Is the SEC Going Soft on Credit Rating Agencies?: Certified Public Accountant
Danvers, Kreag;Billings, B Anthony
The CPA Journal; May 2004; 74, 5; ProQuest Central
pg. 16

Is the SEC Going Soft on Credit Rating Agencies?

By Kreag Danvers and B. Anthony Billings

Auditors were the first to be besieged by Congress and the SEC for conflicts of interest and lack of independence in the Enron failure. Enron's collapse questioned the effectiveness of audits and challenged accounting firms' practices, including the purported effects of consulting services on independence. A major outcome of this scrutiny was the Sarbanes-Oxley Act of 2002, which prohibits audit firms from providing certain types of consulting services and created the Public Company Accounting Oversight Board (PCAOB) to oversee auditors of publicly traded firms.

Next came the brokerage and investment banking houses, rife with conflicts of interest from buy-side analysts promoting stocks in order to maintain lucrative investment-banking fees. In April 2003, federal and state regulators reached a settlement with the big Wall Street investment firms that is expected to improve analyst independence as research is separated from investment-banking activities. As part of the agreement, the firms are paying penalties totaling $1.38 billion, which many industry observers consider minor given that the industry's annual profits are approximately $16 billion.

Finally came the credit rating agencies' turn to be scrutinized. Credit rating firms are partly blamed in the major corporate failures for their lack of diligence in identifying credit problems. Indeed, Standard & Poor's (S&P) and Moody's did not reduce Enron's credit ratings from investment grade to junk level until four days before Enron's doors shut.

Considering that WorldCom and Global Crossing were also rated investment grade only months before bankruptcy, an unfavorable pattern emerges. Last year, Congress was keen to target the credit rating sector for failing to identify weaknesses at Enron and other companies as it pressured the SEC to reexamine the role of credit rating agencies and to propose greater oversight of the rating firms' anticompetitive practices and conflicts of interest.

Given how important credit ratings are to securities markets, section 702 of Sarbanes-Oxley contains a directive for the SEC to reexamine the role and function of credit rating agencies in the securities markets. Pursuant to section 702, the SEC released an initial report in January 2003, followed in June 2003 by a Concept Release, "Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws."

Although the SEC readily challenged accounting firms and investment houses, major credit rating agencies have thus far remained unscathed. The SEC appears to perceive that rating firms have been doing an acceptable job and is uneager to make waves. But for the rating agencies to miss Enron, WorldCom, Global Crossing, and others suggests fundamental problems with the current debt rating system. Possibly out of fear that they weren't reacting in a timely manner, the rating firms subsequently became hypersensitive and quickly downgraded some debt issues, which compounded rating problems.

Clearly, the credibility of rating firms is eroding, as reflected by the results of a recent survey of treasury and finance managers. A 2002 survey of the Association for Financial Professionals (www.afponline.org) reveals that about 30% of finance managers perceive the credit ratings of their own organizations to be inaccurate; about 40% perceive rating changes to be untimely. Such factors have concerned Congress and led the SEC to reexamine conflicts of interest, lack of competition, information flow, the ratings process, and regulatory oversight of rating firms.

Links Between Credit Rating Agencies and Accounting Firms

The credit rating and audit functions are interrelated in that the rating analyst relies upon audited, financial statements as a primary information source in making rating determinations. Going forward, the major rating firms must attend more closely to accounting policies and aggressive financial reporting, particularly because they overlooked accounting issues related to special purpose entities for several corporations, including Enron.

With the heightened scrutiny of accounting and financial reporting issues, rating agencies are hiring more accounting professionals and seeking increasing interaction with independent auditors. These concerns were demonstrated when in October 2002 S&P hired its first chief accountant, a former Ernst & Young partner, to focus on accounting quality. Further connections between audit and credit rating functions include the following:

Sources of credit information. Both the CPA and the rating analyst function as information-processing agents for the capital markets. Moreover, both agents exercise information-based judgments and depend on the willingness of investors to accept these judgments. While auditors are compensated through annual audit fees, rating firms assess bond issuers initial fees based on the size of the issue. These fees are intended to cover expenses for initial rating services as well as ongoing monitoring. Such an arrangement provides rating firms with incentives to minimize rating surveillance costs and maintain favorable ratings, to retain clients.

