Credit Rating Agency Reform

Briefing for the Americans for Financial Reform

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What are credit rating agencies?

Credit rating agencies are private companies that assess the creditworthiness of various types of debt instruments (bonds, mortgage-backed securities) as well as the issuers of those debt instruments (companies, government entities).

They typically assign a letter grade designed to convey the risk of default. The highest rated securities, considered “investment grade,” are expected to have a very low risk of default, just slightly higher than the risk of default for securities issued by the U.S. Treasury.

The three major credit rating agencies are Moody’s Investors Service, Standard & Poor’s, and Fitch Ratings.

From Information Providers to Gatekeepers

Credit rating agencies got their start in the early 1900s as information providers.

They were paid by investors who subscribed to their services.

The ratings benefited investors by compiling information that it was difficult or costly for investors to compile on their own.

From Information Providers to Gatekeepers

Credit rating agencies took on a more formal role in the financial system after the 1929 stock market crash.

In the mid-30s, bank and insurance regulators started using ratings in capital requirements and investment guidelines for banks and insurance companies.

To prevent banks from investing in speculative securities, bank regulators limited them to investing only in “investment grade” securities, as determined by the rating agencies.

From Information Providers to Gatekeepers

The collapse of the Penn Central railroad in 1970 led to a renewed concern about credit quality. To reduce the risk exposure of securities firms, the Securities and Exchange Commission incorporated credit ratings into the net capital requirements for broker-dealers.

To ensure that only credible ratings were used for this purpose, the SEC in 1975 introduced the concept of Nationally Recognized Statistical Rating Organization (NRSRO), and grandfathered in the three large firms.

From Information Providers to Gatekeepers

Following the SEC's action, credit ratings were increasingly incorporated in statutes at the federal and state level.

Investment guidelines for pension funds, endowment funds, and other private entities also came to rely on the ratings.

As a result, credit rating agencies became the quasi-official arbiters of credit risk throughout the financial system.

Although they were recognized by the SEC through a "no action" letter process, NRSROs were not subject to new regulatory requirements in keeping with their expanded role.

Warning Signs Missed

The following are a few of the major defaults that were missed by the credit rating agencies over the years.

- Penn Central Railroad
- Washington Public Power Supply System
- Orange County, CA
- Pacific Gas & Electric
- Edison International
- Enron
- Worldcom

Despite these failures, reliance on ratings continued to grow.

The Role of the Credit Rating Agencies in the Current Financial Crisis

The ability to repackage mortgage loans into asset-backed securities made it profitable to make subprime loans and to expand the availability of credit to low- and moderate-income consumers.

These mortgage-backed securities were sold to institutional investors, many of whom could only purchase securities that the NRSROs deemed to be “investment grade.”

As a result, credit ratings were an essential ingredient to make the securities marketable and thus profitable.

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The Role of the Credit Rating Agencies in the Current Financial Crisis

Issuers of mortgage-backed securities (MBS) used a number of techniques to receive high ratings for securities based on subprime mortgages.

- They structured the securities into "tranches," with the lowest tranches absorbing any losses first. Because investors in the lower tranches had to lose everything before investors in the upper tranches lost a dime, the upper tranches were awarded top ratings.
- They "over-collateralized" the security, so that expected payouts from the pool of mortgages exceeded the value of securities issued.
- They purchased bond insurance and credit default swaps to protect against default.

The Role of the Credit Rating Agencies in the Current Financial Crisis

In order to sell the top tranches of MBS, issuers had to first sell the bottom tranches that absorbed any losses.

Hedge funds provided one market, since they were not restricted to buying investment grade securities.

Securitizers found a new way to sell the lower MBS tranches by repackaging them into securities called Collateralized Debt Obligations (CDOs).

CDOs used the same type of tranche structures as MBS, but instead of being backed by mortgages, they were backed by shares of MBS and even by shares of other CDOs.

Credit rating agencies also assigned high ratings to the top tranches of these new, even more complex securities.

The Role of the Credit Rating Agencies in the Current Financial Crisis

Based on policies adopted by Congress and the SEC beginning in the 1980s, credit ratings also substituted for full disclosure in the MBS market.

MBS were typically sold through the SEC's "shelf registration" process, as a result of which, investors typically purchased the securities based only on a basic term sheet.

Collateralized debt obligations (CDOs) were typically sold through private sales, in which investors received even less information.

The sale of these complex, opaque securities without adequate disclosures encouraged investors to rely on credit ratings to assess their risks.

The Role of the Credit Rating Agencies in the Current Financial Crisis

Because they both determined the ability of institutions to purchase MBS and served as the only source of information about their risks, NRSROs were the ultimate gatekeepers in the MBS market.

