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# Credit Rating Should Be Improved, not Discarded

**Regulatory downgrading of the role of credit raters is misguided. Development of ethical and professional standards would make information needed by investors more useful and reliable.**

The culpability of credit rating companies in contributing to the financial crisis of 2008-2009 has been widely debated without conclusive agreement. After months of hearings and study, the January 2011 *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (FR) was adopted only by a vote of 6 to 4. The report concluded that "the failures of credit rating agencies (CRAs) were essential cogs in the wheel of financial destruction" and that "the three credit rating agencies were key enablers of the financial meltdown."

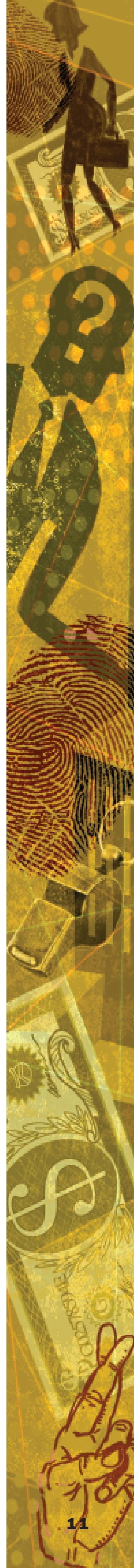
Despite the many criticisms leveled at CRAs by investors, regulators, and Congress for issuing high ratings on debt that didn't deserve it, none of the agencies has yet been sued successfully for damages. In November 2011, however, a federal judge ruled in a New Mexico case that actions of CRAs aren't always protected from lawsuits under the First Amendment to the U.S. Constitution. This ruling may open the door to more litigation directed at the CRAs, who have long contended that their ratings constituted "free speech."

Regulation of CRAs has been overseen on a global basis by the International Organization of Securities Commissioners (IOSCO), of which the U.S. Securities & Exchange Commission (SEC) is a member. In September 2003, IOSCO published *Statement of Principles Regarding the Activities of Credit Rating Agencies*, which was intended to "state high-level objectives for which ratings agencies, regulators, issuers and other market participants should strive in order to improve investor protection and the fairness, efficiency and transparency of the securities markets and reduce systemic risk." The four principles address (1) quality and integrity in the rating process, (2) independence and conflicts of interest, (3) transparency and timeliness of ratings disclosure, and (4) confidential information. Although ethics issues are inherent in each of the principles, the second principle seems most important. It states:

"CRA rating decisions should be independent and free from political or economic pressures and from conflicts of interest arising due to the CRA's ownership structure, business or financial activities, or the financial interests of the CRA employees. CRAs should, as far as possible, avoid activities, procedures or relationships that may compromise or appear to compromise the independence and objectivity of credit rating operations."

Although no one would argue with these concepts, their effect on CRA performance depends on how well they are implemented. IOSCO issued additional guidance in the form of code of conduct fundamentals for CRAs in December 2004, and an IOSCO CRA Task Force issued an updated version of the Code to deal with issues of structured finance in May 2008.

The final report, *Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies*, was published by IOSCO in February 2011. This report outlines the components of CRA regulatory programs in various jurisdictions around the world and describes the various ways CRA regulatory programs promote the objectives of the IOSCO CRA principles. Implementation has proceeded



slowly in most jurisdictions.

The most significant implementation recommendations by a nongovernmental body to improve CRA ethics and compliance issues were contained in the CFA Institute's Centre for Financial Market Integrity proposal for reforms to the European Union, published in 2008 (www.cfainstitute.org/about/press/release/Pages/02052008_26508.aspx). The CFA Institute is the global association of investment professionals that awards the Chartered Financial Analyst and Certificate in Investment Performance Measurement. The recommendations to the EU included (1) creating an executive-level compliance officer position at CRAs to ensure implementation and enforcement of the IOSCO code of conduct fundamentals for credit rating agencies and (2) requiring complete adoption of the IOSCO code to claim compliance.

