



Rethinking Regulation of Credit Rating Agencies:

An Institutional Investor Perspective

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Executive Summary

Credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs) are used to fulfill a wide range of regulatory and contractual requirements in the United States and abroad. Over time, NRSRO ratings have become woven into federal and state laws, regulations, and private contracts. Ratings dictate the net capital requirements of banks and broker-dealers, the securities money market funds may hold, and the investment options of pension funds. As legal requirements for ratings have proliferated, the rating agencies have evolved from information providers to purveyors of “regulatory licenses.” A regulatory license is a key that unlocks the financial markets. Credit rating agencies profit from providing ratings that unlock access to the markets, regardless of the accuracy of their ratings.

The global credit crisis has called into question this role of rating agencies as financial gatekeepers. The debacle was fueled in part by credit rating agencies “licensing” complex, risky financial instruments with triple-A ratings they did not deserve. Both regulators and institutional investors relied on those ratings, to their peril.

In response, policymakers in the United States and abroad are considering measures to make rating agencies more accountable and rating processes more transparent. Proposals to overhaul credit rating agency regulation run the gamut, from increased disclosure requirements to removing references to credit ratings in rules and regulations.

Given the abysmal performance of rating agencies, widespread reliance on ratings is no longer warranted. However, it is not feasible or practical for regulators and investors simply to stop using ratings. Mandates to use ratings have become part of the fabric of financial markets, and cannot be unwoven instantaneously.

There is an immediate need, however, to revamp the regulatory framework surrounding credit rating agencies. This paper offers an institutional investor perspective of the pros and cons of several proposals for redesigning credit rating agency regulation. It focuses on two areas of primary importance — oversight and accountability — and offers specific recommendations in both areas.

Oversight: Congress should create a new Credit Rating Agency Oversight Board (CRAOB) with the power to regulate rating agency practices, including disclosure, conflicts of interest, and rating methodologies, as well as the ability to coordinate the reduction of reliance on ratings. Alternatively, Congress could enhance the authority of the Securities and Exchange Commission (SEC) to grant it similar power to oversee the rating business.

Accountability: Congress should eliminate the effective exemption of rating agencies from liability and make rating agencies more accountable by treating them the same as banks, accountants, and lawyers.

As financial gatekeepers with little incentive to “get it right,” credit rating agencies pose a systemic risk. Creating a rating agency oversight board and strengthening the accountability of rating agencies is thus consistent with the broader push by U.S. policymakers for greater systemic risk oversight. Over the long term, other measures for assessing credit risk may become more acceptable and accessible to regulators and investors. Meanwhile, a more powerful overseer and broader accountability would help reposition credit rating agencies as true information intermediaries.

Background

Three players have long dominated the credit rating business: Fitch Ratings, Moody's Investor Service, and Standard & Poor's Ratings Services. Fitch's market share, however, is significantly smaller than its two main rivals. Despite the presence of seven additional NRSROs, this trio is responsible for 98 percent of all outstanding ratings issued by NRSROs. And because only NRSRO ratings can be used to fulfill certain regulatory requirements, these three rating agencies wield immense, quasi-governmental power.

NRSROs have been the subject of intense criticism because of the part they played in the financial crisis. Just months ago, S&P, Moody's, and Fitch gave high investment grade ratings to 11 big financial institutions that later faltered or failed. They rated AIG in the double-A category. They rated Lehman Brothers single-A a month before it collapsed. Until recently, the NRSROs maintained triple-A ratings on thousands of nearly worthless subprime-related instruments.

In June 2008, the SEC reported that its examination of the three dominant agencies had uncovered serious deficiencies in their ratings and rating processes. For example, one analyst expressed concern that her firm's model did not capture "half" of a deal's risk, and that "it could be structured by cows and we would rate it."¹ Legislators have held hearings criticizing the agencies, and regulators have recommended reforms.

Yet these credit rating agencies continue to play a central role as powerful and influential gatekeepers in global financial markets. It is hard to overstate the importance of the role of credit rating agencies and their letter ratings. Thomas Friedman, the *New York Times* columnist, expressed the prominence of credit rating agencies succinctly in 1996, well before the significant increase in the prominence of ratings and ratings-driven deals:

"There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful."²

Given the central role of ratings, it is worth rethinking a basic paradoxical question: Why are credit ratings and rating agencies so important if they are often so unreliable? This background section addresses this question. Then, the two following sections address the pros and cons of two major areas of reform: oversight and accountability.

From Information Intermediaries to Regulatory Licensors

Rating agencies began as information intermediaries, entities that step in to assess product quality when sellers cannot credibly make claims about product quality themselves. Information intermediaries function best when they have reputational capital at stake and will suffer a loss if their assessments are biased, negligent, or false.

In the early debt markets, credit rating agencies helped to bridge information gaps between bond buyers and sellers. In 1909, John Moody published his first *Manual of Railroad Securities*, in which he rated 200 railroad companies and their securities. Moody's insight was that he could profit by selling to the public a synthesis of complex bond data in the

form of single letter ratings: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C, in declining order of credit quality. These letter ratings were not designed to have any specific meaning, as might be the case for modern financial analysis. They were not, for example, designed to mark categories of percentages of expected probability of default or of recovery in the event of default. Instead, they were a rough compilation of disparate information about bonds that investors found difficult or costly to assess on their own.