Monitors of firms' management and representations. Evaluating management representations and "certification" functions are commonly associated with accounting firms and auditors. From the auditor's perspective, investors seek unqualified or "clean" opinions on firms' financial statements; similar functions are also attributed to credit rating agencies. Within a principal-agent setting, agency costs can be reduced when a firm engages rating firms, in addition to auditors, to monitor managers that have incentives to undertake risky projects that adversely affect bond values. Similar to many accounting firms, rating firms are clear that they do not accept responsibility for detecting fraud.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

Credibility and value-added through independence. Independence is critical to ensuring credibility of the audit function. The Sarbanes-Oxley Act attempts to promote auditor independence by prohibiting consulting services that are perceived to impair independence. Rating agencies also contend that credibility is vital to their independent performance. While independence is highlighted and safeguarded in the auditing profession, in the rating industry it is merely presumed.

While the auditor has an inherent conflict between independence and client retention, an identical conflict exists for rating agencies, although it may be less because the industry is an extreme oligopoly, duopoly, or cartel. Client fees can be significant for rating firms; S&P may charge particular issuers as much as $1.5 million for rating services. It has been suggested that conflicts of interest, stemming from client relationships and rating fees, restrained S&P and Moody's in downgrading firms such as WorldCom and Enron.

In sum, the political process has significantly affected accounting firms and the auditing profession through increased regulation. Political pressure has also forced the SEC to scrutinize rating firms and reexamine several industry issues, the results of which were presented in its January 2003 report.

Scrutiny Resulting from Sarbanes-Oxley

Following November 2002 Congressional hearings that focused on credit rating deficiencies and directed the SEC to examine the role and function of the rating agencies, the SEC issued its January 2003 report, "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets." The House Financial Services—Capital Markets Subcommittee conducted further hearings in April 2003. Testimony by Annette L. Nazareth, director of the SEC's Division of Market Regulation, highlights the Commission's position regarding further examination of credit firms as contained in the January 2003 report.

Ratings process and information flow. Credit rating firms are very guarded about the specific methodologies and information they use in the credit rating process, often deferring to the required "judgment" associated with the decision. Contrast this with a purported SEC consideration for determining Nationally Recognized Statistical Rating Organization (NSRSO) status in the use of systematic rating procedures.

Users require a more complete understanding of the methods underlying rating decisions, as well as specific information on which analyses are based. A further concern relates to asymmetric information disclosure, which occurs when subscribers directly contact rating analysts who inappropriately disclose information. In particular, analysts may reveal information to subscribers that they obtain through a Regulation FD exemption.

Rating agency disclosure of rating triggers in debt instruments also needs to be examined. The Association of Financial Professionals survey indicates that over 25% of firms have debt with rating triggers, while other reports suggest that only 20% of these firms provide sufficient disclosure. Such triggers may require an issuer to repay debt on an accelerated schedule, or restrict access to further borrowings, thus setting the stage for liquidity crises.

Independence and conflicts of interest. Lack of independence in accounting and brokerage firms has been a significant issue. A fundamental impairment of independence also arises through the fee structures and reliance of rating agencies on issuer fees, which may diminish the diligence of the rating agency in identifying and acting upon negative credit information.

Similar to concerns about auditor–client relationships, a rating agency may be reluctant to downgrade a company if it risks losing future fees. U.S. Representative Michael G. Oxley (R-Ohio), Chairman of the House Financial Services Committee, expressed this concern in his opening statement in April 2003 hearings on rating agencies, commenting that "the similarities between the potential conflicts of interest presented in this area (rating agencies) and those that were addressed in the area of accounting firms in Sarbanes-Oxley are impossible to ignore."

In response, rating firms contend that their internal processes and controls mitigate adverse independence effects. To illustrate, S&P President Leo C. O'Neill describes the rating change process as beginning with two analysts who make recommendations to a committee that votes on the credit change recommendation, with peer review being an additional check in the process. These "controls" are similar to those typically found within accounting firms before Sarbanes-Oxley.

Closely tied to independence issues are widespread conflicts of interest in the rating agencies. The provision of ancillary consulting, including hypothetical rating assessment services, further compounds independence problems. Such hypothetical analyses, based on proposed transactions (e.g., merger, acquisition, stock buyback), may oblige the rating agency to align actual to hypothetical rating decisions.

Finally, the tone set at the top of the rating organizations alarms many observers. Consider Moody's chairman Clifford Alexander, who was a board member of WorldCom and resigned only one year before the firm became the largest bankruptcy in U.S. history. It is interesting that Alexander believes this relationship did not compromise Moody's ratings of WorldCom's debt instruments, notwithstanding that Moody's did not downgrade WorldCom's debt to subinvestment grade until shortly before its collapse.

