The role and function of rating agencies

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Introduction to Moody's

Moody's Investors Service is the oldest bond rating agency in the world. We have been rating bonds since 1909. Today, we have more than 1,000 analysts in 19 countries around the world. Our products include our familiar credit rating opinions (which are publicly disseminated through the press and made freely available on our website), as well as research and special reports about debt issuers and their industries, that reach more than 2,600 institutions and 16,500 users around the globe. Our ratings and analysis cover approximately 10,000 corporations and financial institutions, more than 20,000 municipal debt issuers, over 12,000 structured finance transactions, and 100 sovereign issuers.

Role and function of credit rating agencies

In Moody's view, the main and proper role of credit ratings is to help to enhance transparency and efficiency in debt capital markets by reducing information asymmetry between borrowers and lenders. We believe that this benefits the market by increasing investor confidence and allowing borrowers to have broader access to funds.

Moody's does this by publishing forward-looking rating opinions publicly, freely and broadly, and by publishing credit research about debt securities and their issuers. Our credit ratings are opinions about the future probability of full and timely repayment of debt obligations, such as bonds, notes and commercial paper. Our opinions are communicated to the market through a symbol system originated almost 100 years ago, which ranks relative credit risk on a scale with nine broad categories ranging from Aaa to C. Most of the broad rating categories are further refined with numerical indicators, from 1 to 3.

Attributes and uses of ratings

We believe there are several attributes of credit ratings that have caused their increased adoption and use by both regulators and market participants. First, ratings are widely and publicly available to the market at no cost. Second, ratings are independently formed and objective - indeed, rating agencies are motivated to act independently of each other, governments, issuers and their agents to reach the highest standards of ratings performance and accuracy. Third, and possibly most importantly, the performance of ratings has been measured - and they have consistently demonstrated predictive content. Overall, our ratings have done a good job in predicting the likely credit risk of debt securities and debt issuers.

Yet, ratings are not, nor should they be construed as, "pass-fail" assessments, performance guarantees, investment recommendations or statements of fact. If we were able to perfectly predict the

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future, there would be two ratings: “will not default” and “will default”. Because the future is inherently uncertain, our ratings are necessarily limited to forecasting a probabilistic opinion of relative credit risk, with lower ratings indicating increasingly higher probabilities of default.

Evolving perceptions about the role and function of rating agencies

Demand for and use of credit ratings has grown tremendously over the past two decades. Advances in information technology, globalisation, economic integration, deregulation and asset securitisation are all well-chronicled drivers of this growth. Less frequently identified, but arguably no less important, are some basic attributes of ratings themselves - such as their acceptance as simple, widely understood symbols, their predictive content and their broad public availability, to name but three.

The demand for ratings also benefited from the favourable conditions that prevailed during much of the 1990s, and should continue to benefit from them in the coming years. They include, *inter alia*:

- low inflationary expectations and historically low interest rates in many developed economies;
- product innovation in the area of risk management and enactment of legislation enabling asset securitisation; and
- ongoing adoption of ratings by regulators seeking common risk benchmarks and financial system stability, and by the private sector for securities selection and portfolio composition guidelines.

Throughout this period of market expansion, Moody’s has invested significantly in analytical resources, attracting experienced, local professionals to address rapidly growing demand in domestic markets, including in Beijing, Hong Kong, Singapore, Sydney, Taipei and Tokyo. Moody’s now has more than 250 associates in the Asia-Pacific region.

We have listened to concerns about the existing system of checks and balances, as revealed by the repeated instances of malfeasance and corporate failure starting with the collapse of Enron. Moody’s has responded by embarking on significant initiatives to expand the range and depth of our analysis. We are applying greater analytical focus and committing additional resources to analysis and published research on the quality of accounting, the transparency of corporate disclosure, corporate governance issues and risk management/transfer issues related to credit.

We are strengthening teams of specialists who focus solely on these critical areas. We have also increased our scrutiny and reporting of issues such as short-term liquidity and rating triggers. One of the reasons for doing so is the growing complexity of corporate structures and financial reporting, requiring more specialised expertise. A suitable analogy might be the medical profession, in which general practitioners are increasingly supported by specialists with ever more sophisticated diagnostic tools. A second reason for this increased focus is that, while the vast majority of companies endeavour to report their financial and operating condition in good faith, publicly available information taken at face value has too often proved to be misleading.

In this context, we must add that, despite our enhancements, Moody’s is not, nor will it be, in a position to audit the work of auditors or systematically uncover cases of outright fraud. We do not have, and do not seek, powers to compel disclosure or enforce regulations.

Not surprisingly, this evolution in the uses of ratings has also increased the number of disparate users with competing needs and objectives. Some of those needs and objectives are not principally aligned with Moody’s objectives of market efficiency, transparency and investor protection. For example, issuers in many jurisdictions use ratings because many investors demand that they do so in order to access the capital markets. Understandably, issuers would like to receive the highest possible plausible ratings, as well as exercise greater control over the rating process. Large institutional investors, on the other hand, often use our ratings in their portfolio composition and governance guidelines. Generally, these investors prize stability in the ratings on securities they own and look with particular disfavour on major downgrades of names held in their portfolios or rating actions that are subsequently reversed.

