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Regulating the Credit Rating Agencies? Less Would Be More

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Regulating the Credit Rating Agencies? Less Would Be More

Lawrence J. White[1]

I. INTRODUCTION

The three major credit rating agencies ("CRAs")—Moody's, Standard & Poor's ("S&P"), and Fitch—continue to receive widespread media and policy attention. Since 2008 the Securities and Exchange Commission ("SEC") has expanded its regulation of the CRAs—partly on its own initiative and partly as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Injured investors—primarily pension funds—have sued the CRAs. In early 2013 the U.S. Department of Justice sued S&P for fraud. All of these events have attracted substantial media attention, as do proposals for new CRAs.

The major CRAs surely wish that all of this attention would evaporate; but it is likely to persist. Their excessive optimism with respect to mortgage-related securities in the middle years of the decade of the 2000s made them important for the housing bubble of that era and then in the financial crisis that followed.

However, as many disgruntled commentators have noted, despite the heightened attention little has changed: The same three CRAs still dominate the ratings business. Their ratings—and especially downward changes in their ratings—still attract media attention and often move markets. And the same troubling business model that seemed to encourage that excessive optimism—they are paid by the issuers of the bonds that the CRAs rate—still prevails among the major CRAs and even among most of the smaller ones.

So, what needs to change? Is more regulation needed? Better regulation? Maybe less regulation? Is there a role for antitrust? After all, there are only three CRAs that dominate the ratings business—and have done so for decades. Is more competition needed? If so, how might it be created?

This essay will argue that public policy should remove the pedestal on which past policy has placed the major CRAs. Their deification should be revoked, which should allow less (but better focused) regulation and more competition.

II. WHAT DO THEY DO?

At the heart of any lending/borrowing relationship is the following question: Will the borrower repay the lender? To try to determine the answer, lenders usually gather and assess information about the borrower: before deciding whether to make the loan, and then (if the loan is made) during the time that the loan is outstanding. Some lenders are able to do this themselves; others turn to third parties for help.

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With respect to bonds—which are loan instruments between the companies or governments that borrow by issuing (selling) bonds and the investors that lend by buying the bonds—many issuers and investors have traditionally looked to CRAs for help. John Moody was the first to offer publicly available assessments—"ratings"—of railroad bonds in 1909. Other information companies—notably, Standard, Poor's,[2] and Fitch—entered the ratings business over the following 15 years. They earned their revenues by selling their ratings to investors. In modern parlance, they had an "investor-pays" business model.

The major CRAs never were and still are not the only source of creditworthiness information about bonds. Large institutional investors[3]—such as banks, insurance companies, pension funds, and various kinds of investment funds – often have the scale to support skilled in-house personnel to make the assessments. There are also smaller creditworthiness advisory firms—which may or may not describe themselves as CRAs but perform similar assessments—to which bond investors may turn. Large securities firms employ "fixed-income analysts," who provide creditworthiness assessments of bonds for their firm's investor clients, as well as for the firm's securities traders.

But, still, the three major CRAs continue to dominate the ratings area. How and why is this so?

III. SOME HISTORY

For the first few decades of the major CRAs' existence the use of ratings by investors was wholly voluntary. However, starting in the 1930s important categories of institutional investors—initially banks, and then insurance companies, pension funds, broker-dealers (securities firms), and money market mutual funds—were required by their prudential regulators to pay attention to the major CRAs' ratings of the bonds in which those institutions might invest. Thus, from the 1930s onward, the major CRAs had a guaranteed audience among prudentially regulated institutional investors for their ratings. Concomitantly, smaller creditworthiness advisory firms were at a substantial disadvantage vis-à-vis the major CRAs, since the former's views/opinions/ratings would carry less weight with those regulated institutional investors.

This arrangement was formalized in 1975, when the SEC created the category of "nationally recognized statistical rating organization" ("NRSRO"), for the purposes of designating exactly which CRAs' ratings should be heeded by the prudentially regulated financial institutions. The SEC immediately designated Moody's, S&P, and Fitch as NRSROs—which then became a barrier to entry: During the following 25 years the SEC designated only four additional CRAs as NRSROs; but mergers among the new designees and with Fitch caused the number of NRSROs to shrink back to only the original three by year-end 2000.