Anticompetitive practices and barriers to entry. Credit rating agencies are permitted to operate as an oligopoly, or duopoly in some cases, with Moody's and S&P partnering to share monopolistic rents. In addition, these rating agencies have allegedly abused their monopolistic positions by refusing to rate new issues unless the agency has already been engaged to rate a substantial portion of certain classes of the issuer's outstanding securities (sometimes called notching). Other strong-arm practices by the rating agencies include requesting payment from issuers for unsolicited ratings. Northern Trust Corporation describes such practices in its response to the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

SEC's July 2003 concept release. The company states that rating agencies have implicitly forced it to pay for unsolicited ratings in order to receive desired ratings.

Historically, the SEC has been reluctant to admit new entrants into the NSRSO business, perhaps partly because it hasn't clearly established the requirements. Given that major users of credit ratings, such as financial institutions, are required to have NSRSO-based ratings to meet capital requirements, rating agencies without this coveted designation cannot easily compete. Clearly, the NSRSO arrangement has created regulatory barriers to entry into the credit ratings business.

Recognizing additional credit rating agencies as NSRSOs would significantly improve the competitive environment. At least one rating agency is loudly protesting the lack of competition. The cofounders of Egan-Jones Ratings argued, in a letter it submitted to the SEC as part of the November 2002 hearing on credit rating agencies (as well as in its comment letter following the SEC's 2003 concept release), that the industry is best described as a "partner monopoly." Because two ratings are usually obtained to issue bonds, the gains of one partner do not reduce the gains of the other (i.e., S&P and Moody's jointly enjoy the gains of issuing ratings).

Due to increased pressure, the SEC granted NSRSO status in February 2003 to a fourth rating agency, Dominion Bond Rating Service Limited of Canada—the only additional firm to be recognized by the SEC since 1991. The SEC agreed to recognize Dominion Bond only one month after submitting its initial study to Congress. Considering the SEC's recent concept release on the rating agencies, the NSRSO market will probably become open to a few more participants in order to improve competition and promote better ratings.

Regulatory oversight. Legislators continue to call for increased government oversight of the relatively unregulated rating industry. In the absence of increased SEC supervision, Congress may legislate periodic auditing of credit-rating firms, as suggested by Senator Joseph Lieberman and proposed in the SEC's concept release. The SEC concept release, discussed below, proposes that increased oversight may include establishing standards for ratings and training, as well as monitoring compliance with those standards, which ultimately means a more active role for the SEC in operational reviews. Similar to general auditing standards, the SEC is considering imposing minimum standards for analyst training and qualifications, as well as for diligence in performing credit analysis. In addition, a formal program of recordkeeping, inspections, and reviews may become part of the Commission's final proposal.

Given the steps the SEC has taken to improve levels of independence for accounting firms and equity analysts, similar action should be required to restore the credibility of and confidence in the rating system.

SEC June 2003 Concept Release

In June 2003, the SEC followed up on its January 2003 report with a concept release (CR) regarding the use of credit ratings for regulatory purposes, the process of determining which credit ratings to use, as well as the degree of regulatory oversight. The CR presents possible approaches to address the above-mentioned issues of concern, and has received at least 50 comment letters as of February 2004.

NSRSO alternatives. The CR considers the possibility of eliminating the NSRSO designation, but expresses concerns about whether alternatives will support regulatory objectives. For example, the SEC could permit, with regulatory approval, internally developed ratings by broker-dealers for computing capital charges under the Net Capital Rule (Rule 15c3-1). Statistical models or credit spreads could also be used as alternatives to the NSRSO-based ratings.

Rule 2a-7 of the Investment Company Act of 1940, however, requires objective (NSRSO-based) investment-grade ratings, as well as subjective components (internal credit analysis by the fund manager). In the absence of NSRSO ratings, the SEC appears to be open to considering the subjective test component only. Comment letters, such as one submitted by Federated Investors, Inc., appear to favor retaining the objective basis for credit quality standards. Because these comments reinforce the SEC's apparent desire to retain the NSRSO designation, all additional issues presume an ongoing NSRSO presence.

Recognition criteria for NSRSOs. In the likely event that NSRSO designation is retained, the SEC seeks to improve the clarity of the recognition process for ratings firms. For instance, information requirements would be more explicitly specified and ratings firms within limited sectors could be considered. It is critical for the SEC to establish and define the appropriate criteria for NSRSO recognition.

