

REGULATING THE CREDIT RATING AGENCIES

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Abstract

The status of the United States market and economy can be partially blamed on the credit rating agencies' actions and failure to change. The SEC needs to implement change now with greater regulation and monitoring of the NRSROs. The Credit Rating Agency Reform Act should do more than open the doors for great competition. Consumer and investor confidence will only increase when the SEC, CRARA and credit rating agencies agree to a level of accountability for rating stocks, bonds and companies.

I. INTRODUCTION

It is no surprise to say the financial markets today are in upheaval with the sub-prime mortgage predicament impacting areas beyond itself. Though not the sole answer to the problems with the market, the credit rating agencies play a large role in some of the foundational issues in the markets today. Calls from hesitant investors require the credit rating agencies to be not only regulated more from within, but from Congressional action as well.

This Note proceeds as follows: Part II provides background information about the history of rating agencies as well as the governmental intervention and regulations. Part III describes the basics of obtaining a rating, what the ratings systems are, and how the ratings systems work. Part III also discusses how the ratings failed the market, namely in the mortgage sector, which has spread to affect the majority of the economy. Part IV discusses the problems within the credit rating agency market, and is followed by possible solutions to those problems in Part V. Part VI provides potential solutions to this issue and Part VII concludes the Note.

* J.D., The Ohio State University Michael E. Moritz College of Law, expected May 2009. I would like to thank Dad for the support; Craig for the critical eye, patience, and advice, though sometimes ignored; and Alex for the countless free articles he threw my way.

II. THE HISTORY OF THE RATINGS AGENCIES

A. *The Beginnings*

It is fitting for the credit rating industry to undergo a renovation as 2009 will mark the industry's 100th year of being in service. Bond ratings first became available in 1909, when John Moody founded Moody's Investment Service, a unit of Moody's Corporation (Moody's). At the time, companies were in the need of more capital than they could raise through traditional means. The rating agencies were able to facilitate the process by aiding investors with company appraisals and the benefits or costs of investing in said company.¹ The foundational business model for ratings agencies revolves around "predicting default probabilities for all kinds of debt securities and debt issuers."² Through this business model, rating agencies also grant market licenses, for without the rating, many investments would hit enormous market entry barriers.³ Today, Moody's operates in over 100 sovereign nations with over 9,300 customer accounts.⁴ In 2006, Moody's received \$2.037 billion in revenue, with a net income of \$753.9 million.⁵

Standard and Poor's (S&P) formed in 1941 through the merger of two bond rating agencies: Poor's Publishing (started rating in 1916) and Standard Statistics Company (in 1922).⁶ S&P was later taken over by the publishing company McGraw Hill in the 1960s.⁷ In 2006, S&P received \$2.75 billion in revenue.⁸ In the same year, S&P rated over 495,000 ratings, 223,000 of which were new, the remainder consisting of revised ratings.⁹ Together, Moody's and S&P comprise nearly eighty percent of the debt-rating market.¹⁰

¹ Hill, Claire. *Regulating the Rating Agencies*. WASH. U. LAW QUARTERLY, Vol. 82, p 43, 2007, at 46, <http://ssrn.com/abstract+452022> (last visited 9/21/08).

² Dittrich, Fabian. *The Credit Rating Industry: Competition and Regulation*, page 9, <http://ssrn.com/abstract-991821>. (last visited on 11/17/08).

³ *Id.* at 9.

⁴ About Moody's. http://www.moody.com/moodys/cust/AboutMoody/AboutMoody.aspx?topic=intro&redir_url=/cust/AboutMoody/staticRedirect.asp (last visited on 11/17/08).

⁵ Moody's 2006 Annual Report, Page 4, available at <http://library.corporate-ir.net/library/12/123/123831/items/236881/annualreport2006.pdf>.

⁶ White, Lawrence. *A New Law for the Bond Rating Industry – for Better or for Worse?* Law & Economics Research Paper Series. Working Paper No. 07-09. February 2007, page 2.

⁷ Hill, *supra* note 1, at 46.

⁸ S&P Fact Sheet. Page 1.

http://www2.standardandpoors.com/spf/pdf/media/FactSheet_General_091907.pdf.

⁹ *Id.* at 1.

¹⁰ Rupini Bergstrom, *Bond Raters Get Subpoenas*, WALL ST. J., Oct. 27, 2007, at B2.

