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Different Actions Needed on Credit Rating Agencies

The strategy being proposed by the SEC to better regulate credit rating agencies (CRAs) shifts the burden to investors and users of the ratings, forcing them to judge the quality of the ratings before making their investment decisions. A better approach would be to professionalize CRAs in much the same way as public accountants, dentists, or doctors. Establishing an oversight body that functions like the PCAOB in public accounting would foster improved quality among CRAs and help users feel more secure in relying on the ratings directly.

Before 2006, no governmental agency or private-sector body had any oversight over how the critically important functions of the credit rating industry were performed. The Credit Rating Agency Reform Act of 2006 designated the Securities & Exchange Commission (SEC) as the enforcement body. Previously, in 1975, the SEC deemed certain firms as "nationally recognized statistical rating organizations" and required a rating from one of those firms before a corporation could issue its debt instruments to the public.

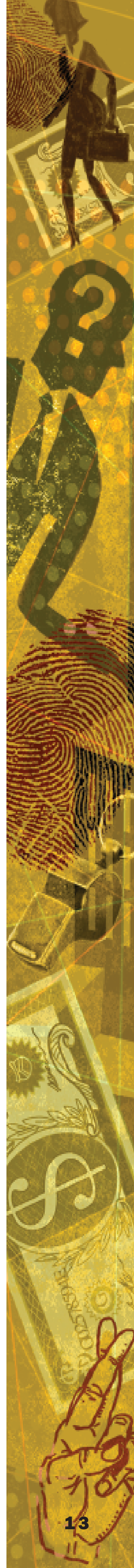
Ratings of bond investments held by commercial banks and thrift institutions are also embedded in their various regulatory structures. Lower-rated bond assets require these institutions to hold a greater amount of reserves. To this day, unofficial "ratings" of equity securities continue to be determined by securities analysts employed by investment banks, brokers, and others.

Reguating CRAs

The SEC proposed its first series of rules designed to regulate credit rating agencies (CRAs) in June and July 2008. The new rules were intended to address mounting concerns about the integrity of credit ratings and the methodology and procedures used to determine ratings during the burgeoning crisis of defaults in securities supported by subprime residential mortgages. Originating banks either sold risky mortgages to government-backed Freddie Mac and Fannie Mae or had them collateralized by investment banks into mortgage-backed securities (MBS), a type of collateralized debt obligation (CDO). These instruments were sold to investors all over the world. In spite of their risky nature, the selling banks worked with a CRA to structure an investment product that would merit an AAA (or highest) credit rating, denoting almost negligible risk of default. The unexpectedly high default rate on AAA-rated CDOs is believed by many to be a major cause of the global banking and financial crisis.

The most important final rule the SEC issued in December 2008 from its initial regulatory proposals prohibits CRAs from structuring the details of investment products they later rate. Additional rules include a prohibition on gifts over $25, a rule that forbids the CRA employee who determines a credit rating to negotiate or discuss the fee paid for the rating, and rules requiring agency record keeping, including the rationale for any material difference between the final rating of a structured financial product, such as a CDO, and the rating implied by a quantitative model. You might ask, however, how the SEC is enforcing these rules.

The next regulatory activity by the SEC took place in February 2009, when several more of the proposed rules were adopted. These require CRAs to provide an additional annual report; disclose enhanced performance measurement statistics and methodologies used to rate investment products; perform additional record keep-



ing; and publicly disclose after six months a random sample of 10% of the ratings histories of credit ratings paid for by the sponsor, underwriter, or issuer.

The enhanced disclosure of rating methodologies specifically includes how information about asset verification is relied on in determining credit ratings; how assessments of the quality of originators of assets play a part in determining credit ratings; and how frequently credit ratings are reviewed and whether different models or criteria are used for ratings surveillance than for determining initial ratings.