Unfortunately, putting profits over professionalism, they failed to fulfill their gatekeeper functions.

The Role of the Credit Rating Agencies in the Current Financial Crisis

Lax Procedures

Credit rating agencies failed to detect the severe deterioration in lending standards that began in the late 1990s and continued through 2006.

One reason for this failure was that they weren't reviewing information about the loans on which the securities they were rating were based.

Instead, they trusted the structures of the securities to protect against risks and continued to assign investment grade ratings to securities based on "liars loans" (no documentation), "ninja loans" (No Income, No Job, No Assets), and 100 percent finance loans (no down-payment).

The Role of the Credit Rating Agencies in the Current Financial Crisis

Faulty Models

The models credit rating agencies relied on in assessing MBS and CDOs were faulty.

Developed during a time of rapidly appreciating home prices, they did not even allow for the possibility of a sustained national decline in housing prices.

They also failed to take into account the likely effect having no equity in the home would have on homeowner behavior should housing prices decline.

The Role of the Credit Rating Agencies in the Current Financial Crisis

From Gatekeepers to Enablers of Excess

Credit rating agencies had an enormous incentive to overlook problems in MBS and CDOs.

In the 1970s, at about the same time that the SEC created the NRSRO designation, ratings agencies had begun charging issuers rather than investors for their ratings, creating a basic conflict of interest at the heart of their business model.

As the securitization market grew, profits for the ratings agencies were increasingly driven by their ability to win market share in the business of rating MBS and other structured finance products.

The Role of the Credit Rating Agencies in the Current Financial Crisis

From Gatekeepers to Enablers of Excess

High fees and the large volume of business made rating MBS and CDOs a major profit center for rating agencies.

Profits of the major ratings agencies rose from a combined $3 billion in 2002 to more than $6 billion in 2007, and the CEOs of these three companies earned a collective $80 million during the same period.

Moody's saw its profits quadruple from 2000 to 2007. During five of those years, it had the highest profit margins of any company in the S&P 500.

The Role of the Credit Rating Agencies in the Current Financial Crisis

From Gatekeepers to Enablers of Excess

As a result, ratings agencies had an enormous incentive to provide the investment grade ratings that would keep profits flowing, and evidence suggests that standards suffered.

Analysts who questioned the safety of the securities or the accuracy of the ratings were overruled and, in some cases, demoted or let go.

As mortgage underwriting standards were eroding, S&P and Moody’s engaged in what one executive called “a market share war where criteria were relaxed.”

The Role of the Credit Rating Agencies in the Current Financial Crisis

In 2005, home values first flattened and then began to decline, a scenario not contemplated by the ratings.

As teaser rates on subprime mortgages reset to much higher interest rates, homeowners with no equity, who could not sell their home, and who could not afford dramatically increased payments began to default.

As defaults began to rise, so did losses within MBS and CDOs.

By the beginning of 2009, the ratings agencies had been forced to downgrade more than half the subprime MBS that they rated between 2005 and 2007.

The Role of the Credit Rating Agencies in the Current Financial Crisis

Financial institutions that held the securities suffered major losses on their investments.

Having failed to recognize the risks in MBS, the ratings agencies also failed to recognize the risk piling up on and off financial institutions’ balance sheets.

Among the companies that held AAA ratings headed into the crisis were AIG, Fannie Mae, Freddie Mac, and bond insurers Ambac Financial and MBIA.

As the market lost faith in the validity of the credit ratings, that loss of faith contributed to the fear that caused credit markets to seize and brought the global economy to the brink of collapse.

Why Regulation is Needed

Our regulatory policies have outsourced the job of credit risk assessment to the NRSROs. This has given them a central gatekeeper role in the financial markets. They have been given this role despite the fact that they have none of the qualities essential in a gatekeeper.

- They are not independent.
- They are not subject to effective regulatory oversight.
- They are not accountable.
- They are not transparent.

Investors and regulators need reliable measures of credit risk. Regulation is needed both to restore credit rating agency reliability and to reduce the financial system's vulnerability to ratings failures.

Current Status: The Administration Plan

The Administration released its White Paper on regulatory reform in June. Its recommendations on credit rating agency reform were among the weakest in the reform package. They:

- directed the SEC to “continue its efforts to strengthen the regulation of credit rating agencies”
- endorsed the idea of differentiating ratings for structured finance products
- directed regulators to reduce their use of credit ratings in regulations and supervisory practices “wherever possible”

Fortunately, when the Treasury Department sent its legislative proposal to the Hill, it offered a broader set of reforms modeled on legislation drafted by Sen. Jack Reed.

Current Status: Congressional Action

The House has adopted credit rating agency reform legislation as part of the financial regulatory reform bill that passed the House in December. It is a strengthened version of the Administration legislative proposal.

