ABS Vegas 2015

Aria Resort & Casino – February 8-11, 2015

panel on

Rating Agency Reform

Tuesday, February 10, 2015, 4:20pm

remarks of

Mark Adelson

Thanks Amanda. I want to highlight three provisions in the new rules that should have a positive effect on the integrity and usefulness of credit ratings.

The first is **Rule 17g-5(c)(8)**. That provision establishes an absolute prohibition against a rating agency allowing sales or marketing considerations to influence either credit ratings or criteria development. The explicit inclusion of criteria development is interesting because it was not mentioned in the underlying statutory language.[1] It's also interesting because before the new rules, there was no direct regulatory prohibition against allowing commercial considerations to influence criteria. The closest things on that point were the rating agencies' codes of conduct.

The adopting release for the new rules explains that the inclusion of criteria development within the scope of the prohibition is one of the responses to the problem of **competitive laxity**. That's where a rating agency lowers its standards to win business.

The adopting release also provides key interpretive guidance about the rule. For example, it explains that the idea of **influencing** gets a broad interpretation. It can include compensation arrangements, performance appraisals, and compliance systems, as well as direct pressure from managers. The guidance also explains that the notion of **sales or marketing considerations** likewise gets a broad interpretation. Such considerations can include: fees, market share, and other business interests.

---

[1] Exchange Act § 15E(h)(3)(A).

The prohibition is absolute. The adopting release says so nearly two dozen times. The prohibition also has its own special two-prong enforcement mechanism. First, for individual ratings, there is a new requirement that the person responsible for a rating must attest to three things:

(i) that no part of the rating was influenced by any other business activity,
(ii) that the rating is based solely on the merits of the subject issuer or obligation, and
(iii) that the rating is an independent evaluation of the credit risk of the subject issuer or obligation.

In the second prong, the new rule provides for suspending or revoking a rating agency's registration for violating the prohibition.

The bottom line on the prohibition is that (i) it's absolute, (ii) it has long reach through the interpretive guidance, and (iii) it has a strong enforcement mechanism backing it up. OK. That's it for 17g-5(c)(8).

The second provision that I want to tell you about is **Rule 17g-7(a)(ii)(L)(2)**. This one is interesting because the rule actually means something somewhat different from what it says. The wording of the rule provides that whenever a rating agency publishes a rating it must also publish "[i]nformation on the content of the rating, including … [t]he expected probability of default and the expected loss in the event of default." The wording presumes that every credit rating embodies a specific "default probability" and a specific "expected loss." But we all know that's not right. Ratings from the major agencies provide indications of relative risk. So, just from the wording of the provision, one might think that it requires the agencies to change the meanings of their ratings.

Not so. The adopting release saves the day with interpretive guidance. It explains that the new rules do not require rating agencies to change what their ratings mean. Instead, a rating agency can use appropriate historical default and loss statistics for complying with the disclosure requirement.

OK. The third provision that I'll talk about is **Rule 17g-8(b)(3)**. That provision requires that when a rating agency uses a given symbol, like triple-A, the symbol must mean the same thing for all kinds of securities to which it is applied. However, the rule does not require that the same symbol must mean the same thing at different rating agencies.

The idea that a rating agency's symbols should mean the same thing across sectors is often called "ratings comparability." The idea that the meaning of rating symbols should be the same for all rating agencies is called "rating standardization." The new rule mandates ratings comparability but not rating standardization. Requiring ratings comparability is another way in which the new rules address the issue of competitive laxity.

Strictly speaking, the provision requires a rating agency to have "policies and procedures" that aim for the result of ratings comparability, while not actually requiring the rating agency to achieve it.

Interestingly, although the new rule would prohibit a rating agency from practicing competitive laxity by lowering its standards in a given sector, it does not prohibit competitive laxity by adjusting the stringency of a rating agency's scale across the board; covering ALL sectors, sovereigns, corporates, banks, structured finance, etc. However, such an action could hurt a rating agency's credibility and would require firm-wide coordination.

OK. The very last thing I want to add is that my colleague, David Jacob, and I have an article on this subject appearing reasonably soon in the Journal of Financial Regulation and Compliance. Thanks.

— END —