



**Weiss Ratings' Commentary on Improving  
the Nationally Recognized Statistical Rating Organization  
(NRSRO) System**

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Written Statement to the  
Securities and Exchange Commission  
Washington, D.C.  
In connection with the  
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**Hearings on Credit Rating Agencies**  
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## Conflicts of Interest at NRSROs

The credit ratings issued by nationally recognized statistical rating organizations (NRSROs) suffer from some of the same pressures that have clearly compromised the independence and accuracy of “buy,” “hold,” and “sell” ratings issued by investment banking firms.

As with investment banking firms’ stock ratings, the primary intended *user* of the NRSROs’ credit ratings is the investing public. However, the primary *buyer* of those same ratings is the rated company itself – an obvious conflict of interest. Although many such conflicts are disclosed, they are not well known to the public. It is not well known, for example that:

- **All of the NRSROs are paid substantial fees for their ratings by the rated companies.** This creates a not-so-subtle pressure to award ratings that are favorable to their clients in order to retain business. In fact, the NRSROs’ revenues derived from the rated companies far exceed any revenues from the sale of ratings or rating-related publications to individual investors.
- **Rated companies are almost universally empowered to begin or end a rating contract.** During the initial rating process, if a company does not like the treatment it is getting from one NRSRO, it may terminate the contract and begin work with a different NRSRO that may give the company a more favorable rating.
- **Publication of a rating may be censored.** With two of the three NRSROs, if a rated company does not like its initial rating, it can request that the rating not be published, and the rating firms will comply.
- **Unsolicited ratings can give the appearance of extortion.** When an NRSRO issues both solicited and unsolicited ratings, an unfavorable unsolicited rating has the potential to serve as an incentive for a company to purchase a more favorable solicited rating.
- **Additional revenues are derived from other business lines within the NRSRO.** Each of the current NRSROs uses its existing client relationships as leverage to perform other additional services for that client. Thus, a rating downgrade could lead to the loss of significant revenues for other divisions within the NRSRO. This conflict is similar to that faced by accounting firms that offered consulting services to their auditing clients, and we have already witnessed the serious consequences of that business model.

Given these conflicts, NRSROs are consistently walking a tightrope, balancing the interests of their clients – the rated companies – against the interests of investors. The result is often a reluctance to take quick action to alert the investing public of a corporation’s problems in a timely manner.

The ratings assigned by the NRSROs to Enron bonds provide a classic example. According to the *New York Times*, “Executives at big securities firms that stood to profit from the [Dynergy rescue] deal pressed Moody’s to keep ratings at investment grade, even as Enron bonds fell to levels indicating that the debt was highly risky.”<sup>1</sup> Responding to similar pressures, the other NRSROs also delayed downgrading the company’s bonds to speculative grade until after it was announced the company was filing for Chapter 11. Then, on the day of the Chapter 11

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<sup>1</sup> Alex Berenson, “Enron’s Collapse: The Rating Agencies; Debt Rankings Finally Fizzle, but the Deal Fizzled First,” *New York Times* (November 29, 2001).

announcement, Moody's cut Enron's rating by five notches, S&P slashed its Enron rating by six notches, and Fitch reduced its Enron's rating by 10 notches.

### **Additional Problems with the NRSRO System**

These conflicts of interest are compounded by the barriers to entry for independent credit rating firms seeking NRSRO status. The SEC's criteria for achieving an NRSRO designation and reluctance to grant NRSRO status has created a virtual monopoly for the three existing NRSROs. The resulting lack of true competition produces little incentive for the NRSROs to reform with the goal of producing more objective research.

In addition, there is sorely inadequate disclosure coming from the NRSROs with regard to their business relationships with rated companies and the historical accuracy of their ratings.

### **Recommendations for Comprehensive Reform**

To rectify the deficiencies noted above within the three existing NRSROs, we recommend that:

- 1) All current NRSROs be required to operate without any conflicts of interest in their business model. This means the rating agencies would no longer accept fees from the rated companies for issuing their ratings, nor give rated companies any power to silence the ratings issued by an NRSRO. There are various rating agencies already employing a no-conflict business model, and they have demonstrated a continuing ability to operate profitably strictly through the sale of their ratings and research.
- 2) Existing NRSROs should be given a finite period of time to cease issuing solicited ratings and remove all potential conflicts of interest from their rating process.
- 3) The NRSRO designation should be removed from those rating agencies that do not comply within the allotted time period.
- 4) As long as existing NRSROs continue to operate with their current, conflicted business model, the NRSROs and the rated companies or their agents should fully disclose at the point and time of distribution of their ratings to the public:
  - a) whether the rating has been solicited or is unsolicited,
  - b) the precise payments made by each rated company for acquiring its rating,
  - c) any additional payments made for ratings publications or publication rights,
  - d) any other business relationships, such as consulting services, and the payments received for such services, and
  - e) any formal or informal procedure that grants the rated companies the right to delay or suppress publication of their ratings.

We recognize that it may be difficult to promptly implement these recommendations. Therefore, we also recommend that:

- 5) Three additional rating agencies should be granted NRSRO status as soon as possible, which would double the current number of NRSROs, thereby creating a more competitive business environment without requiring existing users of the ratings to revamp their policies.

- 6) To qualify for an NRSRO designation, each new rating firm should demonstrate a business model that is completely free of conflicts of interest. It must:
  - a) offer exclusively involuntary, unsolicited ratings,
  - b) never accept payments or compensation in any form from the rated companies for developing or publishing the ratings,
  - c) offer ratings-related publications to the rated companies at the same price at which those products are offered to investors and consumers,
  - d) maintain no separate business relationship with the rated companies, and
  - e) never grant to the rated companies the right to delay or suppress the publication of a rating.
- 7) All NRSROs should be required to publish a database accessible to the public that details historical default rates by rating category in a standard format that can be used by researchers. Information on default rates should be presented in a clear and consistent fashion that can be understood by individual investors.
- 8) A review board should be established to evaluate the track record of each NRSRO comparatively and disclose the results regularly to the public. This is especially necessary during a transition period to adequately monitor the consequences of any continuing conflicts of interest at the existing NRSROs.
- 9) Rated companies should be given a formal complaint procedure for reporting any instances of perceived extortion by NRSROs. Such a system would inhibit a rating agency from acting unscrupulously while also giving the securities issuer a venue for voicing its concerns without fear of reprisal or retaliation by an offending NRSRO.
- 10) NRSROs' exclusion from Regulation FD should be removed. Exempting NRSROs from Regulation FD does more harm than good. The premise is that exemption allows the rating agencies to alert the public more quickly with rating upgrades and downgrades. The problem is that, without being able to provide the information on the underlying justification for the upgrade/downgrade, the exemption tends to cause public confusion and speculation.

## **Conclusion**

The NRSRO system will not adequately serve investors until all conflicts of interest have been eliminated from the NRSROs' business models. In the interim, efficiency and accuracy can be improved through increased competition, more opportunities for independent rating firms, and full public disclosure of each firm's track record.