In 1941, Fitch Ratings, now a unit of Fimalac SA, a French conglomerate in Paris, joined the fray, rounding off the top three ratings agencies.¹¹ Fitch Ratings comprises smaller agencies including Fitch, IBCA, Duff & Phelps, and Thomson BankWatch.¹² In 2006, Fitch Ratings contributed eighty-five percent of Fimalac's revenue, accounting for nearly \$567 million in revenue.¹³

The impact of these three rating agencies can be felt through the knowledge that most bonds traded on the public market and most industrial companies are rated by these agencies; the majority sometimes requires two ratings—mainly Moody's and S&P.¹⁴ Reports state "Moody's rates 78% of the industrial companies in the United States, while Standard & Poor's rates 66%."¹⁵ Additionally, ninety-nine percent of the bonds and preferred stock publicly traded in the United States is rated by S&P.¹⁶ Moody's, on the other hand, rates more than 90% of the public market in bonds that are investment grade.¹⁷ A *New York Times* columnist even declared "Moody's as one of the two superpowers in the world, the other superpower being the United States."¹⁸ This type of power, consequently, makes it impossible for bonds and stock to be bought without being rated by one of the three major named agencies. In Congressional hearings, Senator Joseph Lieberman commented on the power by stating:

The credit rates hold the key to capital and liquidity, the lifeblood of corporate American and of our capitalist economy. The rating affects a company's ability to borrow money; it affects whether a pension fund or a money

¹¹ White, *supra* note 6, at 2.

¹² Hill, *supra* note 1, at 47.

¹³ Fimalac Annual Report. Page 61.

<http://www.prline.com/rootMRI/3794/docsMRI/Rapportannuel2006anglais.pdf>. (Fimalac reported €383.6 million as the fiscal 2006 revenue, accounting for nine months of the 2006 year, with its year end in September. The €383.6 million converts roughly to \$567,229,065 in U.S. dollars.)

¹⁴ Hill, *supra* note 1, at 48.

¹⁵ See *New Interests, New Conflicts*, THE ECONOMIST, Apr. 14, 2001, Finance and Economics, at 2001 WL 7318498.

¹⁶ *Rating the Ratings Agencies: The State of Transparency and Competition: Hearing Before the Capital Markets Subcommittee of the House Financial Services Committee* (Transparency and Competition Hearing), 108th Congress. 219-230 (2003) <http://financialservices.house.gov/media/pdf/108-18pdf>.

¹⁷ Moody's.com, Products and Services brochure – Corporate Research, *available at* http://www.moody.com/cust/prodserv/prodserv_detail.asp=11&c=1 (last visited on 11/17/08).

¹⁸ Hill, *supra* note 1, at 47 (quoting an Interview with Thomas Friedman, *The MacNeil/Lehrer Newshour* (PBS television broadcast, Feb. 13, 1996)).

market fund can invest in a company's bonds; and it affects stock price.¹⁹

As powerful presences in the financial markets, both in the United States and internationally, the ratings agencies must have a degree of accountability to both the markets and companies served, as well as to the investors relying on the appraisal information provided.

B. *Federal Intervention and Regulation*

In 1975, the Securities and Exchange Commission ("SEC") desired to use the ratings agencies to ensure that the broker-dealers it regulated had capital requirements so as to not expend its own resources researching every bond itself.²⁰ As a result, the category of Nationally Recognized Statistical Rating Organizations ("NRSROs") was born out of the SEC.²¹ Moody's, S&P and Fitch Ratings were all grandfathered into the NRSRO category, granting each organization the ability to rate bonds. This all important status should be highlighted as regulated financial institutions must follow the NRSRO ratings in order to invest in bonds.²² However, that the SEC "never intended or expected that the nationally recognized statistical rating organization concept [NRSRO] would become so widely relied upon."²³

Achieving an NRSRO status since 1975 has been exceedingly difficult, as the process has been unclear, leaving the designation to serve as a barrier to entry for market participants.²⁴ Since the inception of NRSROs, eight agencies have received that designation, through February 2003.²⁵ Due to buyouts and mergers, however, the numbers quickly dwindled back down to essentially the main three. While the process of obtaining an NRSRO designation is opaque, the SEC has stated that it considers the following criteria:

¹⁹ *Rating the Raters: Enron and the Credit Rating Agencies: Hearing Before the Senate Comm. on Governmental Affairs* (Enron Hearing), 107th Cong. 116 (2002), available at <http://govt-aff.senate.gov/032002lieberman.htm> (last visited on 1/22/09).

²⁰ White, *supra* note 6, at 4.

²¹ Buttonwood, *Credit and Blame*, THE ECONOMIST, Sept. 8, 2007, at 77.

²² Mr. Jack White, A Hearing of the Senate Banking, Housing and Urban Affairs Committee; Subject: The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets. Sept. 26, 2007.

²³ *A Hearing of the Senate Banking, Housing and Urban Affairs Committee: The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets* (Impact of Credit Agencies), Cong. 10 (2007) (statement of Senator Shelby).

²⁴ Lawrence White, *A New Law for the Bond Rating Industry*, REGULATION, Spring 2007, at 50.

²⁵ Transparency and Competition Hearing, *supra* note 16.

The organizational structure of the rating organization, the rating organization's financial resources . . . , the size and experience of training of the rating organization's staff . . . , the rating organization's independence from companies it rates, the rating organization's rating procedures . . . , and whether the rating organization has internal procedures to prevent the misuse of non-public information and whether those procedures are followed.²⁶

Additionally, the most important criteria includes the agency being "nationally recognized" for its ratings reliability.²⁷ This aspect leads to an inevitable Catch-22: "an agency has to be nationally recognized to be an NRSRO but has to be an NRSRO to become nationally recognized."²⁸ Consequently, barriers to market entry and competition are hatched through the SEC's lack of discernable regulatory definitions of NRSRO designations and clarity within its own structure for evaluating potential market participants.

