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Reining In the **Credit Ratings** Industry

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THE REFORM OF CREDIT rating agencies is sure to occupy a central place in the regulatory and legislative agendas of 2010. While the full extent of these changes remains to be seen, they will likely represent a turning point in the history of this troubled part of the financial services sector.

Few dispute that some kind of reform of the credit rating industry is long overdue. In the wake of the financial crisis of 2007 and 2008, a broad consensus has developed that credit rating agencies failed in their critical function of assessing the creditworthiness of companies and financial instruments.

The evidence of systemic failures in credit risk analysis was everywhere. Just months preceding the collapse of Lehman Brothers, the three top credit rating agencies gave the company investment grades of A or higher. The rating agencies' assessments of toxic securities backed by subprime assets were even more suspect. In e-mail comments uncovered in a recent SEC investigation, one rating analyst suggested that her firm's model did not capture "half" the risk in a deal it rated, and that the deal "could be structured by cows and we would rate it."

A Brief History of Credit Rating

The roots of the systemic problems in the credit ratings industry lie in the history of credit rating practices in the United States.

Credit rating agencies evolved as a means to permit investors to evaluate the creditworthiness of a financial instrument without having to rely on potentially self-serving representations made by the instrument's seller. This independence was ensured by the fact that the ratings agencies' only allegiance was to investors, who paid subscription fees to get access to ratings. However, beginning in the 1970s, ratings agencies came to be paid on a fee-for-service basis by the very companies whose issuances were being rated.

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This new compensation structure significantly undermined the independence of ratings agencies, in that each one was now paid by the issuers of the instruments that were being rated, and they would be paid only if the instruments they rated were actually offered for sale. This arrangement was rife with potential conflicts of interest, in that the agencies now had a financial incentive to offer high ratings in order to secure business.

By the mid-1970s, Congress was aware of this potential pitfall. In an effort to discourage the spread of unscrupulous agencies that might sell good credit ratings to the highest bidder, in 1975 Congress designated Moody's Investor Services, Standard & Poor's Ratings Services and Fitch Ratings, Ltd. as nationally recognized statistical rating organizations (NRSROs), the only organizations whose ratings may be used to comply with federal regulations relating to bank and broker capital. See Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirement for Certain Brokers and Dealers, Release No. 34-11497 (June 26, 1975), 40 FR 29795 (July 16, 1975).

The emergence of structured finance products only exacerbated the potential for conflicts of interest. Beginning in 2003 there was a dramatic increase in the market for structured finance ratings, making revenue from these ratings an important source of growth for credit rating agencies. Moreover, because these agencies collaborated closely with the issuers of structured finance products to engineer instruments, there existed a greater opportunity for an issuer to exert pressure on an agency to give good ratings.

It seems likely that these conflicts of interest left credit rating agencies with little incentive to ensure that their ratings procedures produced accurate assessments of risk. A possible link between the subprime crisis and flawed procedures employed by the credit ratings agencies was explored in detail in the SEC's July 2008 "Summary Report of Issues Identified in the Staff's Examinations of Select Credit Rating Agencies."

In the Summary Report, the SEC concluded that the disconnect between ratings and actual risk was greatest with instruments that had significant exposure to the subprime market. The Summary Report determined that this was at least in part because the models that the agencies used to assess risk for these instruments looked

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only to performance of mortgage loans in periods when the real estate market was booming, often during time periods before the subprime market even existed, which had the effect of artificially inflating the ratings given to recently issued residential real estate backed instruments.

Rectifying Past Wrongs

Despite the possible links between the actions of the agencies and the catastrophic collapse of mortgage-backed securities, there is presently little chance that investors injured by reckless or misleading ratings practices could seek compensation via private litigation under the federal securities laws. When a rating is used in connection with a registered offering, Rule 436(g) under the Securities Act of 1933 currently exempts NRSROs from liability.

Nevertheless, in both the European Union and the U.S., politicians and regulators have been inspired by the crisis to undertake systematic reforms of the credit ratings industry.

The European Union has already adopted new regulations that aim to ensure "independent, objective and of adequate quality" ratings by implementing a regime for registering, regulating and supervising credit rating agencies. Under the new regulations, all rating agencies that wish their credit ratings to be used in the European Union will need to apply for registration with the Committee of European Securities Regulators (CESR) and be supervised by it and the relevant home member state. Registered rating agencies are subject to new, legally binding rules that prohibit agencies from offering advisory services, and enhance disclosure and transparency requirements

regarding the models and methodologies on which they base their ratings.

The EU regulations also provide that credit rating agencies are not allowed to rate financial instruments if they do not have sufficient information on which to base their ratings. The agencies are required to create an internal body to review the quality of their ratings and to have at least two independent directors on their boards at least one of whom should be an expert in securitization and structured finance. The board's compensation must not depend on the business performance of the rating agency, and the members must be appointed for a single term of office that can be no longer than five years and can only be dismissed in case of professional misconduct.

The regulations also allow for the withdrawal of registration and initiation of criminal proceedings against agencies that are in violation of these provisions.

In the U.S., legislative and regulatory proposals to reform the credit rating industry have been comparatively modest.

On Oct. 28, 2009, the House Financial Services Committee passed H.R. 3890—Accountability and Transparency in Rating Agencies Act, a bill introduced by Congressman Paul Kanjorski (D.–Pa.). The Kanjorski bill, built on draft legislation that the Obama administration sent to Congress in July, contains provisions designed to reduce conflicts of interest at NRSROs by barring them from selling consulting services to issuers whose debt or creditworthiness they are already rating, and by imposing new duties on compliance officers at each NRSRO to monitor and manage the many conflicts of interest inherent in the industry.