Senate Banking Committee Chairman Chris Dodd introduced draft regulatory reform legislation in November. The Senate bill includes a package of credit rating agency reform in Title IX, Subtitle C that resembles but is not identical to the House bill.

As part of Senate efforts to develop a bipartisan bill, Sen. Reed and Sen. Judd Gregg have been assigned to negotiate on credit rating agencies.

The Legislation: Overview

The House and Senate bills are based on legislation introduced by Sen. Jack Reed. Though there are differences in the two bills, they share a common overall approach designed to:

- Enhance the SEC's oversight authority over credit rating agencies
- Reduce credit rating agencies' liability protections
- Increase credit rating transparency
- Improve corporate governance practices at ratings agencies
- Decrease federal regulatory reliance on credit ratings

Neither bill would require any changes in the issuer-pays business model, though both would require a study of the issue.

Reducing Conflicts of Interest

Conflicts of interest and shoddy business practices both contributed to the rating agencies' failure to act as effective gatekeepers. Faith in credit ratings cannot be fully restored without rectifying these problems.

We therefore believe reducing conflicts of interest should be a focus of reform efforts. Toward that end, we support a proposal to create an independent clearinghouse to randomly assign rating engagements and pay credit rating agencies.

In addition, we support measures to improve corporate governance at credit rating agencies as another means of improving their operations.

The Legislation: Conflicts of Interest

Neither the House nor the Senate bill directly addresses the issue of credit rating agencies’ issuer-pays business model, but they do include modest provisions to reduce conflicts of interest.

The House bill:

- requires the SEC to adopt rules on payment mechanisms to encourage incentives for reliable ratings and post-rating surveillance and
- prohibits rating agencies from providing certain types of non-rating services to rating clients

The Legislation: Conflicts of Interest

The Senate bill:

- requires the SEC to issue rules to prevent sales and marketing considerations from influencing ratings and
- directs the SEC to act to ensure that ratings are not unduly influenced by conflicts of interest.

Both bills require studies of alternative payment mechanisms to reduce conflicts of interest.

The Legislation: Corporate Governance

Both bills also seek to improve corporate governance practices at credit rating agencies, though the House bill is significantly stronger on this point. It would:

- ❖ Require credit rating agencies or their parent companies to have a board of directors
- ❖ Make that board responsible for key functions on which reliable ratings rely
- ❖ Clarify and expand the authority of the compliance officer
- ❖ Put stronger protections in place to ensure the independence of the compliance officer

The Legislation: Corporate Governance

The Senate bill does not require credit rating agencies or their parent entities to have boards and thus does not require that the board oversee key activities important to ensuring reliable ratings.

The Senate bill does not include a provision from the House bill requiring compliance officers to develop procedures to ensure that credit ratings take into account all the information that comes to the attention of the NRSRO and that it believes to be relevant, including information from non-issuer sources.

Enhancing Regulatory Oversight

Although the credit rating agencies perform an essential function in our financial system, they are subject to only minimal regulatory oversight. It wasn't until 2006 that Congress passed the Credit Rating Agency Reform Act (CRARA), and it is quite weak.

- It requires NRSROs to adopt written policies regarding conflicts of interest, and it gives the SEC authority to regulate conflicts.
- It gives the SEC authority to prohibit unfair, coercive, or abusive practices.
- It precludes the SEC from regulating methodologies or procedures, including due diligence practices, of ratings agencies.

We support strengthening regulatory oversight, either through the SEC or through an independent oversight board.

The Legislation: Regulatory Oversight

Both bill creates a new office within the SEC to oversee ratings agencies. The SEC is required to inspect rating agencies for compliance with appropriate procedures to support reliable ratings.

Both bills also authorize the SEC to impose fines for violations.

The House bill:

- ❖ Expands the SEC’s sanction authority to include failure to conduct adequate post-rating surveillance and failure to supervise
- ❖ Removes NRSROs’ protections from SEC anti-fraud authority with regard to methodology and procedures
- ❖ Gives the SEC broad rulemaking authority under the statute.

The Legislation: Regulatory Oversight

The Senate bill lacks these three provisions.

On the other hand, the Senate bill includes a provision allowing for temporary suspension or revocation of NRSRO status with regard to a particular class of securities.

Enhancing Rating Agency Accountability

Credit rating agencies enjoy special protections from liability, which makes them less accountable for adopting appropriate procedures to support reliable ratings.

- Courts have sided with ratings agencies when they claimed their ratings were opinions protected under the First Amendment.
- NRSROs are protected from liability under Section 11 of the Securities Act with regard to use of their ratings in securities registration documents.
- The CRARA expressly states that it is not enforceable through private action.