III. THE NUTS AND BOLTS OF RATINGS

The NRSRO ratings are supposedly designed to relate to only one area—"the likelihood that rated securities will default."²⁹ According to both Moody's and S&P, a rating is the firm's opinion of the credit quality or general credit worthiness of an issuer's debt security or financial obligation.³⁰ Ratings are not agency recommendations of whether or not to invest or not in a certain company or security.³¹

The following chart lists the grades from S&P on the left hand side, and the probability that the investment will meet its financial commitment on the right hand (i.e., not default). There are ten ratings in all, falling into two categories: investment grades or speculative grades. Among the gradations, there are pluses and minuses that add even more levels of

²⁶ Enron Hearing, *supra* note 19.

²⁷ *Id.*

²⁸ Hill, *supra* note 1, at 55.

²⁹ Ms. Vickie Tillman, A Hearing of the Senate Banking, Housing and Urban Affairs Committee; Subject: The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets. Sept. 26, 2007. *See also* Hearing of the Capital Markets, FEDERAL NEWS SERVICE, Sept. 27, 2007; *and* Hearing of the Senate Banking, Housing and Urban Affairs Committee, FEDERAL NEWS SERVICE, Sept. 26, 2007.

³⁰ S&P Credit Ratings Fact Sheet, *supra* note 8, at 1; Moody's Rating System, at 1, available at <http://www.moodys.com/moodys/cust/research/mdcdocs/24/200570000433096.pdf>. For the purposes of defining the rating system, Moody's and S&P's approaches will be the focus, as these firms are the most renowned in the market.

³¹ *See* S&P Credit Ratings Fact Sheet, *supra* note 8, at 1; *See* Moody's Rating System, *supra* note 30, at 1.

predicted reliability against default. The ratings are a formal part of the financial system through the actions of regulators, including the SEC and banks.³²

| Credit Ratings Gradations ³³ | |
|--|-----------------------------|
| Investment Grades | |
| AAA | Extremely Strong |
| AA | Very Strong |
| A | Strong |
| BBB | Adequate Protection |
| BBB- | Adequate Protection |
| Speculative Grades (or "Junk") | |
| BB | Less Vulnerable |
| B | More Vulnerable |
| CCC | Currently Vulnerable |
| CC | Highly Vulnerable |
| C | Currently Highly Vulnerable |
| D | In Default |

For Moody's, the chart looks relatively similar, except that instead of pluses and minuses within a certain grade, numbers are associated with the letters so that its system resembles the chart below.³⁴

| Investment Grade | |
|-------------------------|--|
| Aaa | Highest rating, representing minimum credit risk |
| Aa1 | High-grade |
| Aa2 | |
| Aa3 | |
| A1 | Upper-Medium Grade |

³² Buttonwood, *supra* note 21, at 77.

³³ Henry, David. *Anatomy of a Ratings Downgrade: How S&P and Moody's miscalculated risk on two top-rated pools of mortgage-backed bonds*. BUSINESSWEEK, Oct. 1, 2007 at 66.

³⁴ Moody's Rating System, *supra* note 29, at 2.

| | |
|--------------------------|--|
| A2 | |
| A3 | |
| Baa1 | |
| Baa2 | Medium Grade |
| Baa3 | |
| Speculative Grade | |
| Ba1 | Speculative Elements |
| Ba2 | |
| Ba3 | |
| B1 | Subject to high credit risk |
| B2 | |
| B3 | |
| Caa1 | Bonds of poor standing |
| Caa2 | |
| Caa3 | |
| Ca | Highly speculative, or near default |
| C | Lowest rating, bonds typically in default, little prospect for recovery of principal or interest |

Combined, the two rating systems aid investors ranging from individuals to businesses to pension fund managers, in their evaluation of an investment's safety. However, the majority of investments are not rated on an unsolicited basis; instead, issuers pay the ratings agencies to appraise its security or investment.

