Chapter 15*

Regulation of Rating Agencies

Overview

Credit rating agencies (CRAs) are firms that offer judgments about the creditworthiness of debt instruments – specifically, their likelihood of default – that have been issued by various kinds of entities, such as corporations, governments, and most recently, securitizers of mortgages and other debt obligations. Beginning in the 1930s, financial regulation has mandated that the rating agencies be the central source of information about the creditworthiness of bonds in U.S. financial markets. Reinforcing this centrality was the Securities and Exchange Commission’s (SEC’s) creation of the Nationally Recognized Statistical Ratings Organization (NRSRO) designation in 1975 and its subsequent protective entry barrier around the incumbent NRSROs.

Most financial market analysts would agree that the current payment model of CRAs can lead to severe conflict of interests that tend to reduce the quality of ratings and the accountability of the rating agencies. The conflict of interest stems from not only who pays but also the fact that the rating agencies provide other revenue-generating services to rated companies. In the current “issuer pays” model, the issuer can troll NRSROs for the “best” rating. If the rating is inflated or of low quality, there is very little accountability, and in general, there is almost no incentive for rating agencies to compete on quality. Even if the model switched to “investor pays,” and the free rider problem of investors could be solved, it is not clear the conflict of interest would be eliminated. Many investors use ratings not to measure risk internally but to exploit prudential regulation. In the ratings market, there is a race to the bottom. Given that ratings are an important part of the regulatory process, this suggests there is a need for reform.

The Crisis

The three largest U.S.-based credit rating agencies -- Moody's, Standard & Poor's, and Fitch - - were clearly central players in the subprime residential mortgage debacle of 2007-2008. Their initially favorable ratings were crucial for the successful sale of the bonds that were securitized from subprime residential mortgages and other debt obligations. The sale of these bonds, in turn, was an important underpinning for the U.S. housing boom and bubble of 1998-2006. When house prices ceased rising in mid-2006 and then began to fall, the default rates on the underlying mortgages rose sharply, and those initial ratings proved to be wildly over-optimistic. The prices of the mortgage bonds cratered, wreaking havoc throughout the U.S. financial system and damaging the financial systems of many other countries, as well. The latest severe criticism comes after prior rating debacles involving the Asian crisis of the late 1990s and many fraud related, but fairly transparent, cases like Enron and WorldCom of the early 2000s. It is therefore no surprise that the legislative proposals for financial regulatory reform have included specific provisions for regulating the credit rating agencies.

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Current Proposals

The U.S. House and Senate have recently proposed legislation to strengthen the regulation of rating agencies and to restore investor confidence in the rating process.

Both the House and Senate bills present new rules for internal control and governance, independence, transparency, and liability standards. A key element in the Senate bill, which is also included in the House bill, is the establishment of an Office of Credit Ratings at the SEC to “administer the rules of the Commission (i) with respect to the practices of nationally recognized statistical rating organizations (NRSROs) in determining ratings, for the protection of users of credit ratings and in the public interest; (ii) to promote accuracy in credit ratings issued by NRSROs; and (iii) to ensure that such ratings are not unduly influenced by conflicts of interest.”*

Both bills also propose an internal control structure and annual ratings review process, which gives the SEC the right to suspend temporarily or to revoke the registration of an NRSRO with respect to a particular class or subclass of securities if the NRSRO “has failed over a sustained period of time to produce accurate ratings for that class of securities” and/or “the performance of the NRSRO has been significantly worse than the performance of other NRSROs.”†

Both bills address in some way the reliance on NRSRO ratings in financial regulation, independence of rating agencies, alternative business models, and methods of compensation.

(1) The House bill recommends the development of “rules providing for the establishment of a system of payment for each NRSRO that requires that payments are structured in a manner designed to ensure that the NRSRO conducts accurate and reliable surveillance of ratings over time, as applicable, and that incentives for reliable ratings are in place.”‡ As one example, the bill solicits a study on creating a system in which NRSROs are assigned on a rotating basis to issuers seeking a credit rating.

(2) The House bill explicitly calls for regulatory agencies to reduce their reliance on credit ratings and to develop separate “standards” of creditworthiness. This includes removing the language dealing with investment and non-investment grade.

To enhance transparency, both bills require that each NRSRO disclose considerable information on the procedures and methodologies used in estimating credit ratings and potential limitations of the ratings and the types of risks not included in the rating (such as liquidity, market and other risks). The House bill also goes into much more detail about how ratings should be publicized (there is a proposal for 3-digit ratings in the bill, where the first digit gives a "base case rating," and the second and third digits would reflect the impact of mild and severe stress tests). Furthermore, rating agencies are required to indicate the five key determinants of the rating and how sensitive the rating is to changes in these determinants.

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* Sec. 931 Regulation of Nationally Recognized Statistical Rating Organizations. See also H.R. 4173, Sec. 6002 Establishment of SEC Office.
† Sec. 931 Suspension or Revocation for Particular Class of Securities.
‡ H.R. 4183, Sec. 6002 Corporate Governance, Organization and Management of Conflicts of Interest.
The House bill removes the exemption from the fair disclosure (FD) rule for credit rating agencies.

In order to incentivize the rating agencies to do their job correctly and effectively, both bills define liability standards for knowingly or recklessly failure to investigate or obtain analysis from independent sources. The Senate bill requires qualifying exams and continuing education for rating analysts.