In the aftermath of Enron's November 2001 bankruptcy, the media discovered that the three major CRAs had maintained "investment grade" ratings on Enron's bonds until five days before that company's bankruptcy filing. In the Congressional hearings that followed, the

[2] The two companies merged in 1941.

[3] The bond markets are overwhelmingly institutional: Of all bonds that are held by U.S. entities, over 85 percent (by value) are held by financial institutions. Thus, the typical bond "investor" is (or ought to be) a professional manager of a financial institution's bond fund.

NRSRO system and the SEC's opaque administration[4] of it was aired. In response to Congressional pressures, the SEC designated a fourth NRSRO in 2003 and a fifth in 2005 but retained its opaque administration.

Unsatisfied with the SEC's response, the Congress enacted the Credit Rating Agency Reform Act ("CRARA") of 2006, which requires the SEC to establish a clear application process for firms that want to become NRSROs and a set of criteria for the SEC to use in assessing those applications.[5] Since 2006 the SEC has approved six additional NRSROs; one subsequently requested decertification, so there currently are ten NRSROs. Nevertheless, the three major CRAs have continued to dominate: As of 2012, of all of the outstanding bond ratings that were reported by the ten NRSROs to the SEC, the three major CRAs accounted for 96.5 percent of the total.[6]

One other historical event is noteworthy: In the late 1960s/early 1970s the three major CRAs changed from John Moody's "investor-pays" business model to the "issuer-pays" model that prevails today. The CRAs feared that unauthorized high-speed photocopying (which was just coming into widespread use at the time) would limit their ability to expand their revenues (similar to what digital reproduction would do to the recorded music business in the early 2000s).

IV. THE HOUSING BUBBLE, THE DEBACLE, THE ROLE OF THE CRAS, AND THE DODD-FRANK RESPONSE.

Starting in the late 1990s, the U.S. economy experienced a major housing boom—which is now recognized to have been a bubble. Helping fuel the housing bubble was the technology of mortgage securitization: the pooling of hundreds (and sometimes thousands) of residential mortgages into residential mortgage-backed securities ("RMBS")—bonds—that could be sold to investors. And helping fuel the mortgage securitization process were the favorable ratings that the major CRAs assigned to these securities.[7] As is now well known, the CRAs initially gave favorable (high) ratings to hundreds of billions of dollars of these RMBS that subsequently required substantial downgrades.

The Dodd-Frank Act included important sections that applied to ratings and the NRSROs. Recognizing that the regulatory use of NRSRO ratings was an artificial enhancer of the importance of the NRSROs, and especially of the three major CRAs, the Act eliminated all references to NRSROs in federal statutes and instructed federal financial regulators to examine and, wherever possible, remove from their regulations references to NRSROs' ratings (and concomitantly find alternative ways to achieve their regulatory goals without the use of NRSRO ratings).[8] The Act also instructed the SEC to toughen its regulation of the NRSROs themselves:

[4] For example, the SEC had never established a formal application process or formal criteria for becoming a NRSRO.

[5] In addition, by requiring annual recertification of all NRSROs, the CRARA effectively established SEC regulatory powers over the NRSROs.

[6] However, this was down from 98.8 percent of the total in 2007. Also, in one category—the ratings of insurance companies—the three major CRAs accounted for "only" 75.5 percent of the total.

[7] More specifically, the CRAs' favorable ratings were important for the sale of "private-label" RMBS—i.e., those that were not issued by Ginnie Mae, Fannie Mae, or Freddie Mac.

[8] However, the Act was silent with respect to one major category of the use of NRSROs' ratings: the prudential regulation of insurance companies by the 50 states.

specifically, to force the NRSROs to pay greater attention to their conflict-of-interest issues (e.g., as embedded in the issuer-pays business model) and to the transparency of their rating methodologies.

V. WHAT WENT WRONG?

Why did the CRAs give such favorable initial ratings to such large amounts of RMBS? Many commentators have pointed to the issuer-pays business model of the CRAs and its obvious potential conflict of interest: Issuers can "shop around" and thereby pressure each CRA for a more favorable rating.

However, just pointing to the issuer-pays model is not sufficient. *All* of the major CRAs' ratings have been issued under this model since the early 1970s. But the CRAs' ratings in their traditional areas (corporate, municipal, and sovereign debt) didn't deteriorate in the three decades that followed, and still have not deteriorated[9] in the way that the MBS ratings clearly did. Why the difference?