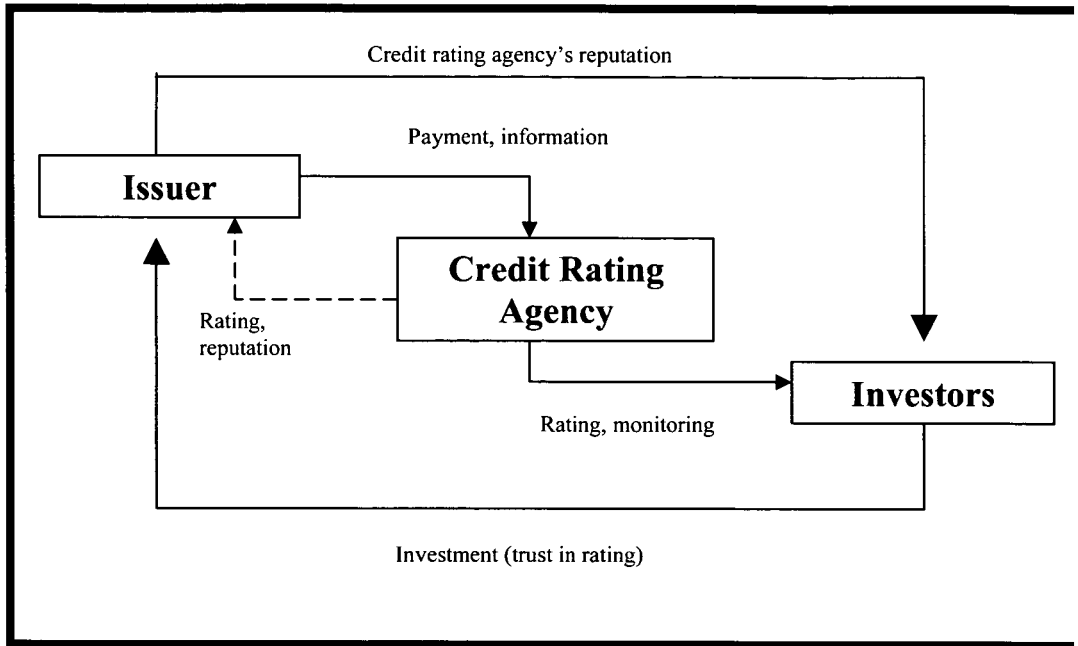
A. *How the Securities Are Rated*

In the typical life of a security, the issuer first sells the debt security to an investor—a higher predicted creditworthiness correlates to a higher investment given for the security.³⁵ At that point the rating agency receives payment from the issuer, along with information, in order for the rating agency to evaluate and subsequently rate the issuer's creditworthiness.³⁶

³⁵ Dittrich, *supra* note 2 at 10.

³⁶ *Id.* at 10.

The following chart follows the flow of information, reputation and money through the three main categories of actors—issuers, credit rating agencies and investors.³⁷



According to an S&P press release, its ratings are based on:

business fundamentals, including the issuer's industry, prospects for growth and its vulnerability to technological change or regulatory action; . . . economic strength of a country; . . . the political system and the social environment; . . . prior financial statements, financial and cash flow projections, transaction documents, supporting legal opinions and other relevant data.³⁸

Additionally, the team assigned within the rating agency to give a rating meets with the issuer's management to discuss "operating and financial plans and management policies."³⁹ From there a rating is issued.

³⁷ *Id.*

³⁸ S&P Credit Ratings Fact Sheet, *supra* note 8, at 3.

³⁹ *Id.* at 3.

Moody's advocates a universal approach to risk analysis.⁴⁰ Moody's Rating System press release advocates its use of the following in assigning a rating:

publicly available data, e.g., annual reports; prospectuses, offering circulars, offering memoranda, trust deeds or indentures of particular securities; market data, e.g., stock price trends, trading volume, data on bond price spreads; economic data from industry groups, associations or bodies . . . ; data from agencies, such as central banks, ministries, or regulators; books or articles from academic source, financial journals, news reports; discussions with expert sources in industry, government, or academia; data that may come from meetings or conversations with the debt issuer.⁴¹

On the surface, both Moody's and S&P use essentially the same data in placing the issuers on each agencies spectrum of ratings.

Once the initial rating is given though, the process does not stop, at least it is not supposed to. Historically, the agencies do well in terms of initial ratings, but falter when it comes to ongoing ratings.⁴² Surveillance of the rated investments is theoretically to continue according to the agencies procedures; S&P states that it conducts surveillance formally once a year when meeting with the issuer's management.⁴³ Notably in recent years, failure of useful and thorough surveillance allowed Enron to maintain an "investment grade" rating with both Moody's and S&P until five days before Enron filed for bankruptcy.⁴⁴ Similar situations occurred with WorldCom and with regard to the Asian Flu crisis, where the downgrade came too late.⁴⁵

Both Moody's and S&P employ systems to consider a change in rating, either upgrading or downgrading.⁴⁶ Once circumstances contradict the current rating or underlying support information, Moody's will place a rating on the Watchlist and this review can include possible upgrade or

⁴⁰ Moody's Rating Approach, <http://www.moodys.com/moodys/cust/AboutMoody/AboutMoody.aspx?topic=rapproach> (last visited on 11/17/08).

⁴¹ Moody's Rating System, *supra* note 29 at 2.

⁴² Hill, *supra* note 1 at 68.

⁴³ S&P Credit Ratings Fact Sheet, *supra* note 8, at 3.