International proposals by the Group of Twenty (G20), Financial Services Authority (FSA), Financial Stability Board (FSB), International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), and the European Commission (EU) all call for stronger (and internationally coordinated) regulatory oversight of registered rating agencies, in order to ensure good governance and manage conflicts of interest, and require an increase in transparency and quality of the rating process. Similar to the U.S. House bill, the G20, FSA and EU proposals recommend the introduction of differentiated ratings for structured products. The OECD proposal focuses on increasing the competitiveness of the rating industry by lowering barriers to entry through simpler registration requirements and by encouraging unsolicited ratings to stimulate expansion of small credit rating agencies with new business models. In comparison with the U.S. House and Senate bills, the EU and OECD proposals appear to be more explicit in recommending changes in the business model of rating agencies (e.g., the EU proposal suggests an internationally coordinated switch from the “issuer pays” to “investor pays” model) and a reduction in the use of NRSRO ratings in financial regulation.

Evaluation of Current Proposals

The legislation proposed represents a major change in the way credit rating agencies would be regulated. The legislation, especially the House version, does address the two core problems: first, the central role of NRSRO ratings in financial regulation and the dominance of a few rating agencies in the industry; and second, the conflict of interest in the issuer pays model and how some investors use these ratings.

With respect to the role of NRSROs, on the positive side, the legislation is a clear attempt to hold the rating agencies accountable and to open up the system to higher quality information on the risk of securities. Specifically, we favor the following aspects of the proposals:

- Some regulatory oversight, since regulators are among the largest consumers of ratings through determining capital requirements of financial institutions and prudent rules for investors.
- The periodic audit of ratings provided by NRSROs and the ability of the SEC to rescind the NRSRO status based on its findings.
- The removal of specific language requiring regulatory agencies to rely on credit ratings. This is quite important, as ratings are not sufficient to measure the risk of fixed-income securities. That said, we endorse the idea that rating agencies provide more than a single

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* H.R. 4183, Sec. 6007.
† Both U.S. bills propose a GAO study looking into the desirability of these issues within a year of enactment of the legislation (see Sec. 937, Studies and Reports, and H.R. 3890, Sec. 7, Studies and Reports).
point estimate of risk with the addition of potential stressed outcomes, -- for example, beyond a single estimate of default risk, a specification of a reasonable distribution of different scenario outcomes. But the regulator should look to other sources for risk measurement. Beyond the default risk estimated by rating agencies, both the regulator and investor need to consider “model/misspecification” error, liquidity/funding risk, and market risk.

We have concerns, however, with the legislation with respect to the NRSRO status. While oversight of NRSROs is needed, some of the provisions are quite onerous in terms of compliance, yet would appear to yield only small benefits. In practice, given their fixed-cost nature, this will impose a relatively heavier burden on innovative startup NRSROs, cementing the monopoly of the larger rating agencies. The amount of oversight should be streamlined. In addition, the success of the legislation depends on the ability of the SEC to implement oversight -- an area in which it has not been particularly successful. One suggestion would be to explore creating the equivalent of the public company accounting oversight board for rating agencies. Finally, holding the NRSROs accountable introduces the notion of legal liability. While legal liability will clearly increase their accountability and thus improve their “behavior,” it may impose considerable costs on the system. By construction, almost any ex ante credit rating is wrong ex post upon default of the issuer. This could lead to frivolous lawsuits.

With respect to the current “issuer pays” model, the legislation does little to prevent ratings shopping -- the process whereby asset issuers shop around for the highest possible rating. While the proposal to force more disclosure of preliminary ratings sounds like a step in the right direction, it is easily circumvented. Investment banks are well aware of the methodologies that raters use and can figure out which agency is likely to offer the highest rating. Imposing more uniformity on ratings -- by penalizing agencies that perform worse than their peers or by dictating ratings methodologies -- may reduce the variety of ratings. However, by making ratings more similar, these measures also diminish the additional information content of multiple ratings, which may leave investors -- and more importantly regulators -- less well-informed.

A reform that could reduce the scope for ratings shopping, without compromising agencies’ willingness to voice a diversity of opinions, is to have the SEC choose a rating agency, either at random or according to expertise, to rate each asset. Removing issuers’ choice of rating agency diminishes the scope for ratings shopping and removes the incentive for agencies to attract business by offering favorable ratings. If the SEC uses expertise as a criterion, this reform will also more likely spur competition among agencies to produce a higher-quality product. We are pleased that the House bill explicitly calls for a study of such a proposal.

There is little discussion in either bill of the problem that ratings are currently used by some investors to conduct regulatory arbitrage -- that is, simultaneously to take excessive risk while adhering to regulator’s safety standards because of the NRSROs’ overly optimistic rating. This suggests that alternative models, such as “investor pays,” may suffer from similar abuses and not provide a solution to the rating agencies’ problem. The House legislation’s requirement that the sole reliance on ratings by regulatory agencies be removed is one way to solve this problem.
As a final note, the House bill’s removal of the FD exemption for rating agencies will clearly reduce the monopoly power of the NRSROs, but also lead to unintended consequences. Empirical evidence suggests that the removal of the exemption from Reg FD will reduce the information content of rating changes, and thus may reduce the efficiency of financial markets.