We believe that, in order to make credit rating agencies more accountable and more conscientious, they should lose their special protections from liability.

The Legislation: Liability

Both bills significantly reduce credit rating agencies' liability protections.

Though they take slightly different approaches, both clarify that, in claims against rating agencies, the pleading standard can be met by showing that the rating agency knowingly or recklessly failed to conduct adequate due diligence.

Both make the statute enforceable through private right of action.

The Legislation: Liability

The House bill removes ratings agencies’ exemption from liability under Section 11 of the Securities Act.

The House bill clarifies that credit ratings are not forward-looking statements entitled to rely on the safe harbor for such statements.

The Senate bill includes findings, not included in the House bill, that challenge the credit rating agencies’ claim of First Amendment protections.

Reducing Reliance on Credit Ratings

Some have concluded that the only rational response to the credit rating agencies' massive failure to live up to their gatekeeper responsibilities is to eliminate our financial system's reliance on ratings.

Others argue that rashly eliminating reliance on ratings without putting anything in their place could have dangerous consequences.

We support a careful reduction in reliance on credit ratings that distinguishes between different uses of ratings and allows regulators flexibility in adopting this approach.

The Legislation: Reliance on Ratings

The House and Senate bills take very different approaches to reducing reliance on ratings, with House bill eliminating reliance on ratings entirely and the Senate bill requiring only a GAO study.

The House bill:

- directs certain such references to be eliminated within six months and replaced with other measures of creditworthiness
- directs federal financial regulators to identify all other references to ratings in their statutes and rules, to eliminate those references, and to replace them with other measures of creditworthiness
- provides regulators with no flexibility in the process

This approach was adopted during committee mark-up, replacing a more careful case-by-case review proposed in the manager's amendment.

Enhancing Credit Rating Transparency

Another way to reduce reliance on ratings is to make them more transparent.

Even under the enhanced disclosure obligations included in the CRARA, credit rating agencies disclose little information about their methodologies or procedures.

As a result, their ratings are extremely opaque. Because investors cannot assess the assumptions behind the rating or its sensitivity to those assumptions, many are unable to independently assess the validity or reliability of the rating.

We believe rating transparency should be improved in order to promote informed investment decision-making.

The Legislation: Transparency

Both bills include expansive new disclosure requirements from credit rating agencies. These include better information about:

- ❖ The assumptions underlying rating methodologies
- ❖ The quality of data relied on
- ❖ The rating's sensitivity to assumptions and likely volatility
- ❖ Ratings agency performance
- ❖ Business relationships that may create conflicts of interest

The House bill requires disclosure of post-rating surveillance practices, but the Senate bill does not.

Universal Ratings Scale

Although ratings agencies claim that ratings are consistent across different types of investments, highly rated MBS have higher default rates than corporate bonds, and corporate bonds have higher default rates than comparably rated government bonds.

This is confusing to investors.

It also imposes steep, unwarranted costs on taxpayers.

We support requiring credit rating agencies to adhere to a universal rating scale.

The Legislation: Universal Ratings Scale

The House bill requires NRSROs to have written policies and procedures to assess default risks, to clearly define symbols, and to apply those symbols in a consistent manner.

The Senate bill does not.

The Senate Bill: Suggested Amendments

- The bill should be amended to create an independent clearinghouse to make ratings assignments.
- The bill should be amended to include the key regulatory oversight provisions from the House bill on anti-fraud authority, post-rating surveillance, and rule-making authority.
- The bill should be amended to eliminate NRSRO's exemption from Section 11 liability and to clarify that credit ratings are not forward-looking statements.
- The bill should be amended to require credit rating agencies to adopt and adhere to a universal rating scale based on default risk.

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The Senate Bill: Suggested Amendments

- The bill should be amended to require credit rating agencies or their parent entities to have a board, to require that board to include robust representation for users of credit ratings, and to make the board responsible for key functions essential to producing reliable ratings.
- The bill should be amended to encourage a gradual and careful reduction in regulatory reliance on ratings that provides regulators with flexibility and discretion in how they accomplish that goal and that distinguishes between different types of ratings.

Senate Banking Committee Members

Democrats

Christopher Dodd (CT), Chairman
Tim Johnson (SD)
Jack Reed (RI)
Charles Schumer (NY)
Evan Bayh (IN)
Robert Menendez (NJ)
Daniel Akaka (HI)
Sherrod Brown (OH)
Jon Tester (MT)
Herb Kohl (WI)
Mark Warner (VA)
Jeff Merkley (OR)
Michael Bennet (CO)

Republicans

Richard Shelby (AL), Ranking Member
Robert Bennett (UT)
Jim Bunning (KY)
Mike Crapo (ID)
Bob Corker (TN)
Jim DeMint (SC)
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