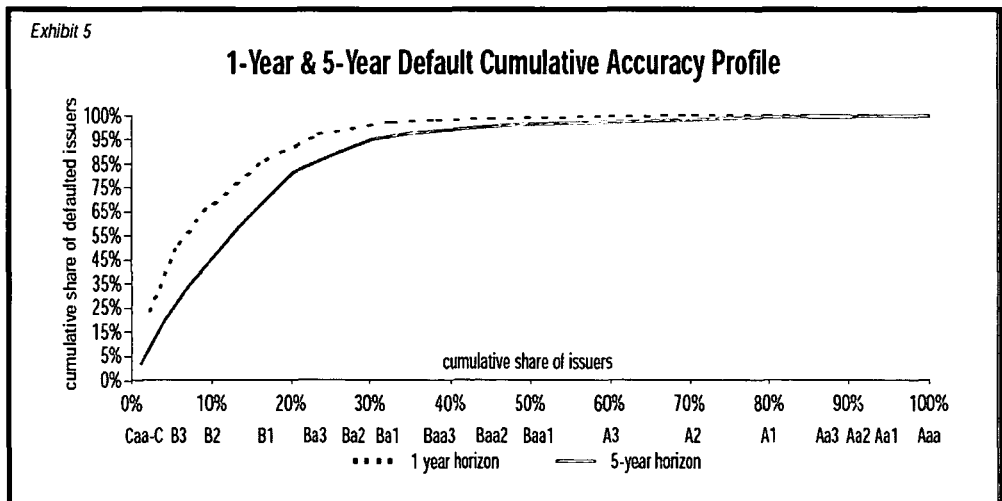
⁴⁴ White, *supra* note 24, at 50.

⁴⁵ Hill, *supra* note 1, at 46.

⁴⁶ See S&P Credit Ratings Fact Sheet, *supra* note 8, at 3; *see also* Understanding Moody's Corporate Bond Ratings and Rating Process, Page 7, <http://www.moodys.com/moodys/cust/research/MDCdocs/06/2001400000389218.pdf?frameOfRef=corporate> (last visited on 11/17/08). S&P calls this system "CreditWatch," while Moody's refers to it as "Watchlist."

downgrade.⁴⁷ Under the Moody's regime, a formal committee confers with the issuing firm's management once placed on the Watchlist to garner information in order to determine a change in rating.⁴⁸ Moody's estimates between sixty-six and seventy-six percent of its ratings have changed in the same direction as suggested by the Watchlist committee.⁴⁹ S&P follows essentially the same process with its CreditWatch system—invoking analysis, a potential meeting with the issuing firm's management, and subsequent recommendation to the rating committee.⁵⁰

Both the initial rating and the subsequent surveillance of an investment in each rating agency rely on "the best information available at the time," according to Vickie Tillman, the chief rating officer of S&P.⁵¹ The chart below illustrates Moody's "Default Cumulative Accuracy Profile," obtained through a 2002 press release issued as a special comment to its rating policy for both customers and investors alike.⁵² Additionally, Moody's indicates that since 1983 90% of all rated companies that have defaulted "were rated Ba3 or lower at the beginning of the year in which they defaulted, and almost 80% were rated Ba3 or lower at the beginning of the fifth year before they defaulted."⁵³



However, investors are witnessing drastically different trends nearly every week in newspapers and newscasts alike. As of December 21, 2007,

⁴⁷ Understanding Moody's Corporate Bond Ratings and Rating Process, *supra* note 45, at 7.

⁴⁸ *Id.* at 7.

⁴⁹ *Id.* at 7.

⁵⁰ See S&P Credit Ratings Fact Sheet, *supra* note 8, at 3.

⁵¹ Allan Sloan, *House of Junk*, FORTUNE, Oct. 29, 2007, at 117.

⁵² Understanding Moody's Corporate Bond Ratings and Rating Process, *supra* note 45, at 10.

⁵³ *Id.* at 9.

The Wall Street Journal reported S&P had lowered ratings on 1,078 investments as a direct result of the mortgage market.⁵⁴ The investments affected comprise \$68.16 billion.⁵⁵ The new year has brought an additional 200 ratings downgrades, adding just under another \$20 billion to the group of investments affected by the change in rating.⁵⁶ S&P is not alone in the trend of downgrading ratings; Moody's and Fitch have both participated in the process as well.

B. Ratings Failure

Though the ratings are claimed to only provide investors with information on the possibility of default, many, including professional financiers and laymen alike, have relied on the credit ratings as a basis for their own investment decisions.⁵⁷ For buyers of securities there are two options for analyzing her investments: (1) the prospectus, which includes company information, financials and other public records, or (2) the credit agencies.⁵⁸ The majority of people will take option number two.⁵⁹

As a result, the credit ratings agencies have helped to fuel the current sub-prime mortgage disarray, though admittedly these agencies are not the sole cause. Ratings firms have become an essential part of the financial market, including the mortgage sector. Financial stability is the goal, with an important segment of that stability being confidence from the participating actors in the system.⁶⁰ In the mortgage context, homeowners would borrow from mortgage bankers only to have those loans resold to firms.⁶¹ The mortgage loans would then be repackaged as part of securities, often referred to as collateralized debt obligations ("CDOs"), which were then evaluated by the ratings firms, given a grade and sold to investors.⁶² Through providing top ratings to security investments comprised of