Let's start with how the issuer-pays model—despite the potential conflict—could be robust: A CRA's concern for its long-run reputation should serve as a counterbalance to issuers' requests for more favorable ratings, since bond investors' eventual discovery that the CRA had acceded to issuers' pressures will cause the investors to reduce or cease their trust in the reliability of that CRA's future ratings. In turn, future issuers will cease (or be more reluctant) to engage that CRA for future bond ratings. Accordingly, if the expected gains from maintaining a reputation for accuracy exceed the expected gains from acceding to issuers' requests for favoritism, the CRA will resist those pressures.

This appears to have been the case for the major CRAs' traditional corporate, municipal, and sovereign ratings business.

However, the concerns about any organization's long-run reputation can be overwhelmed by the prospects of sufficient short-run gain. And it appears that these long-run concerns were overwhelmed in the area of RMBS ratings. Strong anecdotal evidence indicates that "rating shopping" and pressures by issuers on the CRAs occurred during the 2005-2007 period; and academic statistical studies indicate that issuers did shop for favorable ratings and also that this shopping did induce more favorable ratings.

So, why did the reputation model melt down in the latter area but not the former?

For the former: The traditional bond rating areas have thousands of issuers; no single issuer represents a significant portion of the revenue of a major CRA. This makes it easier for the CRA to resist an issuer's shopping-around threats. Further, an abundance of publicly available information is available about these issuers' finances (e.g., SEC-mandated corporate disclosures, and annual budgets and related documents for municipalities and sovereigns), so that outside analysts (e.g., those fixed-income analysts at securities firms and the smaller CRAs) could readily spot and trumpet any apparent rating deviation that would unduly favor an issuer. A CRA's

[9] Instances of sluggish downward adjustments in ratings—as for Enron—are indicative of a long-standing "cultural" tendency to adjust ratings slowly, which was present in the credit rating industry long before the change to the issuer-pays business model.

awareness of this external scrutiny and its consequences would strengthen the CRA's resistance to issuers' pressures.

By contrast, the numbers of issuers/packagers of RMBS were far fewer: Approximately a dozen issuers accounted for about 80-90 percent of the RMBS that were being issued and rated. The flows of new RMBS issuances were large, and were expected to continue to be large, and the major CRAs' margins on these RMBS ratings were considerably wider than for their traditional business. Thus, the temptations to accede to RMBS issuers' requests (and the fears of the consequences of not acceding) were substantially greater.

Reinforcing this temptation was a far more opaque information setting: Although the issuer would provide to the CRA detailed "loan-level" information about the characteristics of the underlying mortgage loans for the RMBS, the general public was provided only with summary statistics (e.g., means and ranges) for those same characteristics.[10] Accordingly, any "favors" that a CRA might do for RMBS issuers would be less likely to be discovered (as compared with the CRAs' traditional ratings), which would make a CRA more likely to accede to RMBS issuers' requests.

In sum, the market characteristics of the traditional rating areas of corporate, municipal, and sovereign bonds were (and are) such that the potential conflicts of the issuer-pays model were (and are) unlikely to be converted into actual conflicts that would undermine the CRAs' long-run reputations. But the market characteristics of the newer RMBS bonds were substantially different and more conducive to a breach of that reputation-maintenance model.

VI. WHAT IS TO BE DONE?

It is easy to understand the desire by legislators and regulators to want (figuratively) to grab the major CRAs by the lapels and shout, "Do a better job!" And the portion of the Dodd-Frank Act that instructs the SEC to regulate the NRSROs more tightly reflects that desire.

"Do a better job!" is a call for better outcomes: more accurate ratings. But the SEC doesn't try to assess the accuracy of the NRSROs' ratings; indeed, the CRARA forbids the SEC from directly influencing the content of the NRSROs' ratings as well as their methodologies and their business models. Instead, the SEC's regulation has focused on "inputs:" the transparency of a NRSRO's methodology and rating results, and efforts to address any conflicts of interest. This focus on inputs rather than outputs is, at best, an indirect way of achieving the goal of improved accuracy of ratings.

Further, regulation of this sort will bear more heavily on the smaller NRSROs, since there are substantial fixed costs of compliance. This could make it harder for smaller NRSROs to compete and discourage other creditworthiness advisory firms (which tend to be small) from applying to become NRSROs. A potential irony of such regulation is that *the relative importance of the three major CRAs could increase* as a consequence of the SEC regulation.