These and other uses of ratings result in incongruent expectations, and, therefore, differing opinions about their performance, including the following:

- Rating agencies act too slowly to lower ratings on deteriorating credits;
- We act too quickly to lower ratings, restricting companies' access to capital and *causing* credits to deteriorate;
- We are compromised by revenue derived from issuers, and thus rate issuers too highly; and
- We are overly conservative and assign ratings that are too low.

Adding to this complexity are the government entities that have incorporated ratings into banking, insurance, securities and other financial institution regulations for the dual purpose of protecting investors and maintaining the financial stability of those institutions.

Some of these same regulatory bodies have, over the past year, engaged in a re-evaluation of our role in the market, which brings me to the second topic, the future for ratings, which I discuss below.

The future for ratings and oversight of rating agencies

We, like the regulators, acknowledge the important role ratings have come to play in the global capital markets. We are encouraged by their adoption by so many users, although we worry about the ability of a simple symbol system to satisfy increasingly diverse demands.

Although we cannot speak for other rating agencies, we can tell you that Moody's internal deliberations about oversight are based on the following facts:

- First, the value of ratings lies in their independence;
- Second, the role of ratings in financial market architecture has expanded materially in recent years;
- Third, Moody's and other rating agencies have benefited from many of the new applications for ratings, including in securities and financial regulations;
- Fourth, however, differing and often inconsistent expectations for ratings and the performance of ratings have emerged coincident with these new applications.

We therefore emphasise that oversight intended to bolster the "quality" of ratings will necessarily depend on, first, exactly what ratings are supposed to do and, second, who ratings are supposed to serve. As stated in the introduction, Moody's believes that the primary role of rating agencies and ratings is to support the normative objectives of securities laws: market efficiency, transparency and investor protection. Oversight should bolster, not impair, those intended roles and uses of ratings.

Although there are a number of examples I could cite to illustrate risks of impairment, I will briefly describe just two:

First, regulation seeking to control that which we believe is crucial to our credibility - that is, our independence and objectivity - raises concerns. We are uneasy with the prospect that improper influence over the rating process may become insinuated through regulation.

Specifically, if authorities do not favour independence and objectivity, at least for opinions concerning important constituencies - for example, a government bond rating in a jurisdiction where the government holds a low rating - regulation could become a means through which our opinions are controlled or silenced.

Second, regulation could prescribe conditions for liability that are inconsistent with the nature of ratings. One might well imagine that Moody's finds this troublesome, but perhaps without completely understanding why.

Moody's ratings provide predictive opinions on one characteristic of a corporate entity's financial enterprise - namely, its likelihood of repaying debt in a timely manner. *Inter alia*, our ratings are based primarily on analyses of companies' financial statements, as well as on assessments of management strategies and industry position.

Because of the nature of our analysis, it heavily relies on the quality, completeness and veracity of information available to us, whether such information is disclosed publicly or provided confidentially to Moody's analysts.

It is crucial that our ratings be reliable in their aggregate probability assessments of credit risk. Nevertheless, however desirable this may be, it is impossible for any single opinion to be "correct" or "incorrect" on a case-by-case basis. For example, while the vast majority of Baa-rated securities repay in a full and timely manner, certain Baa securities default. Neither result is "right" or "wrong" *per se*. However, an issuer with a Baa rating whose bonds do, in fact, repay will argue that its securities were rated too low, just as investors holding the rare defaulted Baa security will argue that the rating was too high.

To judge the quality of any opinion about the future, including a rating opinion, on such a basis is to place an inordinate burden on the fundamental nature of opinions. Furthermore, while our ratings have proven to be good predictors of creditworthiness, we do not intend, represent or scale our fees for them to act as performance guarantees. Accordingly, we strongly urge that oversight measures look to promote the trustworthiness of rating opinions in the aggregate, rather than on an unmeasurable, individual basis.

I should also acknowledge that there are areas where additional regulation would be reasonable, or even desirable, from Moody's vantage point. The area in which we believe regulation can have the greatest positive impact is the quality of information available in the market. We fully support the adoption of standards that promote better financial reporting and other financial disclosure from all entities that wish to participate in the capital markets.

We further believe that there is room to enhance the disclosure of our own rating processes. As you know, Moody's periodically publishes updates of our rating methodologies and practices. We have also codified core principles of our rating process to include the following:

- *Independence from commercial interests*. The level of ratings shall not be affected by a commercial relationship with an issuer.
- *No forbearance*. Moody's shall not forbear, or refrain from taking a rating action based on the potential effect of the action on Moody's or an issuer.
- *Controlling conflicts of interest*. Moody's does not make investment recommendations or offer any investment products. Moody's has in place procedures to control the latent conflicts of interest that exist because the issuers we rate provide most of our revenues.
- *Proper use of confidential information*. Moody's uses confidential information provided to it by issuers only in ratings, and will not otherwise use or disclose confidential information.
- *Judicious consideration*. Rating actions will reflect judicious consideration of all circumstances believed relevant to an issuer's creditworthiness.
- *Rating committees*. Rating decisions shall be made by committee, not by an individual, and so reflect the knowledge, experience and judgment of the organisation, rather than a single individual.

