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Executive Comment:

The Role Of Credit Rating Agencies In The Financial System

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Executive Comment:

The Role Of Credit Rating Agencies In The Financial System

*(**Editor's Note:** On Sept. 10, 2013, Standard & Poor's Ratings Services President Douglas L. Peterson participated in a United Nations thematic debate. The speech he delivered, published here, touched on the important role ratings play in the global capital markets and the changes that have occurred since the financial crisis. Participants also considered competition among credit rating agencies, the role of regulators, and the merits of particular regulatory proposals. For further information, please contact 212-438-6667.)*

Introduction

Mr. President, Under Secretary-General and Excellencies, thank you for inviting me to join you today. It is an honor to be at the United Nations, an organization with a long history of promoting global cooperation, sustainable development, freedom and peace. S&P looks forward to deepening the relationship with the U.N. and its member states, along with our parent company, McGraw Hill Financial.

At Standard & Poor's, we trace our origins back to 1860 when Henry Varnum Poor first started publishing information for investors about railroads and canals. And we've been rating bonds for nearly a century.

Today, S&P has more than 1,400 analysts around the world. We assign ratings to 127 countries. In total, we have ratings on over 1 million securities with a face value of more than 60 trillion dollars.

Ratings play an important role in the international financial system and worldwide there are more than 75 credit rating agencies. This morning I'd like to share with you my views of that role as well as discuss the changes that have occurred in the ratings business since the financial crisis.

Ratings help foster the development and smooth functioning of the global capital markets, allowing people to start and grow businesses, cities and states to build highways and hospitals, and manufacturers to build factories and create jobs.

Before we discuss the role of ratings, however, some background about them is in order. Ratings are informed opinions about credit risk. They are designed to answer the question "What is the ability and willingness of an issuer to meet its financial obligations in full and on time?"

Credit ratings are intended to provide a long-term view of creditworthiness based on fundamental analysis. Unlike market-based indicators such as bond spreads or credit default swap prices, ratings do not reflect market sentiment or the dynamics of supply and demand. In other words, they are NOT a trader's view of credit risk. They don't address asset value nor do they speak to the liquidity of a security. They aren't a buy or sell recommendation. Ratings address only one aspect of a debt instrument--credit quality.

At S&P, we strive to make our ratings comparable, transparent and forward looking--three attributes that are important

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to investors. Because credit markets are global, we aim for comparability in our ratings around the world as well as across asset classes and sectors. It is critically important to provide a consistent view of credits across countries for those issuers who seek a global market for their debt and investors who seek global diversification.

Transparency is important in both the criteria we use to rate bonds and the actual ratings themselves. We believe that making clear the methodologies we use to establish ratings and publishing them on our web site, help market participants understand how we analyze credit risk.

Ratings look forward. They incorporate an assessment of the potential impact of foreseeable future events. While it is always difficult to predict the future, our ratings record is strong. We, like others, did not anticipate the U.S. housing downturn, which led to the financial crisis. But with the exception of our ratings on U.S. mortgage-related securities, our ratings have performed as expected.

Comparable, transparent and forward-looking ratings serve the capital markets by contributing to their efficiency and stability. But while ratings are important, they are certainly not the only source of information available to the credit markets. Investors draw on many different sources, including their own analysis, other research houses and local rating agencies. They are very clear in telling us that they make their own decisions and do not rely mechanistically on ratings from the major agencies.

That's an approach we welcome. A diversity of views creates healthy debate about credit risk and can only be good for the market and the financial system.

Role of Ratings In The International Financial System

That said, ratings play many important roles in the global capital markets, helping countries and companies gain access to funding for initiatives that promote prosperity and jobs.

Ratings play a role in portfolio diversification as well as encouraging a more liquid flow of capital around the world. As a 2010 IMF report pointed out, ratings ". . . allow borrowers to access global and domestic markets and attract investment funds, thereby adding liquidity to markets that would otherwise be illiquid."

Ratings also meet the need for less well-known issuers to gain market access by having information and analysis of their credit widely available on a comparable basis.

Furthermore, the capital markets are playing a greater role in financing governments, companies and consumers--a trend that is likely to continue for years to come as banks become subject to higher capital requirements and other restrictions. That means that there will be a strong need for credit research and ratings.

Our research suggests that bank loan and debt capital markets will need to finance up to 53 trillion dollars of corporate borrowings over the next five years. This amount includes existing debt of approximately 35 trillion dollars that requires refinancing.

Global corporate bond issuance has been running at record levels since last summer. It topped nearly 4 trillion dollars for the whole of 2012.

In addition, governments around the world must find sufficient funds to pay for ongoing growth and development, particularly in the area of infrastructure.