⁵⁴ Shwiff, Kathy. *S&P, Fitch Reduce CDO Ratings*. WALL ST. J., Dec. 18, 2007, <http://online.wsj.com/article/SB119826225072045517.html> (last visited on 11/17/08). As of December 12, 2007, *The Wall Street Journal* reported that S&P had lowered ratings on 991 investments as a direct result of the mortgage market. That particular day alone, 156 ratings, linked to \$6.84 billion, were downgraded. See also Barris, Mike. *S&P Slashes its Ratings on \$6.8 Billion in CDOs*. WALL ST. J., Dec. 18, 2007, <http://online.wsj.com/article/SB119799218586936741.html> (last visited on 11/17/08).

⁵⁵ Shwiff, *supra* note at 54.

⁵⁶ *Id.*

⁵⁷ Sen. Charles Schumer. A Hearing of the Senate Banking, Housing and Urban Affairs Committee; Subject: The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets. Sept. 26, 2007.

⁵⁸ Sloan, *supra* note 51, at 117.

⁵⁹ *Id.* at 117.

⁶⁰ Dittrich, *supra* note 2, at 9.

⁶¹ Aaron Lucchetti & Kara Scannell, *Ratings Firms: A Dollar Short and a Day Late?*, WALL ST. J., Sept. 26, 2007, at A1.

⁶² *Id.* at A1.

“questionable loans, the firms were able to make the securities seem as safe as a Treasury Bond.”⁶³

Problems arose when homeowners began to default on their mortgages due to two other causes of the sub-prime mess: adjustable rate mortgages kicking in and homeowners simply living too far above their allowable income.⁶⁴ The default rates came in much higher than the credit ratings agencies predicted, causing a severe downgrading of CDO investments, as well as backlash against the ratings agencies as investors lost confidence in the ratings themselves.⁶⁵ Only six nonfinancial U.S. firms are still rated AAA, down from 25 in 1992 and 12 in 2002: United Parcel Service Inc. (ratings are in doubt), Pfizer Inc. (ratings are in doubt), Exxon Mobil Corp., Automatic Data Processing Inc., General Electric Co., and Johnson & Johnson.⁶⁶ In the financial sector, the number of top rated firms as “AAA” is down to 53 as opposed to 61 in 2002 and 76 in 1997.⁶⁷ As of October 27, 2007, Moody’s Investors Service, S&P and Fitch had downgraded over \$50 billion in mortgage-backed securities.⁶⁸ The loss of investor confidence and subsequent call for greater transparency in the ratings system came with these downgrades, and hit hardest when some of the CDOs and other securities fell from a AAA grade at least four levels to junk.⁶⁹ For example, Moody’s took a AAA-rated, \$873 million CDO down ten steps to a Moody’s junk rating of Ba1.⁷⁰

The 2006-2007 credit ratings agency failure in the mortgage market sector is not the first time these agencies have failed the broader economy and investors and the economy.⁷¹ Some of the failures include: Penn Central bankruptcy (1970), New York City financial crisis (1975), Washington State Public Power default (1983), Orange County debt crisis (1994), Asian financial meltdown (1997), and most recently and notably the Enron collapse of 2001 and Worldcom bankruptcy of 2002.⁷² Post-Enron, the financial markets and press realized that Moody’s and S&P kept the investment grade ratings on Enron up until five days before Enron filed for bankruptcy.⁷³ These repetitive failures on the part of the credit rating

⁶³ *Id.* at A1.

⁶⁴ *Id.* at A1.

⁶⁵ *Id.* at A1.

⁶⁶ David Wessel, *And Then There Were Six...*, Wall St. J. Economics Blog, Nov. 5, 2007, <http://blogs.wsj.com/economics/2007/11/05/and-then-there-were-six> (last visited on 11/17/08).

⁶⁷ *Id.*

⁶⁸ Aparajita Saha-Bubna & Carrick Mollenkamp, *CDO Ratings are Whacked by Moody’s*, WALL ST. J., Oct. 27, 2007, at B1.

⁶⁹ *Id.* at B1.

⁷⁰ *Id.* at B1.

⁷¹ *The Great Global Meltdown of 2007 – Brought to you Courtesy of the SEC*, PR NEWSWIRE, Sept. 28, 2007.