Information flow and ratings process. The SEC may make the credit rating process more transparent by requiring greater disclosure about the underlying assumptions that influence rating decisions. Rating firms could implement procedures to ensure appropriate disclosure about ratings and related processes. In addition, specific events and key assumptions that influence ratings decisions would need to be routinely disclosed. Such requirements would be rolled into NRSRO criteria.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

Conflicts of interest. To control conflicts of interest, the SEC proposes that employee compensation not be linked to new business development or client maintenance. Rating firms may also need to establish procedures that restrict direct contact between subscribers and analysts. Moreover, the SEC may require firms to establish firewalls across ratings and ancillary business development. The SEC suggests that adequate financial resources and a limited revenue percentage (e.g., 3%) derived from a single source would improve independence, but a 3% rule is unlikely to affect major rating firms; nor would such a rule have eliminated conflicts of interest at the big accounting and brokerage firms. These requirements would be operationalized through NRSRO recognition criteria.

Unfair practices. Rating firms might be required to implement procedures to control unfair and anticompetitive practices. Firms would not be able to engage in strong-arm tactics or require issuers to purchase ancillary services in order to receive other rating services. Again, the SEC would incorporate these requirements into the NRSRO recognition criteria.

Rating triggers. The SEC solicited comments on improving disclosure by issuers and rating agencies of financial covenant triggers. In addition, further disclosure regarding special purpose entities and material future liabilities has been recommended. At least some improvement from the current level of disclosure should be forthcoming.

Regulatory oversight. The SEC might require rating firms to file annual certifications of compliance with any established NSRSO criteria. In addition, firms would be required to maintain internal records about ratings decisions and other activities.

Overall, it appears that the SEC proposes making the NSRSO designation a more formal process with better-defined criteria. Ongoing review of firm compliance with the criteria incorporates a regulatory oversight that has not previously existed. Although the CR addresses Congress' concerns, several proposals are inoffensive to the big rating firms and in step with the industry's earlier assertions, particularly with respect to conflicts of interest.

Implications and Recommendations

Financial planning. It is increasingly important to identify rating triggers within credit facility agreements. Although many companies have such triggers, often this information is not disclosed to investors. Bear in mind that such triggers could make a business lose significant control over debt repayment and liquidity. Auditors should also be prepared to increase disclosure of such triggers within footnotes to financial statements. In addition, auditors will need to spend more time explaining accounting policies and procedures associated with complex financial transactions to the rating firms. This will increase the time and cost of audit engagements.

To the extent that the rating process becomes more transparent, more-detailed information will be available about the credit prospects of rated firms. Such changes should improve the ability to make informed investment recommendations.

Regulators and policymakers. The SEC appears to be accommodating the interests of big rating firms by permitting ancillary consulting services. For example, providing hypothetical rating services inherently compromises rating firm independence and may lock in the agency's response when a particular scenario materializes. Given the steps the SEC has taken to improve levels of independence for accounting firms and equity analysts, similar action should be required to restore the credibility of and confidence in the rating system. The authors recommend that rating firms be prohibited from offering any consulting-related ancillary services. Opening the supplier market to additional firms, closely monitoring internal processes, and taking further steps to prevent conflicts of interest are also critical to accomplishing the objectives of Sarbanes-Oxley.

Under the Sarbanes-Oxley Act, audit committees have direct responsibility for appointing, overseeing, and compensating external auditors. This provision is intended to reduce management's influence over the auditor and to enhance independence from management. However, no such provision has been required for credit rating agencies. Thus, there is a clear role for the audit committee to oversee relationships with credit rating agencies as well as auditors, in order to mitigate management influence over credit firms' judgments.

Increased disclosure about rating processes and decision outcomes would also improve transparency in the rating process. Credit firms must be more forthcoming in explaining the "black box" workings of their ratings. In addition, the current rating system implies greater precision than is actually available regarding issuer creditworthiness. While equity analysts have moved to a three-tier system (buy/hold/sell), rating agencies use scales with more than 20 different levels. Some simplification of rating schemes should be considered in the NSRSO criteria.

Looking for a Smoking Gun

Although the SEC reexamined rating agencies and prepared recommendations for NSRSO criteria in 1997, far greater political pressure arising from Sarbanes-Oxley should result in definitive changes. The SEC's reports to date portray favorably the rating industry's performance, however, and this relatively soft stance suggests that any reform in this area will be limited.

In an attempt to solidify its reputation, S&P has begun a corporate governance rating system to evaluate the quality of corporate boards. The rating firm has also compiled a study of financial statement disclosures for S&P 500 companies and beefed up its in-house accounting expertise to begin addressing the disclosure concerns. In light of recent rating industry action and SEC inaction, perhaps the accounting industry would have achieved a more favorable outcome if the profession had been similarly proactive in its response to legislative criticism. ❑

Kreag Danvers, PhD, CPA, *is an assistant professor of accounting, and* ***B. Anthony Billings, PhD,*** *is a professor of accounting, both at the School of Business Administration, Wayne State University, Detroit, Mich.*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com