Over time, however, rating agencies have shifted from selling information to selling “regulatory licenses,” keys that unlock the financial markets. This shift began after the 1929 crash, when regulators turned to the rating agencies, primarily Moody’s and S&P, for measures of bond quality in banking and insurance guidelines. Federal Reserve examiners proposed a system for weighting the value of a bank’s portfolio based on credit ratings. Bank and insurance regulators expressed the “safety” or “desirability” of portfolios in letter ratings, and used such ratings in bank capital requirements and bank and insurance company investment guidelines. States relied on rating agencies to determine which bonds were “legal” for insurance companies to hold. The Comptroller of the Currency made similar determinations for federally chartered banks.

The SEC’s introduction of the NRSRO concept in the mid-1970s further encouraged regulators to increase their reliance on ratings.³ During that same period, the NRSROs stopped selling ratings to investors and began charging the companies that issue the debt they rate. The issuer-pay model introduced significant new conflicts of interest — chiefly, the challenge for credit raters of impartially rating securities of companies that generate their revenues. But the rating agencies believed that they could manage these conflicts internally.

Regulators now mandate that institutions of all types pay heed to NRSRO credit ratings as a necessary step for regulatory compliance. Some rules require that certain investors can only buy bonds with high ratings. Other rules reduce capital requirements for institutions that purchase highly rated bonds. Without high ratings, bond issuers cannot access certain markets because they do not have a “license” from the NRSROs to comply with NRSRO-dependent regulations.

Regulatory dependence on ratings created higher demand for ratings and increasingly higher profits for NRSROs, even when their ratings proved spectacularly inaccurate. Too often, rating changes lagged the revelation of public information about rated issuers and instruments. Prominent examples included California’s Orange County and Enron, both of which received high credit ratings until just before they filed for bankruptcy protection. Even so, the rating agencies have been shielded from liability by their insistence that their ratings were merely opinions protected by First Amendment free speech privileges.

Rating agencies also began rating substantially greater numbers of issuers and increasingly complex instruments. But the resources expended per rating declined. As they expanded ratings to cover large numbers of structured finance products, including tranches of various collateralized debt obligations, some NRSROs neglected to divert resources to update rating models and methodologies or recruit additional staff needed to ensure quality. As a senior analytical manager at one of the big three rating agencies put it in a February 2007 e-mail: “We do not have the resources to support what we are doing now.”⁴

The Paradox of Credit Ratings

Paradoxically, the leading NRSROs have become more profitable even as the quality of their ratings has declined. Operating margins for some in recent years topped 50 percent; Moody's profit margins were higher than the margins of any other company in the S&P 500 for five consecutive years during the early 2000s. Moody's market capitalization was nearly \$20 billion at its peak; S&P was similarly profitable and large. The companies that owned NRSROs drew savvy investors, looking to profit from the reliable returns associated with the sale of regulatory licenses. Warren Buffet is a major investor in Moody's, and as of Dec. 31, 2008, held more than 20 percent of its outstanding common shares.

One explanation of this paradox is that profits from the sale of regulatory licenses do not depend greatly on the informational value of ratings. If regulators and private actors defer to private standard setters, those private standard setters will earn profits from that deference even if their standards are not useful. Over time, both regulators and private actors might decide to shift to alternative sources of information and analysis. However, to the extent they do not shift, the private standard setters will continue to prosper, even if their standards lack informational value.

Another explanation is that rating agencies have been effectively exempt from civil liability. With rare exceptions, rating agencies have not suffered damages from litigation even when they were negligent or reckless in issuing overly optimistic ratings. To some extent, the rating agencies' success in avoiding liability is due to legislative policy, such as the explicit statutory exemption from liability under Section 11 of the Securities Act of 1933 or the limitations on private rights of action in the Credit Rating Agency Reform Act of 2006. But the exemption also is due to a handful of judicial decisions accepting the rating agencies' assertion that ratings are merely "opinions," which, under the First Amendment, should be afforded the same protection as opinions of publishers.

The accountability of NRSROs has deteriorated so much that institutional investors now are vulnerable if they rely on credit ratings in making investment decisions. To the extent rating agencies are not subject to liability, an institutional investor's defense of reliance on ratings is weakened, because constituents can argue that ratings are less reliable when rating agencies are not accountable for fraudulent or reckless ratings.

Overall, this lack of accountability has impeded the ability and willingness of rating agencies to function as information intermediaries because they do not credibly pledge reputational and economic capital in the event they fail to perform their core function. But it also partially explains the paradox: Rating agencies that are insulated from liability have a more profitable, dominant franchise.

The paradox of credit ratings has persisted during the recent financial crisis. Even though ratings have plummeted in informational value, since portions of the U.S. government rescue efforts rely on them, ratings are more important than ever. Specifically, the Federal Reserve's \$1 trillion Term Auction Lending Facility (TALF) plan, which lends money to investors to purchase new securities backed by consumer debt, mandates that only securities rated by two or more major NRSROs are eligible for government support.

Moreover, when government officials anticipated the potential negative impact of AIG's announcement of quarterly earnings in March 2009, they implemented a fourth rescue package for the insurer and consulted privately with representatives of the dominant NRSROs, to be sure the plan would be attractive enough to avoid a downgrade of AIG, which would have killed the company. Because of overdependence on NRSROs, both regulators and investors were in a ratings trap.

Recent Efforts by Regulators

In response to several market crises over the last decade, regulators have tried to remedy some of the problems in the credit rating industry. The SEC and the International Organization of Securities Commissions (IOSCO), an organization representing dozens of global regulators that focuses on establishing standards of financial regulation, produced reports assessing the role of rating agencies in the markets.