The Kanjorski bill proposes to substantially increase the SEC's role in supervising the credit rating agencies. The bill would create an office in the SEC to oversee the agencies and their ratings. The draft legislation also requires at least yearly reviews by the SEC of the agencies' practices and internal functions, including newly required disclosures about how issuers pay rating agencies. The SEC is allowed to impose fines on those that fail to meet acceptable internal risk controls. The bill also would require the SEC to issue new rules to increase the disclosure of information on both initial ratings and subsequent comparable ratings.

The Kanjorski bill also contains a key provision clarifying the ability of individuals to sue credit rating agencies that would likely permit more lawsuits by investors against agencies over flawed ratings. Under the provisions, if an agency failed to follow its own internal rules in assigning a rating, investors would be permitted to bring a private civil suit.

The proposed legislation would also require each NRSRO to have a board with at least two independent directors with the duty to oversee policies and procedures aimed at preventing conflicts of interest and improving internal controls, among other things.

If Kanjorski's bill were enacted, it would require that when certain NRSRO employees go to work for an issuer, the NRSRO would have to conduct a review into the ratings in which the employee was involved to ensure that procedures were followed and proper ratings were issued. The bill requires NRSROs to report such investigations to the SEC, and for the SEC to make such reports available to the public.

Finally and perhaps most controversially, Kanjorski's proposed legislation calls for removing some references in federal law that mandate use of NRSROs' credit ratings. While such an action might lessen investors' exclusive reliance on credit ratings to assess the quality of companies and financial instruments, critics point out that the proposal risks opening the ratings market to a flood of smaller agencies that may compete with one another to offer more favorable ratings to attract business.

Legislation recently introduced by Senator Christopher Dodd (D.–Ct.), titled the Restoring American Financial Stability Act of 2009, would erode the statutory immunity for credit rating agencies even further than Kanjorski's bill. Under Dodd's bill, investors could bring actions against ratings agencies for a knowing or reckless failure to investigate or to obtain analysis from an independent source.

On the Regulatory Front

The regulatory agenda for 2010 will also be crowded with reforms of the ratings industry.

On Sept. 17, 2009, the SEC voted to approve six measures aiming to improve the quality of credit ratings. According to the SEC, these measures were designed to require greater disclosure, foster competition, help to address conflict of interest, shed light on rating shopping, and promote accountability.

> The SEC's proposal to adopt amendments that **eliminate references** to nationally recognized statistical rating organization credit ratings in certain SEC rules and forms has been met with **largely negative responses** from those offering comments.

Under the new proposed rules or amended rules, NRSROs would be required to disclose their ratings action histories regarding any ratings, including upgrades, downgrades, affirmations and withdrawals that the NRSROs initially made as of June 26, 2007.

Second, when an issuer asks an NRSRO to rate a structured finance product and so reveals information on those products to the NRSRO, it would be required to also provide that same information to all other NRSROs. The goal of this measure is to foster competition by enabling competing credit rating agencies the ability to offer unsolicited ratings of those products. Some analysts have warned, however, that giving non-public information such wide circulation may risk creating new incentives for insider trading.

Third, NRSROs would be required to provide the SEC with an annual compliance report outlining the steps taken by the compliance officer to administer the NRSRO's policies and practices to ensure compliance with the securities laws, describing any material issues identified and the steps taken to solve them, including a list of the people within an NRSRO who were advised of those compliance issues. In addition, in order to mitigate the conflict of interest issue stemming from issuer-pay model, the proposed regulation requires that information regarding potential sources of revenue-related conflicts be publicly disclosed on NRSROs' Web sites and their employees be banned from rating or determining a fee for the same product.

Fourth, the proposed rules require that when ratings are used in connection with selling registered securities, disclosure of what the credit rating covers and any material limitation on the scope of the rating must be revealed in the registration statement. Required information also includes who paid for the credit rating and whether any "preliminary ratings" were obtained from other rating agencies in order to identify where there might have been "rating shopping."

Fifth, the SEC voted to seek public comment on eliminating a current provision that exempts NRSROs from being treated as experts when their ratings are used in connection with a registered offering. With this exemption withdrawn, the ratings agencies would no longer enjoy any statutory protection from liability for violations of federal securities laws.

Finally, the SEC also voted to issue a proposal to adopt amendments that eliminate references to NRSRO credit ratings in certain SEC rules and forms. This proposal has been met with largely negative responses from those offering comments, principally financial institutions and law firms. The common theme of their criticism is that elimination of NRSRO ratings would remove an important investor protection, weaken investment standards, and pose a risk to the long history of stability of the market.

Surprisingly, Moody's and S&P have suggested in their own comments that they support the long-term goal of eliminating references to the NRSROs' ratings, as they fear that reliance on their ratings may subject them to a higher regulatory burden in the future. They are concerned that the regulators would eventually intrude into the content of the ratings, which in turn may homogenize the ratings methods employed by all agencies. Nevertheless, the agencies warn that efforts to remove references to NRSROs from regulations must take place slowly, in that any immediate change would disrupt the already fragile markets.

Whatever form the regulatory and legislative reforms of the credit rating industry take, 2010 is sure to represent a watershed moment for investors and the markets alike. Whether these reforms will actually prove to be effective at preventing future financial crises is still open to lively debate.

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