⁷² *Id.*

⁷³ White, *supra* note 24, at 51.

agencies and subsequent call during the Enron and Worldcom debacles for greater regulation and transparency led to the adoption of the Credit Rating Agency Reform Act of 2006 (“CRARA”).⁷⁴

IV. THE CREDIT RATING AGENCY REFORM ACT OF 2006

President George W. Bush signed the CRARA on September 29, 2006.⁷⁵ The 109th Congress moved the CRARA, then Senate Bill 3850, very quickly through the congressional pathways as the bill was only introduced twenty-three days earlier on September 6, 2006 by Senator Richard Shelby.⁷⁶ However, as Senator Shelby proclaimed just after the CRARA was signed, the need for this bill was immediate:

“The dominant rating agencies failed millions of investors by neglecting to lower their ratings on Enron, WorldCom and other companies headed for bankruptcy . . . The absence of timely downgrades in these cases was a product of an industry that was beset by conflicts of interest and a lack of competition. Ultimately, this compromised the integrity of the market and investors paid the price.”⁷⁷

The text of the CRARA legislation itself even provided in its Section Two findings why Congress found that credit rating agencies to be of national importance.⁷⁸ To Congress the credit rating agencies are a participant in interstate commerce; their issued ratings relate to the securities issued by national banks and those of the Federal Reserve System; the agencies “affect interstate commerce, the securities markets, the national banking system and the national economy;” oversight is imperative to investor protection; additional competition is necessary to the public interest; and in order for oversight to occur, the SEC needs statutory authority.⁷⁹

The CRARA Section Four provides an amendment to the Securities Exchange Act of 1934, inserting a new section entitled “SEC. 15E. Registration of Nationally Recognized Statistical Rating Organizations.”⁸⁰

⁷⁴ *Id.*, at 48.

⁷⁵ Credit Rating Agency Reform Act, S. 3850 – 109th Congress., *GovTrack.us*, <http://www.govtrack.us/congress/bill.xpd?bill=s1099-3850> (last visited 11/17/08).

⁷⁶ *Id.*

⁷⁷ Marie Leone, *Bush Signs Rating Agency Reform Act*, CFO.COM, Oct. 2, 2006, www.cfo.com/article.cfm/7991492/c_7989907=TodayInFinance_Inside (last visited 11/17/08).

⁷⁸ Credit Rating Agency Reform Act. Public Law No. 109-291, Section 2, Sept. 29, 2006.

⁷⁹ *Id.*

⁸⁰ Credit Rating Agency Reform Act. Public Law No. 109-291, Section 4, Sept. 29, 2006.

The areas legislated in the CRARA Section Four include, among others: registration procedures for NRSRO's, update of the registration, accountability for rating's procedures, registration suspension, denial or termination, management of conflict of interests, prohibited conduct and SEC authority of NRSROs.⁸¹ The most important and necessary parts of this section are contained within the NRSRO registration process, accountability of the NRSROs and the oversight authority of the SEC.

The CRARA provides a credit rating agency with at least three consecutive years experience, immediately prior to the application, the ability to submit an application to become registered as an NRSRO.⁸² A NRSRO application under the CRARA contains the following:

“(i) the credit ratings performance measurement statistics over short-term, mid-term, and long-term periods (as applicable) of the applicant;

(ii) the procedures and methodologies that the applicant uses in determining credit ratings;

(iii) policies or procedures adopted and implemented by the applicant to prevent the misuse, in violation of this title (or the rules and regulations hereunder), or material, nonpublic information;

(iv) the organizational structure of the applicant

(v) whether or not the applicant has in effect of a code of ethics, and if not, the reasons therefor;

(vi) any conflict of interest relating to the issuance of credit ratings by the applicant;

(vii) the categories described in any clauses (i) through (v) of section 3(a)(62)(B) with respect to which the applicant intends to apply for registration under this section;

(viii) on a confidential basis, a list of the 20 largest issuers and subscribers that use the credit rating services of the applicant, by amount of net revenues received therefrom in the fiscal year immediately preceding the date of submission of the application.

⁸¹ *Id.*

⁸² *Id.*

(ix) on a confidential basis, as to each applicable category of obligor described in any clauses (i) through (v) of section 3(a)(62)(B), written certifications described in subparagraph (C), except as provided in subparagraph (D); and

(x) any other information and documents concerning the applicant and any person associated with such applicant as the Commission, by rule may prescribe as necessary or appropriate in the public interest or for the protection of investors.”⁸³

The required written certifications of (B)(ix) (above) are provided by at least ten qualified buyers not affiliated with the applicant and must include more than two certifications for each category of obligor.⁸⁴

The CRARA § 15E(c) sets forth the accountability for the ratings procedure and the basic authority of the SEC.⁸⁵ It grants the SEC the authority to enforce the provisions of the CRARA to designated NRSROs.⁸⁶ This section specifically prohibits the SEC from regulating the substance of the credit ratings or the procedures followed by the NRSROs to determine the credit ratings.⁸⁷ The CRARA, however, does permit the SEC to censure, deny or suspend the registration of any NRSRO, if the SEC believes it is necessary for the “protection of investors and in the public interest.”⁸⁸

Additionally, the SEC is required to submit an annual report to the Senate Committee on Banking, Housing and Urban Affairs and the House of Representatives Committee on Financial Services.⁸⁹ The annual report is to include identified applicants for NRSRO status, the number of applicants and any actions taken thereon as well as how the SEC views “competition, transparency and conflicts of interest” in the credit rating agency market.⁹⁰

On May 23, 2007, the SEC voted to adopt the final rules it would use to implement the Congressional legislation of the CRARA.⁹¹ In adopting the final rules, the SEC took to heart the goal of the new law espoused by its own chairman, Christopher Cox. Chairman Cox stated that “the heart of the Act calls on the Commission to replace the barriers to

⁸³ *Id.* at § (a)(1)(B).