After a series of hearings, Congress adopted the Credit Rating Agency Reform Act of 2006. While this act standardized the process for NRSRO registration and gave the SEC new oversight powers, it prohibited the SEC from regulating “the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings.” The act also stated that it “creates no private right of action.” The rating agencies supported this act, in part because its scope was so narrowly circumscribed.

More recently, many federal and state legislators and regulators have lambasted the rating agencies for their part in the financial crisis. Even the President's Working Group on Financial Markets, long a champion of deregulation and financial innovation, sharply criticized the flaws in the rating agencies' assessments of complex products and called them a “principal underlying cause” of the crisis.⁵ Lawmakers in the European Union have continued to push for the development of a new European credit rating agency regulatory authority.

In June 2008, the SEC released a report outlining serious deficiencies in the ratings process. It subsequently adopted new rules designed to increase the transparency of NRSRO rating methodologies, strengthen NRSRO disclosures of ratings performance, prohibit certain conflicted NRSRO practices, and enhance NRSRO recordkeeping. These rules reflected much political compromise. For example, regulatory review and scrutiny of NRSRO procedures were limited. Even the NRSROs' obligation to make publicly available their ratings histories was limited to a random sample of 10 percent of issuer-paid ratings for each class of ratings.

In December 2008 the SEC re-proposed rules governing the conduct of NRSROs. Specifically, the SEC proposed barring NRSROs from issuing ratings for structured finance products unless the information related to those securities was published on a password-protected Web site that other NRSROs could access, under certain conditions; other NRSROs would have to agree to provide and maintain ratings on 10 percent of the securities for which they tapped the Web site. The proposals also included a provision requiring complete disclosure of issuer-paid ratings and ratings histories.

The SEC shelved its proposal to eliminate requirements for NRSRO ratings in some of its own regulations. The proposal had received mixed views from investors. Many preferred a more incremental approach. This idea is discussed in more detail later in this paper.

Oversight

It is now widely accepted that the architecture of credit rating agency regulation needs reform. SEC Chairman Mary L. Schapiro recently stated: “To this end, allow me to highlight a few of the initiatives that I hope to pursue as priorities: Improving the quality of credit ratings by addressing the inherent conflicts of interest credit rating agencies face as a result of their compensation models and limiting the impact of credit ratings on capital requirements of regulated financial institutions.”⁶

These improvements require both a change in regulatory structure and new regulatory powers. Like other areas of financial regulation, the regulation of credit ratings has been piecemeal and is spread throughout numerous state and federal governing bodies, including securities, banking, and insurance. Ideally, improvements in regulatory structure would entail consolidation of credit rating regulation within one umbrella organization with additional responsibilities and new powers.

Regulatory Structure

One approach would be to create a single independent Credit Rating Agency Oversight Board (CRAOB), with a structure and mission similar to that of the Public Company Accounting Oversight Board (PCAOB). It could be a free-standing entity created by statute to oversee registration, inspections, standards, and enforcement actions related to NRSROs, just as the PCAOB oversees audit firms. The board also could encourage and facilitate the development of alternatives to NRSRO ratings among market participants. Congress should make this mission to facilitate the eventual removal of “regulatory licenses” explicit in authorizing the board.

Two alternative options to a free-standing rating agency oversight board would be to establish an office within the SEC strictly dedicated to the regulation of NRSROs, with enhanced powers, or to house oversight of credit rating agencies within the PCAOB. The functions and duties of a rating agency overseer are somewhat consistent with the mandate of the PCAOB, which was created to protect investors and the public interest by promoting informative, fair, and independent audit reports. Under the PCAOB approach, Congress would simply authorize additional funds for the PCAOB to establish these new functions, and pass legislation creating new PCAOB authority. However, integrating credit rating agency oversight duties into the PCAOB could present organizational and legislative challenges.

Ideally, a consolidated credit rating agency overseer would have two overriding characteristics: independence and specialized expertise. A free-standing board would require independent funding so that it would not depend on Congress or other agencies for frequent funding or decision-making. Initial funding could be in the form of an endowment. Alternatively, funding could be provided through required, periodic NRSRO user fees or transaction fees.

Securing reliable funding would be particularly important in order to offer salaries sufficient to attract high caliber board members. Board members should have specific expertise in assessing credit risk and, more generally, an understanding of financial markets, asset pricing, and alternative information sources and intermediaries.

Members of the board should be independent and appointed for limited terms. The appointment process should be designed to limit the potential for influence by the credit rating agencies, and board members should not be permitted to join NRSROs after their service.

Proponents acknowledge that the SEC recently has stepped up its oversight of the rating business. But many believe that the agency is not likely ever to be a bold enough regulator. They say the SEC has been reluctant to use its existing authority or request additional power from Congress and often has been captive to the ratings industry, which has lobbied strenuously against proposals to strengthen accountability and disclosure rules.

In addition, regulatory reliance on NRSROs beyond the SEC's authority limits the commission's ability to implement a coordinated approach to credit rating agency regulation. For example, even the SEC's proposal to eliminate ratings references in some of its own rules would have applied narrowly, and would not have affected regulatory reliance on ratings in banking and insurance regulations.

Critics of a free-standing rating agency oversight board, however, counter that more fragmentation of financial regulation would add more layers to the already complex web of financial market regulation in the United States. They also believe that the SEC already has the staff, expertise, and contacts to regulate rating agencies; they say it simply needs greater authority and resources from Congress.

Adding New Oversight Authority

Whatever structure the overseer takes, it will need additional legislative authority to implement its objectives.

Although the SEC recently has adopted new rules for credit ratings, the scope of its legislative authority is limited.

