best). Overall, the exemptions are a small compromise of standards for the principles of competition to get the bigger victory for the market over a longer time horizon.

The process was certainly an interesting one to watch. The fact that the duopoly had their brand-name First Amendment lawyers hard at work trying to kill this initiative may be part of the reason why almost no coverage of this legislation was provided by some rather noteworthy dailies (in the corporate sector, people complain about "interlocking directorates." What is the complaint when well connected law firms cut across media outlets?). In contrast, the DC press (and Bloomberg) covered it well. In the end, Congress saw the First Amendment angle as a rather undignified ploy, and adroitly stepped around the potential challenges. Basically, the NRSRO's can all keep all of their First Amendment defenses, and that was never in doubt anyway. They were waving it around in the interest of remaining the largest totally unregulated force in the capital markets, but that just did not work (perhaps wars have not been fought to protect 50% margins from competition?). For the NRSROs, their explicit protection against liability in the underwriting process under the securities laws (covered in past pieces) also remains very much intact.

The next steps will be a revision of the NRSRO rules by the SEC and release for public comment, and it is safe to say that the incumbent NRSRO lobby machine will be in there pitching away to shape the rules to subtly deter competition and raise the barriers some more, undermine the use of quantitative models, roll in requirements that will make it harder for more rapid entry into the ABS and securitization markets, discourage capital commitment from investors, and generally slow competition. Their pitch will include some scuffing of the ball and a liberal application to lubricants to get maximum break on the delivery so new entrants might swing and miss. It is just the way it is. They will be busy recruiting comments during the "comment period" for SEC rulemaking, and we would recommend investors and issuers that are concerned to get their votes in for more choice and more transparency. **We recognize that supporting change that works against the rating agencies is a risky business given their clout. That—if anything—says a lot about why this bill is a good thing. No one in the market should have that kind of clout.**

Highlights of Credit Rating Agency Reform Act of 2006

- Mandates a registration process for those that elect to be treated as a Nationally Recognized Statistical Ratings Organization (NRSRO) for various categories of obligors
- Sets requirements for being an NRSRO under Federal rules, but is voluntary for those in the credit ratings business generally. In other words, the legislation still allows independent credit research and ratings services without being an NRSRO, but does govern those firms seeking the NRSRO distinction for business purposes
- Allows statistical models as well as fundamental approaches to ratings
- Requires disclosure of ratings methodologies, historical performance of ratings, and policies and procedures
- Mandates general compliance and controls procedures and raises the bar for financial and management infrastructure to sustain a viable rating agency
- Requires disclosure of an NRSRO applicant's 20 largest clients for the most recent fiscal year on a confidential basis
- Requires certification—on a confidential basis—by at least 10 Qualified Institutional Buyers (QIB) that those organizations have used the ratings for the prior 3 years and not less than 2 QIB certifications for each category of obligors they plan to rate. The QIBs will be exempt from any liability under the certifications.
- Exempts current NRSROs from the certification process
- Details "prohibited acts and practices" that primarily relate to coercive, hostile ratings that are linked to fees and sales of other products and the practice of "notching" (e.g. penalizing an ABS pool for an asset not rated by that NRSRO).

Some Longer Term Benefits of the Legislation

- Will set the stage for entry by larger strategic players that bring global reach and a broader array of product offerings in areas such as data, analytics, and risk products. The competition from larger players will allow scale and lower pricing for issuers and investors. The "leaning" of the financial information chain will accelerate.
- Will allow for more innovation in ratings products by creating opportunities for new market entrants looking to differentiate from the traditional NRSRO issuer-pays approach.
- Will provide alternatives for issuers who may not feel as compelled (coerced?) to embrace issuer-pay models propagated by the duopoly. This is especially true for those issuers with more concentrated institutional placement that are well covered by new entrants. In other words, you can reach those investors with high quality coverage without paying the ratings fee.
- New ratings services from high quality market entrants will dilute the distorting impact of the "regulatory arbitrage" trading around cusp ratings, particularly around the

investment grade/speculative grade divide.

- The potential for higher information content in new ratings services will raise the level of analytical depth in ratings products, and this is especially the case with the "investor pays" subscription model as newer firms look to make a dent in duopoly stranglehold.
- Will raise the level of local market research in the non-US base of issuers as non-US firms exploit their local market advantage and also look to expand organically in the massive U.S. markets or by rolling up new market entrants in a consolidation process. Cross-border alliances and mergers will increase.
- The legislation will provide more outlets for the well of intellectual capital and experienced personnel that are part of the street wave of "unbundling" research.

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