Ultimately, the most important role ratings play is to foster the development and smooth functioning of capital markets to help companies and countries grow.

Changes In The Regulatory Landscape

I'd like to shift focus now to a brief review of the enormous changes in the regulatory landscape for credit rating agencies over the past six years. Today there is greater transparency and more accountability and oversight at the ratings agencies than at any time in our history.

In September of 2008, we were all in the depths of the financial crisis. During that time the vast majority of the securities S&P rated performed as we anticipated, including many structured finance ratings. But the performance of our ratings of certain U.S. residential mortgage-related securities was a major disappointment. Like nearly every other market participant, analyst and interested government entity, we did not anticipate the U.S. housing collapse and its effect on the economy as a whole.

This is something that we at S&P deeply regret and we learned a great deal from that experience. We spent much of the past few years strengthening our credit ratings, not only in U.S. mortgage securities but across all sectors globally, including areas that performed well, in order to better serve the capital markets.

Since 2007, we have invested approximately 400 million dollars in our systems, governance, analytics and the methodologies that we use to rate securities. We brought in new leadership, instituted new governance and enhanced risk management.

We have taken significant actions to further strengthen our independence from issuer influence. We have long had policies to manage potential conflicts of interest such as a separation of analytic and commercial activities, a ban on analysts from participating in fee negotiations, and de-linking analyst compensation from the volume of securities they rate or the type of ratings they assign. After the crisis, we decided to strengthen analytical independence by rotating the analysts assigned to a particular issuer and enhancing analyst training.

We also improved the integrity and validity of our methodologies and models: We reassessed the principles underlying the way we rate all debt and changed the way we rate almost every type of security that was affected by the financial crisis. For mortgage-related securities, for example, we significantly increased the credit enhancement required to achieve a 'AAA' rating and made it more difficult for securities to achieve high ratings.

Since the crisis, new regulations for ratings have been put in place worldwide including in the U.S., the European Union, Japan, Australia, Argentina, Canada and Brazil. Others are being contemplated. Here in the United States two landmark pieces of legislation--the Credit Rating Agency Reform Act and Dodd-Frank--have resulted in a robust and evolving set of requirements that have significantly changed the way we conduct our operations.

In the European Union, three rounds of regulations have been put into effect over the past three years. These new regulations include stringent measures to increase oversight, accountability and transparency, including a comprehensive supervision and inspection regime. We have been supportive of these new measures since we believe that they can help restore confidence across the financial sector.

One of the most important changes has been the elimination of the mandatory use of ratings in government regulations, which we have supported. Ratings should be one way--but not the only way--of assessing credit risk.

In addition, the International Organization of Securities Commissions, known as IOSCO, has long played a significant role in relation to credit rating agencies. Most recently IOSCO announced the creation of supervisory colleges for internationally active credit rating agencies. These colleges will serve as a resource for supervisors by facilitating the exchange of information, consultation and cooperation. International regulators--and ourselves--believe they could have an important role to play in promoting globally consistent standards of regulation. This is critical given the global nature of ratings and the markets they serve.

One final issue I'd like to address before I close is the business model question. S&P and the vast majority of credit rating agencies have employed a business model where the issuer of the debt pays the rating agency. This has been the case since the 1970s, when the bankruptcy of the Penn Central Railroad demonstrated the need for greater transparency in credit ratings, which this model offers.

The issuer-pays model is unique in its transparency compared with the alternatives--subscriber-pays or government sponsored. Ratings in a subscriber-pays model are selectively disclosed only to those who can afford the subscription, and are also vulnerable to influence by subscribers. Markets have questioned whether a government-sponsored model or a model in which the government simply chooses or assigns the rating agency could deliver truly independent ratings on countries, local governments or politically important companies.

By contrast, the issuer-pays model enables ratings to be made widely available to the public, free of charge. This fosters more efficient debt markets, public scrutiny and coverage of emerging companies.

As part of the Dodd-Frank Act, the SEC is evaluating additional measures to manage conflicts of interest that may arise between market participants and rating agencies, including measures to improve the transparency around the creditworthiness of securities.

Conclusion

To sum up where we are today, the regulatory landscape for rating agencies has been irrevocably changed. Governments have put in place many new rules and regulations to address the issues that led to the crisis. Rating agencies are subject to regulatory controls that did not exist before the crisis.

For our part, we have reinforced the integrity and independence of our ratings process. We have increased our transparency, providing more information to the market about how we develop our criteria, arrive at our ratings, what they mean, and what could cause them to change.

And we have made important analytical changes that we believe will make ratings more stable, more comparable, more forward looking and thus more valuable to the global financial community.

Thank you very much for your attention today.