Below are several specific areas of oversight authority that could be expanded immediately. One approach would be to enumerate each of these areas in the adopting legislation. Alternatively, Congress might grant the board general oversight authority over NRSRO practices, and let the board adopt rules in each area. Again, the rating agencies might contend that such authority would infringe their free speech privileges; they frequently have made veiled threats to assert such a claim.⁷

Disclosure of Credit Rating Actions. A rating agency overseer should have the statutory authority to require significantly more extensive NRSRO disclosure, including a complete record of rating history, such as initial rating, upgrades, downgrades, placements on watch for upgrade or downgrade, and withdrawals.

Current disclosure proposals are more limited, in part because of questions about the scope of regulatory authority granted by the Credit Rating Agency Reform Act of 2006. For example, the SEC finalized new rules in February 2009 that require NRSROs to make available to the commission individual records for each of their outstanding credit ratings showing all rating actions. In addition, the rules require NRSROs to publicly disclose rating action histories in eXtensible Business Reporting Language (XBRL) format. However, they can delay disclosures for six months and must disclose rating action histories only for a randomly selected 10 percent of issuer-paid ratings. Similarly, in February, the SEC proposed requiring disclosure, on a 12-month delay, of all issuer-paid credit ratings issued on or after June 26, 2007. Under the rules adopted in February and proposals still pending, unsolicited ratings and subscriber-paid ratings are exempt from disclosure.

Congress should authorize the board to require that NRSROs disclose complete records to the public, not merely to the regulator. In addition, disclosure should extend to unsolicited ratings and subscriber-paid ratings. Current rules do not provide investors with the level of information necessary to assess and compare ratings and rating agencies. Securities included in one NRSRO's 10 percent disclosure pool are not necessarily included in other NRSROs' pools, thus making a true comparison between rating agencies impossible. Moreover, excluding unsolicited and subscriber-paid ratings from public analysis eliminates valuable data from market scrutiny.

Critics argue that requiring full disclosure for subscriber-paid ratings would undermine the business model of agencies that issue them. The rationale for bottling up information inside a regulatory authority, however, is not persuasive. Investors need greater transparency to be able to compile and analyze ratings and rating changes. Effective oversight of the credit rating business must include market oversight, which requires that investors have access to complete data regarding credit ratings.

Symbology. Symbology is a contentious topic. Although the oversight board should have the power to assess different categories of ratings and require NRSROs to use alternative symbology (e.g., numbers instead of letters, or letter subscripts) for ratings in different categories, it should take extreme caution before exercising that power.

In June 2008, the SEC proposed amendments to current regulations to require NRSROs to distinguish ratings on structured products by either 1) attaching a report to the rating itself describing the unique rating methodologies used in establishing the rating and how the security's risk characteristics differ from others (i.e., corporate bonds) or 2) using symbols unique to structured products only (i.e., numbers rather than letters). The SEC's intent was to spur investors to perform more rigorous internal risk analysis on structured products, thereby reducing undue reliance on ratings in making investment decisions. Although the commission has not addressed the proposals yet, in March 2009, the European Union moved forward on a proposal to require that rating agencies identify ratings on structured products, as well as unsolicited ratings, by different symbols.

Proponents suggest that alternative symbology could benefit investors in a number of ways. Particular letter ratings mean different things when applied to structured finance issuers vs. corporate issuers vs. municipal issuers. Different symbols for structured products could serve as a flashing light for investors, signaling that the securities' risk characteristics are more volatile than those of other securities. And at a basic level, different symbols for different classes of securities would notify users that the agencies used different methodologies to generate the ratings.

An additional advantage to requiring that NRSROs use letter ratings only for corporate bonds is that most regulations and investment guidelines then would refer only to corporate bonds. Securities rated using a new symbology would fall outside the scope of those rules. Thus, symbology reform could force a wholesale rewrite of the rules governing investments other than corporate bonds. It could remove "regulatory licenses."

Critics assert that if NRSROs were required to use different symbols to rate different categories of securities, the investing public would be more confused than informed. The rating agencies also contend that mandating different nomenclature for different classes of securities would violate their First Amendment protection.

A vital function of the board would be to consider market participants' diverse positions, evaluate the positive and negative consequences relating to credit rating symbols (including which classes of securities could or should be identified by unique symbols), and work with international regulators to mitigate confusion over inconsistencies in symbol regulation.

Methodologies. The board should have the authority to require greater disclosure of NRSRO methodologies. Flawed methodologies were a core reason NRSROs gave overly high ratings to complex structured finance instruments. Allowing investors the opportunity to analyze rating agencies' methodologies would serve as a vital market-based quality check.

Current SEC registration rules require minimal disclosure. Rating agencies' registrations are stale, and their descriptions of methodologies and procedures are opaque. It is not helpful for the rating agencies to release their general statistical methods and models if they do not also specify the assumptions in those models.

The board should focus on disclosures that would enable institutional investors to assess key underlying variables, such as expected probability of default. Letter ratings alone are not helpful. Indeed, the rating agencies admit that letter ratings are ordinal, not cardinal, in that they rank issues in order of relative credit risk, but do not specify any particular expected default. For example, according to S&P: "The definitions of each rating category also make clear that we do not attach any quantified estimate of default probability to any rating category."⁸ Yet the rating agencies use default probabilities in their models, and ratings reflect implied default probabilities, which can vary substantially from those implied by market prices.

