

# The Role of Credit Rating Agencies in Japan and the United States

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*Panel, from left to right: Sean Hirose (interpreter), Mr. Hidetaka Tanaka, Mr. Douglas Peterson Professor Patrick Bolton, and Professor Hugh Patrick*

This symposium featured a panel discussion about credit rating agencies with high-level representatives from the United States and Japan: Douglas L. Peterson, president of Standard & Poor's Rating Services (S&P); Hidetaka Tanaka, Senior Executive Managing Director of Rating and Information Inc. (R&I); and Patrick Bolton, David Zalaznick Professor of Business at Columbia Business School.

Mr. Peterson began the discussion by providing the audience with a brief background and evolution of credit rating agencies. He traced S&P's origins back to 1860 when it assessed railroads and canals, eventually evolving into analyzing bonds. Today, it is one of the largest rating agencies in the world with over 1400 analysts and 23 rating categories, and they have provided over 1.2 million ratings of an array of products across the world. He outlined S&P's key priorities as providing global credit benchmarks across industries and asset classes to enable economic development and growth of capital markets. Rating agencies assess

creditworthiness determined by both the ability and willingness to repay debts in full and on time. He explained how S&P strives to make ratings comparable and transparent across asset classes in many categories by publishing their criteria publicly and soliciting comments and feedback from participants. According to Mr. Peterson, S&P's unique advantage in the marketplace can be attributed to its forward-looking approach and global rating scale. S&P follows an 'issuer pays' business model and maintains separation of its analyst organization from its commercial organization in order to avoid a conflict of interest. Finally, he acknowledged the problems caused during the financial crisis due to the failure of rating agencies to provide accurate ratings of residential mortgages in the United States.



*Mr. Douglas Peterson*



*Mr. Hidetaka Tanaka*

Mr. Tanaka followed by explaining the landscape of rating agencies in Japan. R&I is the largest credit rating agency in Japan in terms of market coverage ratio; this is a unique situation globally since the U.S. big 3 agencies – S&P, Moody's, and Fitch Group – usually hold a stronger position than the local CRAs. Mr. Tanaka said that from an issuer point of view, this is because R&I charges its clients lower fees than its foreign competitors, and R&I's ratings were approximately one to two notches higher than those given by its international counterparts. He also said that, from an investor point of view, in order to maintain a strong position relative to its international counterparts for such a long time, R&I's high credit ratings must be accepted by investors. Two important factors in this regard are (1) the quality of credit ratings and (2) the rating methodologies which evaluate creditworthiness. Japanese investors trust credit ratings whose methodologies are based on Japanese experiences rather than U.S. experiences. Mr. Tanaka also said that appropriate

regulation is useful, but it is more important that the CRAs themselves make efforts to continuously improve their analysis capability and control systems to prevent conflicts of interest. In following, Mr. Tanaka called for more enhanced competition and investor supervision to improve the quality of rating agencies in Japan. More importantly, the CRA leadership needs to maintain a long-term management principle by contributing to the development of the capital market in Japan.



*Professor Patrick Bolton*

Professor Bolton gave the audience an academic perspective of how credit rating agencies play a critical role in supporting regulatory authorities in today's marketplace, and issues that plague them throughout the world. He explained how rating agencies are susceptible to mistakes and conflicts of interest because they do not operate in a vacuum. He then spoke about the two extremes in academic perceptions of credit rating agencies in which one side believes that they are reputational intermediaries, while others think of them as sellers of regulatory licenses. His personal opinion of credit ratings agencies is that they lie somewhere in between these two extremes. Professor Bolton then went on to explain how rating agencies contribute to equilibrium distortions in the market through three channels. First, high competition among agencies reduces market efficiencies because each agency aims to provide ratings that are not largely different from those given by their competitors. This prevents objective and



Hidetaka Tanaka and Doug Peterson converse

independent assessments of creditworthiness. Second, credit rating agencies are more prone to grant higher ratings to clients during boom times and be more conservative during recessions. In this way, they amplify business cycles rather than being indifferent to them. Finally, rating procedures for structured products are not the same as procedures for other credit instruments, but rating agencies

follow a standardized criteria and process to rate vanilla credit instruments as well as structured products. This results in market distortion.



*Audience member Fred Katayama of Thomson Reuters speaks during Q&A*

Before opening the floor to audience questions, Professor Bolton concluded his commentary by sharing his research on the subject and reforms to be included for credit rating agencies under the Dodd-Frank Act. His suggestions on regulatory intervention included changes to the business model by charging upfront payments from clients, as well as mandatory disclosure of every credit rating.

Hugh Patrick, Director of Center on Japanese Economy and Business (CJEB) at Columbia Business School, served as the moderator for the discussion. This event was organized by CJEB and co-sponsored by The Center for Japanese Legal Studies of the Columbia Law School. The symposium was part of CJEB's program, "The New Global Financial Architecture."



*Professor Hugh Patrick, Mr. Hidetaka Tanaka, Professor Patrick Bolton, and Mr. Douglas Peterson*