Global Counsel

Not dead, just hibernating: Bond-rating reform could be revived after November

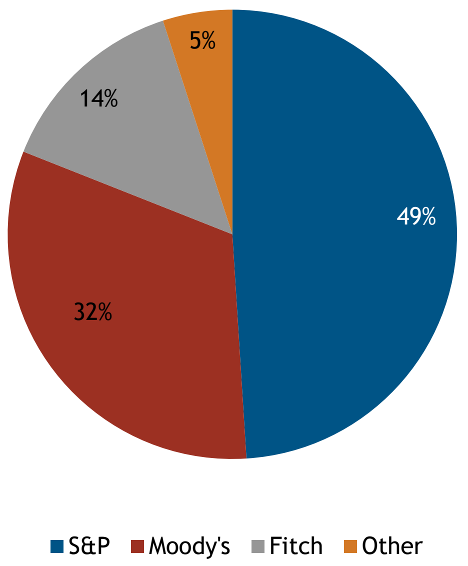
Blog post by Director Erin Caddell, 2 September 2020

The once-vigorous debate around the bond-ratings agencies has faded along with memories of the Global Financial Crisis of 2007-08. In the crisis' aftermath, many critics focused on the role the giant credit rating agencies (CRAs) Standard & Poor's (a unit of S&P Global, ticker SPGI) and Moody's (ticker MCO) played in failing to anticipate the rapid deterioration of mortgage-backed securities (MBS) that helped lead to massive government bank bailouts banks. Indeed, S&P and Moody's worked hand-in-glove with the banks themselves in structuring highly rated MBS deals that quickly went sour in the US housing bust. In one of many damning e-mails revealed in congressional inquiries and media investigations into the two largest CRAs' role in the crisis, one S&P analyst said to a colleague that "a deal could be structured by cows and we would rate it."

The Dodd-Frank package of financial-industry reforms signed into law in 2010 contained a number of proposals for CRAs, including giving the US Securities and Exchange Commission (SEC) authority to implement a new business model for the industry. Ideas included shifting from an issuer-pay to an investor-pay model, or establishing a government-appointed ratings board that would randomly distribute ratings assignments to CRAs, both designed to reduce the conflicts of interest in having firms vie for business from the entities whose bonds they rate. The big CRAs made some changes in the crisis' wake, including beefing up their internal ombudsman functions and making it more difficult for analysts to be hired by their clients. And rules imposed on CRAs in Europe had more teeth: under a rule that took effect in the European Union (EU) in 2013, securitisation issuers are required to secure at least two ratings, and issuers are encouraged to hire at least one CRA with less than 10% market share, among other changes. Nevertheless, major structural changes were left undone as regulators failed to reach agreement on a recommended business model for the CRAs, and financial-industry reform efforts focused on the banks themselves.

This could change. If Joe Biden defeats President Donald Trump in November, Biden would install a Chair of the SEC less friendly to the financial services industry, and the five-member panel would transition from Republican control to a 3-2 Democrat majority. Some liberal advocates for financial-services reform have recently told us they are dusting off long-shelved plans for the CRAs in hopes of a Biden win. CRA reform would dovetail with Biden's pledge to take a more aggressive approach toward antitrust enforcement and high concentration of corporate power. In a 2017 paper entitled "Credit rating agency reform is incomplete", the Brookings Institution, a left-leaning think tank, argued the SEC should institute a panel for assigning ratings in structured-products asset classes only, as the authors believe this area of the CRAs' remit is most prone to conflicts of interest.

Market share of US-based credit rating agencies



Source: US Securities and Exchange Commission

Even if Trump wins in November, CRA reform efforts could accelerate under a new SEC head. In June, the Trump administration said it would nominate current SEC Chair Jay Clayton for a district-attorney position. That appointment has been held up, but Clayton would almost certainly leave in a second Trump term. Clayton's SEC has continued to examine the CRA industry through staff studies and expert roundtables. "[B]arriers to entry continue to exist in the credit ratings industry, presenting competitive challenges for the smaller [firms]," SEC staff concluded in their most recent annual review of the industry, released in January 2020. Staff pointed to rules requiring use of the big CRAs' ratings in contracts of some fixed-income money managers, pensions and endowments; requirements that securities be rated by specified firms in order to be included in some fixed-income indices; and the high regulatory costs imposed on CRAs, all provisions that disadvantage smaller players. An SEC controlled by either party could take such ideas up in 2021.

While a fraction of the size of their larger brethren, the smaller CRAs are a diverse and well-established group, and (no surprise to any student of economics) have been the source of much of the industry's innovation in the post-financial-crisis era. No. 3 player Fitch Ratings, owned by privately held media conglomerate Hearst, has built a strong position in financial institutions and asset-backed securities ratings. The next-largest, DBRS Morningstar - a subsidiary of mutual-fund ratings firm Morningstar (ticker MORN) - has just 2% market share in the US, but is strong in Canada, with presence in the UK, Europe and India as well. Morningstar acquired DBRS from an investor group for $669m in July 2019. Egan-Jones Ratings Company is small but unique in the industry in that it has operated an investor-pay model exclusively since its founding in 1995. Started in 2010 in the financial crisis' wake, Kroll Bond Rating Agency (KBRA) has developed expertise in emerging asset-backed securities classes such as marketplace lending and whole-business securitizations, which are used to securitize income streams such as music royalties or restaurant franchising.

Wharf Street, a private partnership, acquired 90% of KBRA in 2015 at a reported valuation of $300m.

Global government and private debt levels have exploded in recent years as central banks have kept interest rates low to support the wobbly global economic recovery. As often occurs, the largest CRAs have reaped the greatest benefits of the vibrant market. The SEC reports that S&P, Moody's and Fitch generated 94% of the industry's revenues in 2018 (latest data available) while employing 85% of the industry's analysts and supervisors. S&P's and Moody's share prices as of early September were trading near all-time highs and at lofty price-to-earnings ratios of more than 30x expected 20201 earnings.

The giant CRAs have made hay while the sun has shone. But in 2021 and beyond, the playing field could tilt a little bit, or a lot, toward the smaller firms.