Rating agencies contend that their methodologies are proprietary and that requiring detailed disclosure of their methodologies would promote free-riding, remove incentives for innovation, and leave the market with a smaller number of similarly derived credit ratings rather than a larger pool of ratings based on different methods of analysis. On balance, however, the likely benefits of enhanced disclosure far outweigh such objections.

Some critics assert that the board also should have substantive oversight of rating agency methodologies, as a quid pro quo for the benefits NRSROs enjoy from regulatory reliance on their ratings. The rating agencies might fiercely resist such authority and argue it would violate their First Amendment rights. Under pressure from the leading NRSROs, Congress explicitly excluded from the SEC's regulatory authority the ability to oversee rating methodologies.

Others believe NRSRO ratings are systemically important enough to the global market to warrant giving the board this authority. With such authority, the board could sanction rating agencies whose ratings consistently failed to meet or exceed an acceptable level of accuracy. The board could bar NRSROs from issuing ratings on new types of securities for which there is little historical data. It also could require NRSROs to use third-party due diligence services to ensure the accuracy of data used to establish ratings on complex securities. Such powers should be exercised cautiously and only after the regulator has investigated the potential costs and benefits.

Conflicts of Interest. New legislative authority also is needed to police NRSRO conflicts of interests and to investigate the extent to which conflicts of interest differ for issuer-pay NRSROs vs. investor-pay NRSROs (also referred to as subscriber-pay NRSROs). Section 15E(h)(1) of the Exchange Act requires an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed to address and manage conflicts of interest. Although Congress directed the commission in 2006 to issue final rules to prohibit or require the management and disclosure of conflicts of interest, the SEC has been reluctant to take full advantage of its power.

Some market participants have urged Congress to prohibit issuer-pay NRSROs altogether. This approach would eliminate the conflicts of interest associated with rating agencies receiving compensation from issuers of the securities they rate. But investor-pay NRSROs are subject to potential pressure from clients to slide ratings one way or another.

For example, institutions that can only invest in highly rated instruments might pressure a rater to guarantee a particular security gets an investment-grade rating. Others might press the rating agencies for lower ratings in hopes of receiving higher returns.

An alternative to a blanket prohibition of the issuer-pay business model would be to require disclosure of business relationships and to prohibit NRSROs from engaging in business activities other than issuing ratings. Auditors face similar restrictions. Both the SEC and the rating agencies recognize that conflicts of interest are endemic in the rating process and the SEC has stated that “NRSROs that are compensated by subscribers appear less likely to be susceptible to ‘ratings shopping’ or reducing quality for initial ratings to induce revenues.”⁹ The new board should consider whether increased disclosure rules and prohibitions on ancillary business activities should apply equally to all NRSROs.

Fees. Many investors believe the overseer should require rating agencies to disclose their fees. They also call for a reexamination of the compensation structure of NRSROs.

At a minimum, the board should have the power to require NRSROs to publicly disclose fee schedules and individual rating fees for every rated deal. The rating agencies currently disclose only summary information regarding fees, and they do not make data available for fees on individual deals. Fee transparency would increase incentives for ratings accuracy by creating a new method of competition in the ratings business. Ratings “shopping” based on fee levels would not present the same conflicts and challenges as ratings shopping based on rating levels. Moreover, such disclosure could also reveal potential conflicts of interest arising from an issuer’s heavy use of one particular agency.

Alternative pay structures, and the power to reform those structures, should also be considered. Some critics have suggested that issuers could pay a small percentage of any fees upfront, with the remaining fee being “earned out” in the following years, until the maturity of the rated instrument. In order to motivate NRSROs to update their outstanding ratings regularly, fees could depend on certain contingencies or milestones, and might even be related to the accuracy of the rating, as assessed by comparison to other measures of credit risk, including market measures. Over time, such performance-based compensation could discipline NRSROs to strive for greater accuracy. Alternatively, rating agencies might be required to hold stakes in certain instruments that they rate highly.

Fee-for-service style payment also should be considered. Incentives are better aligned if both parties are in a pay-as-you-go situation. Under such a regime, if the credit rating agency breached its arrangement with the issuer (for example, by ceasing its ratings or by changing its assumptions in a way that renders the ratings inaccurate), the issuer would no longer be obligated to pay the agency. Staggering pay in this way might avoid some of the perverse incentives in the ratings process.

Access to Inside Information. For years rating agencies have enjoyed an exemption from Regulation Full Disclosure, or Regulation FD, which allows the rating agencies to receive inside information from issuers that is not shared with the market.¹⁰ The agencies contend that the exemption is needed in order to fully evaluate credit risk. NRSROs say the Regulation FD exemption allows them to alert the public to any substantial changes in the status of a security more quickly and clearly through rating upgrades, downgrades, and watches. Moreover, some argue that credit rating agencies should be able to receive material non-public information from arrangers for the purpose of developing unsolicited credit ratings.

But a strong case can be made for removing this exemption. Rating actions, without a substantial increase in transparency, can cause confusion and speculation. And unsolicited credit ratings are rare. Unless that practice becomes common, there is scant justification for giving credit rating agencies access to inside information through a Regulation FD exemption. Moreover, it is far from apparent that credit rating agencies have incorporated inside information in their ratings. Most notoriously, even though Enron made non-public credit rating agency presentations, information about the risks described in those presentations was not reflected in Enron's credit ratings. The same has been true of structured finance ratings. For these reasons, the board should have the power to limit the subsidy given to credit rating agencies to obtain, and act upon, material non-public information.

Regulators also should set governance standards for NRSROs more broadly. It is worth noting that federal overseers have become more involved in governance of other financial institutions as the government's interest in those institutions has increased during the crisis. Rating agencies, too, played a key role in the debacle, and their quasi-governmental powers need stronger checks and balances.

