Consumer Federation of America

CFA Position Paper
The Need for Credit Rating Agency Regulatory Reform

Background - the Problem for Consumers

Since the stock market crash of 1929, the number of financial regulations and other policies tied to credit ratings has grown rapidly. This practice of incorporating references to credit ratings in legal standards and investment guidelines got a boost in the 1970s, when the Securities and Exchange Commission (SEC) began to designate Nationally Recognized Statistical Rating Organizations (NRSROs) whose ratings could be used for legal purposes. Today, money market mutual funds, bank capital standards, and pension fund investment policies are just a few of the entities that rely on these credit ratings to define the limits of appropriate investments.

This growing reliance on credit ratings has come about despite their abysmal record of under-estimating risks. Never have their limitations been more evident, however, than in the current crisis, when the ratings agencies awarded AAA ratings to thousands of ultimately toxic subprime-related mortgage-backed securities and collateralized debt obligations (CDOs) whose risks they either ignored or did not understand. The high ratings given to these products made them eligible for sale to even the most conservative of investors, spreading the risks of unsound mortgage lending throughout the financial system, and allowed financial institutions to avoid setting aside adequate capital to compensate for their risks.

As the structured finance business grew rapidly in recent years, ratings agencies' profitability became increasingly dependent on their ability to win market share in this highly lucrative line of business. Because credit rating agencies typically charge issuers for their ratings, the conflicts of interest and the pressure to assign favorable ratings were enormous.

Problem for Consumers: Lack of Oversight

Prior to the passage of the Credit Rating Agency Reform Act of 2006, the credit rating agencies were essentially unregulated. The law granted the SEC authority to implement minimal registration, record-keeping, financial reporting, and oversight rules for registered credit rating agencies. Since then, however, the financial crisis has revealed serious gaps in this regulatory authority.

Problem for Consumers: Conflict of Interest

The business model of credit rating agencies, in which issuers pay the credit rating agencies for their ratings, may bias ratings upward and may make rating agencies susceptible to pressure to lower quality standards so as to keep the issuers as clients. To further add to the potential conflict of interest, credit rating agencies charge issuers for advice, including pre-rating assessments (in which issuers learn what ratings will likely be under various hypothetical scenarios) and risk-management consulting, sometimes providing advice on the front-end regarding debt instruments they later rate.

Problem for Consumers: Protected Status

The credit rating agencies are largely immune from civil liability due both to legislative policy and judicial precedent, which has generally honored their assertion that their ratings are merely "opinions" entitled to protection under the First Amendment. To the extent that leading credit rating agencies enjoy this protected status and virtually guaranteed demand as a result of their regulatory significance, they face diminished incentives to maintain the quality of their ratings.

The Solution for Consumers: Credit Rating Agency Regulatory Reform

The Consumer Federation of America supports measures to strengthen regulatory oversight of ratings agencies, increase their independence and accountability, and reduce reliance on ratings. Toward this end, CFA supports passage of S. 1073, the Rating Accountability Transparency Enhance Act (RATE Act), introduced by Sen. Jack Reed (D-RI).

Congress should strengthen regulation of credit rating agencies

- Credit rating agencies should be regulated either by an office within the Securities and Exchange Commission or by an independent office similar to the Public Company Accounting Oversight Board (PCAOB), which oversees audit firms that audit public companies.
- Regulation would set standards, backed by authority to impose sanctions, in areas including compliance practices, due diligence, obtaining adequate documentation to support ratings, requiring on-going testing of adequacy of ratings methodologies, and post-rating surveillance and revision.

Congress should increase accountability of credit rating agencies

- First Amendment protections based on the idea that ratings are nothing more than opinions are inconsistent with the ratings agencies' legally recognized status and their legally sanctioned gatekeeper function. Either their legal status or their protected status must go.
- Holding ratings agencies legally accountable for failure to perform due diligence offers the best counterweight to the conflicts inherent in the issuer-paid business model. The prospect of legal liability should make them more careful about their ratings practices and less likely to rate products whose risks they do not understand.

Congress should decrease reliance on ratings in legal requirements and capital standards

- Congress should reduce reliance on ratings by clarifying, in each place where ratings are referenced in law or regulations, that ratings do not provide an automatic seal of approval and that reliance on ratings does not substitute for due diligence.
- Investors (whether money market mutual funds, pension funds, or financial institutions) must take responsibility for performing their own assessments to determine whether the risk characteristics of the investment in question are appropriate for the intended purpose.