In addition to these core principles, we have published a series of documents related to the performance and attributes of our rating system, and the behaviour of our management and professional staff. We have consolidated our policies and procedures into a single public document - our Code of Conduct. We are not opposed to oversight that can confirm that these policies are being followed.

Of course, this raises the potential for falling short, publicly, of our own stated standards. However, it can also further validate the ratings industry and the legitimacy of our services, and allow us to contribute more substantially to market efficiency.

We would not be encouraged if additional oversight were to reach into the underlying methodology and tactical workings of the rating process, because we believe that innovation and competition between rating agencies better serves the market. To date, we have not heard of such intentions from authorities in established financial markets.

It is self-evident that greater rigour is being demanded of rating agencies, and greater transparency expected of us when explaining rating rationales today than was the case a few years ago, or possibly at any other time in our history. In this context, you can expect Moody's to continually re-evaluate our rating methodologies, and to learn from and respond to market dynamics. You can also expect Moody's analysts to be as thorough in their work as possible, inquiring more about accounting practices, liquidity, corporate governance, rating triggers and other of the less visible factors in overall creditworthiness.

I would like to reiterate that Moody's track record shows that we provide a valuable service in contributing to the efficiency and transparency of capital markets. Moreover, Moody's acknowledges the important niche rating agencies occupy in the global financial markets, and we are not opposed to oversight and practices that bolster the perception of quality and legitimacy by which our efforts are judged. While the environment in which we currently offer our rating services raises the risk that we fall short, it also provides Moody's with a tremendous opportunity to succeed - to further prove our value to the market and contribute more substantially to its development.

Building effective markets in China

What is the best way to allocate China's vast savings pool? Around the world, capital is allocated either through government direction, banks or securities markets. There is certainly a global trend towards market, rather than directed, economies. In market economies, it is desirable to have both a strong banking system and strong securities markets.

In most countries, banks remain the chief institutions responsible for allocating savings. However, in the English-speaking world, where capital markets are probably most developed, bond markets are equally important. Bond markets are also growing in importance in Japan and Western Europe. One benefit of having a vibrant bond market alongside an efficient banking system is that during times of financial stress, if problems arise in the banking system, bond markets can help soften the impact on the economy.

For instance, during the banking sector problems of the 1980s in the US, bond markets provided a ready means for banks to shed non-performing assets. Such asset-shedding, combined with appropriate monetary policy, provided breathing space for the banks to restructure their balance sheets. In addition, during this period of bank portfolio consolidation, US borrowers were able to tap bond markets both for corporate and mortgage finance. Without a vibrant bond market, the economic consequences of banking sector problems would have been somewhat worse. Conversely, when stress has emerged in bond markets, banks have stepped in to provide indispensable support to the US and world economy, as they did in 1998 following the Russian crisis and collapse of the Long-Term Capital Management hedge fund.

A number of preconditions are required for an efficient bond market to thrive. First, rule of law is paramount. Investors must know the ground rules. There must be a corruption-free legal system that creditors can use to enforce debt contracts up to and including liquidation of the insolvent debtor. There should be a sufficient supply of credit to allocate by means of the market mechanism, as opposed to governmental administrative allocation. A clear-cut procedure for restructuring problematic borrowers in a timely manner is also desirable. Also, there should be regular and transparent financial reporting of bond prices and the financial positions of borrowers. Failures in financial reporting for some large borrowers, such as Enron and WorldCom, led to recent bond market volatility in the United States.

A thriving credit culture has a crucial role to play

A sound credit culture is characterised by 1) appropriate understanding of the creditworthiness of borrowers, ie their willingness and ability to meet their obligations; and 2) the ability of investors to decide whether or not to lend, and the price of lending based on proper credit assessments.

Moody's understands that this view is shared by officials directing China's economic reform. The more advanced a country is economically, the more advanced its credit culture is generally. Inscribed over the entrance to our headquarters in New York, you will find the phrase, "Credit - Man's Confidence in Man", a noble sentiment indeed!

Supporting the high economic growth required to meet people's needs

What better way to cater to the economic aspirations of people than by providing the highest sustainable growth rate possible, with the operative word being "sustainable". Since allocating credit effectively means allocating the people's savings efficiently, fostering efficient credit markets is an effective way of serving the needs of the nation as a whole. Efficient credit markets can provide financing for vital infrastructure projects, including roads, railways, energy projects, hospitals, schools etc. Credit doesn't have to be allocated only to state-owned enterprises and the private sector. Indeed, as we have seen in the US, Canada and, increasingly, Western Europe, credit can also be efficiently allocated by bond markets to regional and local government authorities who are often better able to carry out such projects.