Accountability

Although inaccurate and unreasonable credit ratings from NRSROs were a primary cause of the recent crisis, the agencies remain largely unaccountable. As noted above, in order for credit rating agencies to function properly as gatekeepers, they must be able to credibly pledge a loss of reputational capital in the event they fail to perform their functions. Yet the rating agencies vehemently resist any assignment of liability for their ratings, hewing to the dictum that they merely provide “opinions,” and that no one should rely on ratings in making investment decisions. But ratings are more than opinions, and rating agencies must become more accountable.

Critics offer two approaches to improving the accountability of credit rating agencies: litigation and competition. A credible threat of civil liability would force credit rating agencies to be more vigilant in guarding against negligent, reckless, and fraudulent practices. A credible threat that both regulators and market actors will switch to alternatives to credit ratings could force rating agencies to behave more like information intermediaries than providers of regulatory licenses. Both accountability measures are consistent with oversight reforms. A stronger regulator could help to ensure that credit rating agencies are more accountable to private market actors and subject to competition.

Eliminating the Rating Agency Exemption from Liability

Historically, the threat of liability has been an effective tool in encouraging gatekeeper accountability. In general, gatekeepers are less likely to engage in negligent, reckless, or fraudulent behavior if they are subject to a risk of liability.

Although most financial market gatekeepers have been subject to serious threats of civil liability, credit rating agencies have not. Some market observers believe that, with appropriate changes in policy, litigation could become a viable tool for ensuring NRSRO accountability.

Rating agencies have been sued relatively infrequently, and rarely have been held liable. As rational economic actors, rating agencies factor in the expected costs of litigation, including the cost of defending lawsuits as well as any damage awards or settlements. Given the litigation track record, the fact that the rating agencies have published unreasonably high ratings should not be surprising.

Litigation against the credit rating agencies often is deterred by statutory provisions and judicial precedent that limit the liability of NRSROs. NRSROs are immune from liability for misstatements in a registration statement under Section 11 of the Securities Act of 1933. Securities Act Rule 436 explicitly provides that NRSRO are exempt from liability as an expert under Section 11.¹¹

In addition, courts have not been willing to impose liability on rating agencies for other alleged federal and state violations, and the threat of NRSRO liability is limited given judicial precedent in the area. Rating agencies were sued following a number of defaults, including class action litigation related to the Washington Public Power Supply System default in 1983; claims related to the Executive Life bankruptcy in 1991; a suit by the Jefferson County, Colorado, School District against Moody's in 1995; and claims by Orange County, California, based on professional negligence, against S&P in 1996. However, the only common element in these cases was that the rating agencies won. The suits were

dismissed or settled on favorable terms to the rating agencies. For example, Orange County's \$2 billion suit against S&P netted a paltry settlement of \$140,000, roughly 0.007 percent of the claimed damages.

A more recent example was the portion of the consolidated Enron litigation involving claims brought by the Connecticut Resources Recovery Authority.¹² Consider the following statement from the Houston federal district court hearing that case:

“After reviewing the case law regarding credit rating agencies and a number of reports and law review articles, this Court finds that generally the courts have not held credit rating agencies accountable for alleged professional negligence or fraud and that plaintiffs have not prevailed in litigation against them. Moreover, there is even a statutory exemption under the Securities Act of 1933 for Section 11 claims against credit rating agencies like the three Defendants here that have been designated ‘nationally recognized statistical rating agencies’ or ‘NRSROs.’”¹³

The Enron court, like some other courts, extended a qualified First Amendment protection to credit rating agencies. Ironically, in doing so, the judicial decision cited the Senate Committee on Governmental Affairs report, “Financial Oversight of Enron: The SEC and Private-Sector Watchdogs” and its statement that “It is difficult not to wonder whether lack of accountability — the agencies’ practical immunity to lawsuits and nonexistent regulatory oversight — is a major problem.”¹⁴

Recently, however, a few courts have exhibited some skepticism about judicial protection of credit rating agencies from liability. One plaintiff has had success alleging that Moody’s made misrepresentations regarding its independence and ratings methodologies.¹⁵ Another court indicated skepticism of the rating agency’s First Amendment argument in the context of private placements, because the rating is not published generally to the public.¹⁶

Such modest pushback against the rating agencies’ free speech assertions is strongly rooted in the economics of ratings, and the fact that ratings agencies are compensated for their “opinions” by the same issuers they are opining about. Rating agencies’ profit margins have exceeded 50 percent, whereas more traditional publishing companies’ profit margins have been less than 10 percent. Given the high profile nature of the problems with rating agencies and the continuing profitability of the ratings business, judges in future cases may be less inclined to view rating agencies’ “opinions” as on par with opinions of publishers.

Indeed, given the dearth of rating agency employees compared to rated issues, rating agencies hardly act like publishers. In 2005, before the beginnings of the recent crisis, Moody’s provided ratings for roughly 745,000 different securities; even the largest publishing companies publish only a fraction of that number of stories or opinions.

Moreover, in one important context — the compensation of their senior executives — rating agencies behave more like financial service companies than publishers. Compensation of NRSRO senior management is much higher than executive pay at publishing companies.