In addition, such regulation is likely to discourage innovation: in rating methodologies, technologies, and possibly even business models. This would be true for at least three reasons:

[10] To make the setting even more opaque: The "shopping-around" by issuers focused on the fraction of a RMBS's tranches that would be rated "AAA."

First, such regulation often has difficulties in dealing with firms that have new ideas; they often don't fit the "boxes" that regulation usually creates. Second, entry is often the vehicle for innovative ideas, and entrants are often small; but, as discussed above, the SEC regulation bears relatively more heavily on smaller firms. Finally, the Dodd-Frank Act's required transparency may discourage the development of new methodologies if their development is costly but their proprietary advantage is lost because of that required transparency.

There is a better way: That way should emphasize more competition.[11] It thus has the spirit of antitrust, although direct antitrust measures aren't needed.

It starts with the other part of the Dodd-Frank Act that dealt with CRAs: the elimination of financial regulators' blind reliance on the NRSROs' ratings. This elimination would open the field to more creditworthiness advisory firms that can attract the attention of more issuers and institutional investors.[12]

In this respect, the Dodd-Frank Act was a good start but too timid. Although some regulators have made the transition, others have been tardy. The Congress needs to prod the tardy agencies to speed their efforts—and also to convince state insurance regulators that they too must cease blindly relying on the NRSROs.

Next, if regulatory reliance by financial regulators on NRSROs is eliminated, then the NRSRO category and the SEC's regulation of the NRSROs can be eliminated. Recall that the bond market is dominated by institutional investors. Professional bond managers should be able either to gather their own creditworthiness information about bonds or to be able to make informed decisions as to who is a reliable third-party provider of such information.

With regulatory reliance and the NRSRO system eliminated, *competition* among creditworthiness advisory firms would be freed in a way that surely has not been true for almost 40 years—or, arguably, almost 80 years. And, in addition to the current inventory of such firms, some of the fixed-income analysts at securities firms that have established reputations for themselves might feel more encouraged to "hang out their own shingles" and provide more competition as freestanding entities.

A more competitive environment is unlikely to lead to large changes in market shares quickly. A reputation-based market is likely to move slowly—especially since the major CRAs' reputations in their traditional ratings areas are largely intact. Nevertheless, it would be an important start.

Finally, the issue of the ratings of RMBS does deserve more attention: Following (and because of) the debacle of 2007-2008, "private-label" RMBS issuances have been largely absent from the bond market. If and when such RMBS do re-enter the market, the structural features that encouraged the meltdown of the reputation model for the CRAs—notably, the fewness of

[11] Some commentators have noted that more CRA competitors would give issuers more opportunities to shop around for favorable ratings. However, this negative view overlooks the positive role of competition, including entry, in encouraging innovation. Also, in the more open context that is discussed below, professional bond managers and prudential regulators can be expected to be more wary of the shopping-around phenomenon.

[12] Financial regulators will still want to ensure that their regulated institutions can justify their sources of information and aren't relying on flim-flam entities.

issuers, and the opaqueness of information—require some attention. With respect to the former, professional bond managers (after the debacle) will surely be more wary of CRAs that employ the issuer-pays business model for these types of bonds; similarly, prudential regulators should definitely be reminding their financial institutions of the potential dangers.

With respect to the opaqueness of RMBS information, the SEC partially addressed the issue in 2009 by requiring that any NRSRO that has been hired for a RMBS rating must make the detailed loan-level information available to any other NRSRO that requests it. However, the SEC was too timid and placed too many restrictions on this process. Instead, the SEC should mandate that all such information should be available to the general public and not just to a category of CRAs. By doing so, the SEC would bring RMBS information disclosures into harmony with the SEC's general regime of widespread dissemination of material information for publicly traded companies. And this would add more potential critics who could "look over the shoulders" of any RMBS raters, which should help reinforce the reputation-maintenance model.

VII. CONCLUSION.

The question of how to deal with the major credit rating agencies is important and complex—and is not going away soon. Neither of the "easy" answers—"more regulation" or "no regulation"—is satisfactory.

Instead, more—and more effective—competition, along with less (but better focused) regulation would provide a better policy route.