In the United States, regulation of CRAs—legally referred to as Nationally Recognized Statistical Rating Organizations (NRSROs)—has rested with the SEC. As part of the Sarbanes-Oxley Act, the SEC developed a report titled "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets." Congress subsequently passed the Credit Rating Agency Reform Act of 2006 (CRARA), which defines the term NRSRO and provides authority for the SEC to implement rules for registration, recordkeeping, financial reporting, and oversight of CRAs.

Under CRARA, a credit rating agency seeking to be treated as an NRSRO must apply for and be granted registration with the Commission and make public in its application certain information to help people assess its credibility. It must also agree to implement procedures to manage the handling of material nonpublic information and to mitigate conflicts of interest. In addition, CRARA provides the authority to prescribe the records an NRSRO must maintain and retain as well as the financial reports it must furnish.

In the aftermath of the financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) of 2010 included a provision that requires each federal agency to review how its existing regulations rely on credit ratings as an assessment of creditworthiness. At the conclusion of this review, each agency is required to remove these references and replace them with alternative standards that the agency determines are appropriate. Pursuant to this mandate, the SEC adopted final rules in July 2011 eliminating most of the previously required credit rating information in public offerings of debt securities using short form or shelf registrations.

Some of the SEC's rationale for reducing reliance on credit ratings is contained in the cost/benefit analysis section of its July adopting release, which states that issuers of debt securities "will benefit from not having to incur the associated costs of obtaining a credit rating to the extent that they decide not to obtain a credit rating for other uses." Further, "As a result, these rules could lessen the bargaining power rating agencies have with issuers, potentially lowering the cost of obtaining ratings." In addition, "the removal of a provision in our forms requiring the use of a credit rating to establish eligibility for a type of registration generally reserved for widely followed issuers obviates a market externality that may have constituted a barrier to entry to potential competitors seeking to develop alternative methods of communicating creditworthiness to investors…and therefore may increase competition in the financial services sector."

These stated benefits seem limited, obscure, and problematical. The standards prescribed by DFA that would seem to be most beneficial to investors would be for the SEC to mandate professionalizing the CRA industry. With considerable input from the financial services industry, it should set specific "generally accepted" standards for performing the work necessary to express a credit opinion and for how that opinion should be expressed. It should also prescribe adequate controls to ensure quality and provide assurance that the controls are effective.

The SEC began the professional standards-setting process in May 2011 by issuing a 541-page rules proposal dealing with the various aspects of DFA that affected CRAs.

For guidance in applying the *IMA Statement of Ethical Professional Practice* to your ethical dilemma, contact the IMA Ethics Helpline at (800) 245-1383 in the U.S. or Canada. In other countries, dial the AT&T USADirect Access Number from www.usa.att.com/traveler/index.jsp, then the above number.

The proposed rules requested commentary in answer to 20 questions about the internal controls a CRA should have. The proposal also requested commentary on what processes CRAs should be required to maintain on a number of other subjects, including conflicts of interest relating to sales and marketing; a look-back provision requiring CRAs to modify opinions in light of later events; fines and penalties; the subject of public disclosure about the performance of credit ratings; credit rating methodologies; the form and certifications to accompany credit ratings; third-party due diligence for asset-backed securities; standards of training, experience, and competence; universal rating symbols; and the annual report of the designated compliance officer. Effective implementation of sound processes in all of these areas should increase the quality and reliability of credit rating tools, which appear to be very valuable to investors.

The most important aspect of the entire rulemaking process is ensuring that ethical principles are being followed in every aspect of every CRA's operations. Legal compliance can't succeed without ethical underpinnings.

**Questions:**

1. Is there sufficient agreement in both the CRA industry itself as well as the investors who use its product to enable the SEC to develop consensus on the many issues set forth in the SEC proposed rule release?
2. Is the governmental regulatory approach the most effective strategy to assure investors of reliable credit ratings?
3. Will Congress adequately fund the significant resources required by the SEC to both develop the details of its regulatory approach and implement long-term supervisory efforts? **SF**

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