Moody’s peer group for compensation purposes, as disclosed in its most recent Compensation Discussion and Analysis, was dominated by financial services firms, including AllianceBernstein, BlackRock, CME Group, Eaton Vance, Federated Investors, Franklin Resources, Invesco, Morningstar, NASDAQ OMX Group, NYSE Euronext, Union Bank California, and other financial firms.¹⁷ Only a handful of publishing companies were on the list. If NRSROs are not comparable to publishers for compensation purposes, they should not be comparable to publishers in litigation for First Amendment purposes. Firms like BlackRock and Union Bank of California are not immune from securities fraud claims.

Perhaps most important, judicial immunity for rating agencies creates challenges for institutional investors, particularly those that rely, at least in part, on credit ratings in their investment process. If judges find that NRSROs are not accountable for negligent, reckless, or fraudulent behavior, it is riskier for investors to rely on NRSRO ratings. Indeed, investors who rely exclusively or primarily on NRSRO ratings may have an increased risk of liability regarding claims that they unreasonably relied on ratings from unaccountable NRSROs.

Moreover, there is judicial precedent that investor reliance on NRSRO ratings is not reasonable. For example, in one dispute involving the purchase of A-rated collateralized mortgage obligations which were downgraded to CCC and defaulted soon thereafter, the court said: “While it is unfortunate that [the investor] lost money, and we take him at his word that he would not have bought the bonds without the S&P ‘A’ rating, any reliance he may have placed on that rating to reassure himself about the underlying soundness of the bonds was not reasonable.”¹⁸ Thus, investors who rely on unaccountable NRSRO ratings are exposing themselves to liability.

In order to make NRSROs properly accountable, critics contend, there must be a real threat of liability. Many believe that Congress should amend Section 11 of the Securities Act of 1933 to add NRSROs as potential defendants. Further, they say lawmakers also should adopt legislation indicating that NRSROs are subject to private rights of action under the anti-fraud provisions of the securities laws. That legislation should include a description of the pleading standard for cases against rating agencies, to indicate that it would be sufficient for a plaintiff to plead the required state of mind by stating that the credit rating agency failed to conduct a reasonable investigation of the rated security or to have obtained reasonable verification from other sources independent of the issuer.

One final advantage to imposing accountability on rating agencies through liability is that it would obviate the need for regulators to provide parameters upfront governing when NRSROs have satisfied their responsibilities as part of the oversight process. In other words, *ex ante* oversight does not need to be as specific or draconian if regulators and investors can rely on *ex post* adjudication of rating agency negligence, recklessness, and fraud. Through an evolutionary approach, judges and private litigants could develop a common law understanding of appropriate rating agency behavior.

Enhancing Accountability through Competition and Reduced Reliance on Ratings

Finally, critics assert that competition in the credit rating business has not been effective. Some say the problem is due to insufficient industry competition and that the solution is to designate more NRSROs. Others contend that opening the NRSRO designation to more rating agencies fails to change the fundamental feature of the rating business, which is that ratings are driven by regulatory licenses. Instead of a supply-side solution, they argue that the demand side — regulators and market participants — should broaden and deepen their reliance on alternative measures of credit risk.

Credit ratings are an important, and sometimes mandated, tool for many categories of market participants. Today, references to ratings are incorporated in investment guidelines, swap documentation, loan agreements, collateral triggers, and other important documents and provisions.

Most institutional investors do not rely exclusively on ratings. While credit ratings are part of the mosaic of information considered as part of the investment process, they are generally not an appropriate sole source for making decisions.

A variety of alternative measures may be used to evaluate credit risk and supplement or even replace credit ratings. They include the following:

- Investors might use the variables underlying ratings, such as expected probability of default, recovery in the event of default, and default correlation, when relevant. For example, an investor might amend its investment guidelines to state it would only purchase bonds with an expected probability of default of 1 percent or less during maturity. The decision about expected probability of default then could be made based on a wide range of information.

A “first cut” filter might be based on the market-wide expectation of default, as reflected in a bond’s price. Most bond underwriters can provide this information for a range of issues; relatively inexpensive information services, such as Bloomberg and Reuters, also provide such information. Professor Edward Altman also has published extensive data in this area. In addition, credit default swap data is available from services, such as Markit, for numerous fixed income issues. Credit default swaps have been criticized in various ways, but abundant evidence suggests that credit default swap spreads more quickly and accurately reflect underlying credit risks than do NRSRO ratings.

- Investors might use the default probability implied by a bond’s price, not only at the time of purchase but over time, as part of their portfolio management process. Many services provide such information. Indeed, NRSROs increasingly incorporate such market measures into their own ratings, though on a lagged basis. Investors concerned about the volatility of market prices could use 30-day or 90-day rolling averages.

Rolling averages of market prices at least potentially reflect a wider range of available information than credit ratings, and may be a more timely and accurate measure of credit risk. Rolling averages also more accurately reflect available information than credit ratings and are not likely to be subject to manipulation or abuse.

Basing investment decisions on a rolling average of market measures may motivate investors to assess early on the risks associated with investments and to limit their exposure in the event of a market downturn. Some institutions might be forced to sell during periods of price declines, but those that do may avoid more sustained declines that occur when stale ratings permit investors to continue to hold and to deny that investments have declined in value. Moreover, to the extent forced sales occur relatively early, these new policies may help deter prolonged crises.

- Investors might revise their guidelines to reflect a blended standard of information sources used to make investment decisions based in part on professional judgment. For example, investors might rely on: 1) private information obtained through due diligence, 2) publicly available “soft” information, and 3) market-based measures and prices. The blended information might include credit ratings.