Fostering Accountability

The SEC also issued new proposed rules in February 2009 "to accomplish even more of the Commission's objective of providing information to the marketplace in order to gauge the accuracy of ratings over time." The final rule and the new proposals are "designed to foster accountability and comparability—and hence, competition—among CRAs."

This strategy is based on the possibly seriously flawed premise that investor users of credit ratings will be able—and will take the time—to read, evaluate, and digest the wealth of new information being made available and then make an informed decision as to the quality of the rating and CRA. The SEC says its intent is "to tap into the expertise and flexibility of credit market observers and participants to create better and more useful means to compare issuer-paid credit ratings."

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The rules proposed in February describe additional methods for dealing with conflicts of interest resulting from CRAs being paid by arranger/issuers of structured finance products:

1. CRAs hired to perform credit ratings for structured finance products would need to disclose to other CRAs (and only other CRAs) the deals for which they were hired;
2. The arrangers would need to provide the CRAs they hire with a document representing that they will provide to other CRAs the same information given to the hired CRA; and
3. CRAs seeking to access information maintained by the CRA and the arrangers would need to furnish the SEC an annual certification that they are accessing the information solely to determine credit ratings and will undertake to use that information to determine a minimum number of competitive credit ratings using the information.

The SEC has also embarked on a strategy to diminish reliance on credit ratings. Over the years, the credit judgment of CRAs has become embedded in countless laws, private contracts, and regulatory protocols, particularly in the financial services industry.

SEC Commissioner Kathleen Casey said in a February speech that it was imperative to address "the oligopoly in the rating industry" and overreliance on ratings in the SEC's rules. The oligopoly portion seems disingenuous in view of the fact that there are only four registered auditing firms that perform virtually all of the audits of large public companies. The SEC didn't object to the mergers that diminished the numbers of the old "Big 8" firms.

The rush to deemphasize the importance of credit ratings and to ask users to judge the quality instead of working to improve the overall quality of ratings seems particularly unwise. This is analogous to asking investors to avoid reliance on professional audit opinions because some have proven to be unreliable. A better strategy is to professionalize the task of credit raters so that users will feel more secure in relying on the ratings.

The use of legalistic rules to try to demand ethical behavior in the face of financial conflict has failed in the past and is likely to fail again in the future. Trying to force firms to develop "competitive" ratings by requiring an annual certification that they have done so seems to be fraught with loopholes. Instilling greater professionalism into the CRA industry with strict SEC oversight to assure it is in place appears to be a much better strategy to ensure ratings quality rather than encouraging competition without setting any standard of quality to which CRAs should aspire. CRAs have never been held accountable for their actions in setting credit ratings that users rely on. The new rules seem to make this even less likely.

Professionalize the Industry

A much better alternative to fostering competition among different credit rating firms is to professionalize the entire industry, much like public accounting, medicine, or dentistry. The added requirements for CRA actions continue to place the burden of evaluating the quality of the final product—the rating—on the user or investor. Following the example of the independent auditing profession would seem to be more appropriate. In that case, the Public Company Accounting Oversight Board (PCAOB) sets auditing standards that must be followed by auditing practitioners so that the ultimate product—the audit report—can be readily understood and relied upon by readers/users. The SEC (in collaboration with the Commodity Futures Trading Commission (CFTC) until the very similar functions of the two groups are combined) could set up an oversight body like the PCAOB that would set methodological and ethical standards for the proper preparation of credit ratings and then police CRA firms to be sure the standards are being followed.

In June 2008, the Chartered Financial Analyst Institute (CFAI), a 98,000-member global independent professional organization that confers the Chartered Financial Analyst (CFA) designation on individuals who meet its standards, asked its members, "Should CRAs group themselves into an international standard-setting and monitoring body of all stakeholders with powers of enforcement—i.e., a self-regulatory organization?" Nearly 65% of respondents who had an opinion voted "yes."

If the SEC doesn't want to professionalize the critically important function of rating credit instruments directly, it should at least oversee the establishment of a self-regulating organization of stakeholders that would do so. **SF**

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