Liquidity risk is also becoming a more important part of investment decision making. NRSRO ratings do not cover liquidity risk. As a result, the market for information about liquidity risk does not suffer from the same regulatory license distortions as the market for credit risk. Many relatively new information intermediaries, such as Markit, Kamakura, and some investor-pay NRSROs, have developed competing analytic systems for assessing both credit and liquidity risk. As investor guidelines evolve to focus more on assessments of liquidity risk, this focus may apply market pressure to NRSROs, making them more accountable.

Ultimately, institutional investors vary in the amount of time and money they can afford to spend on the analysis of credit and liquidity risks. Accordingly, they have mixed views on whether references to credit ratings should be immediately removed from regulations. Some say ratings are meaningless and useless; they are comfortable with an immediate abolition of regulatory references to credit ratings. They argue that new intermediaries will come forward to fill the gaps left by the dominant NRSROs. Others say credit ratings remain an important tool. They argue that a sweeping removal of regulatory references to credit ratings would leave a gap for certain investment processes, would harm investors by removing a minimal floor for some investment decisions, and would disrupt the credit markets. In order to reduce private reliance on ratings, credible alternatives and substitutes must be developed, particularly for institutions that lack the resources to assess independently the huge number of available fixed income instruments.

Over the longer term, institutional investors at large are likely to grow more comfortable with a regulatory move away from credit ratings. And as institutional investors continue to encourage the formation and development of alternative information markets, market pressures from the demand side should motivate the NRSROs to improve their performance and accountability. Given the lack of accountability of NRSROs, this approach may be more effective and efficient than an approach that explicitly incorporates NRSRO ratings.

Conclusion

Many credit rating agencies have ventured far from their original role as reliable financial gatekeepers. They no longer provide consistently dependable information about credit risk. This has put many institutional investors in a box because they are still required to use ratings, regardless of the accuracy of the ratings. Stung by losses on investments in a string of once highly rated companies, from Enron to Lehman Brothers, investors are seeking ways to strengthen oversight and accountability of rating agencies, as well as new tools to evaluate credit risk.

Alternatives are emerging but may be out of reach for some investors for some time. For that reason, it is the author's view that Congress should step in to ensure that rating agencies are motivated to be more diligent in their assessment of credit risk. Toward that end, lawmakers should create a new Credit Rating Agency Oversight Board with the power to regulate rating agencies. At a minimum, Congress should provide the SEC with the financial and statutory resources to be an effective regulator of the industry. Secondly, it is time to take away the rating agencies' liability shield. Exemption from liability is not justified or tolerable, given the enormous clout that rating agencies now wield.

Ultimately, as institutional investors become more comfortable with alternative sources of credit information, competitive pressure could spur credit rating agencies to improve their performance and accountability. "Regulatory licenses" should disappear. Meanwhile, more vigorous oversight and accountability measures can improve the performance of NRSROs.

Endnotes

- ¹ Summary Report of Issues Identified in the Staff's Examinations of Select Credit Rating Agencies (July 2008), <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>, at 12.
- ² Interview with Thomas L. Friedman, *The NewsHour with Jim Lehrer* (PBS television broadcast, Feb. 13, 1996).
- ³ More precisely, the regulatory dependence on credit ratings began in 1973, when the SEC proposed amending broker-dealer "haircut" requirements, which set forth the percentage of a financial asset's market value a broker-dealer was required to deduct for the purpose of calculating its net capital requirement. Rule 15c3-1, promulgated two years later, required a different "haircut" based on the credit ratings assigned by NRSROs. See 17 C.F.R. 240.15c3-1. Since the mid-1970s, statutes and regulations increasingly have come to depend explicitly on NRSRO ratings.
- ⁴ Summary Report of Issues Identified in the Staff's Examinations of Select Credit Rating Agencies (July 2008), <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>, at 21.
- ⁵ The President's Working Group on Financial Markets, *Policy Statement on Financial Market Developments*, March 2008, at 1.
- ⁶ Address to Practising Law Institute's "SEC Speaks in 2009," Program, February 6, 2009, <http://www.sec.gov/news/speech/2009/spch020609mls.htm>.
- ⁷ For example, in S&P's comment on the SEC's proposal to eliminate some regulatory reliance on ratings, S&P reminded the SEC of its limited statutory authority and said "the Commission should carefully consider" unintended side effects of its proposal. See S&P Letter, Sep. 5, 2008. Although Moody's historically has favored elimination of regulatory licenses, it backed down somewhat from that position in its recent comment letter on the SEC's proposed rules regarding regulatory reliance. See Moody's Letter, at 5.
- ⁸ See S&P, *Fundamentals of Structured Product Ratings*, at 9.
- ⁹ 2008 SEC NRSRO Report, at 41.
- ¹⁰ 17 CFR 243.100-243.103.
- ¹¹ See also Item 10(c) of Regulation S-K.
- ¹² See *Newby v. Enron Corporation*, 511 F. Supp. 2d 741 (S.D. Tex. Feb. 16, 2005).
- ¹³ *Id.* at 815-17.
- ¹⁴ *Newby* at 817 (citing Report at 116).
- ¹⁵ See *In re Moody's Corporation Securities Litigation*, 2009 U.S. Dist. LEXIS 13894 (S.D.N.Y. Feb. 23, 2009).
- ¹⁶ See *In re National Century Financial Enterprises, Inc., Investment Litigation*, 580 F. Supp. 2d 630 (S.D. Ohio. Jul. 22, 2008).
- ¹⁷ Moody's Corporation Schedule 14A, March 18, 2009, at 19.
- ¹⁸ *Quinn v. McGraw-Hill*, 168 F.3d 331, 336 (7th Cir. 1999).



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