⁸⁴ *Id.* at § (a)(1)(C).

⁸⁵ CRARA, *supra* note 80, at § (c).

⁸⁶ *Id.*

⁸⁷ *Id.* at § (c)(2).

⁸⁸ *Id.*, at § (d).

⁸⁹ Credit Rating Agency Reform Act. Public Law No. 109-291, § 6, Sept. 29, 2006.

⁹⁰ *Id.*

⁹¹ SEC Press Release, *SEC Votes to Adopt Final Rules to Implement the Credit Rating Agency Reform Act of 2006*. May 23, 2007, <http://www.sec.gov/news/press/2007/2007-104.htm> (last visited 11/17/08).

entry that had previously existed. The replacement is a transparent and voluntary Commission registration system that favors no particular business model.”⁹² The heart of the CRARA had barely begun to beat before the sub-prime mortgage troubles took control of the market and investors.

V. CREDIT RATING AGENCY PROBLEMS

Inherent in the credit rating agency business model are warning signs dictating to investors to be wary of relying too much on their securities ratings. The most significant problems to the ratings firms are: a monopolization of the credit rating industry segment and the huge potential for conflicts of interest.

A. Duopoly on the Market

As stated previously, Moody’s and S&P control the majority of the credit rating market, with nearly an 80% segment combined.⁹³ This situation results in a duopoly on the market as Fitch comes in as a strong, but distant third in worldwide credit ratings. With such a duopoly, market competition and economic efficiency suffer.⁹⁴ While the long-term impact of the CRARA remains to be seen, the Act attempts to open up the credit rating market to new entrants seeking to gain a NRSRO designation.⁹⁵ The legislation permits a credit rating firm, issuing ratings for at least three years, to apply to be registered as an NRSRO with the SEC; incumbents, namely Moody’s, S&P and Fitch must also apply.⁹⁶

Prior to the CRARA, NRSRO qualifications were never provided by the SEC. Instead, agency applicants would request the designation just to sit patiently by for the SEC to issue a “no action letter” guaranteeing no enforcement action against any broker-dealer that used the agency applicant’s ratings.⁹⁷ Now, however, with the CRARA, after submitting this information, the applicant’s duty is simply to sit and await notification from the SEC within ninety days of whether or not the SEC will designate the applicant as a NRSRO, or whether a proceeding shall be instituted for further inquiry.⁹⁸ The NRSRO designation is quintessential for a ratings firm to become a part of the bond rating business, as many banks and regulators will only take account of the NRSROs credit ratings.⁹⁹

⁹² *Id.*

⁹³ Rupini Bergstrom, *Bond Raters Get Subpoenas*, WALL ST. J., Oct. 27, 2007, at B2.

⁹⁴ Dittrich, *supra* note 2, at 99.

⁹⁵ White, *supra* note 24, at 51.

⁹⁶ *Id.*

⁹⁷ White, *supra* note 6, at 5.

⁹⁸ White, *supra* note 24 at 52.

⁹⁹ White, *supra* note 6, at 4.

Critical to achieving the NRSRO designation is obtaining the business of issuers looking for ratings for their investments and securities. With Moody's and S&P's duopoly over the market, reputation comes into play as well. A large barrier to entry comes with new applicants vying for the business of issuers who solely rely on the ratings of Moody's and S&P. The majority of investors have name recognition with these two large market participants which many of the smaller market players will simply not have. No name recognition leads to a lack of reputation which can in turn lead to little trust from the investors whom the issuers desire to buy their securities and investments. While an extreme drop of investor confidence in the ratings system currently might help the newer credit rating outfits, it is up to the SEC to allow market entrants a regulated path to entry, instead of stifling the competition along the way.

B. *Conflict of Interest*

Rating agencies inherently have a large conflict of interest since they are paid by the issuers whose securities they rate.¹⁰⁰ Numerous statements to this effect have been made, both in Senate hearings and in the market at large, including Former Senate Banking Chairman Richard Shelby, who stated: "They're conflicted. It's driven by money, not responsibility and ethics."¹⁰¹ There is a complete lack of independent assessment of credit risk.¹⁰² Much of the exorbitant income for the credit-rating agencies comes from their opinions on the bank-created, mortgage-related securities.¹⁰³

The credit rating agencies use an issuer-pays business model instead of a subscription model. In an issuer-pays model, it is the issuers, not the investors who pay for the ratings. Ratings agencies are paid for the actual, end-result rating, not for the preliminary work of creating the rating, including researching, analyzing and gathering information.¹⁰⁴ In the end, if the issuer is unhappy with Moody's or S&P's output, the issuer "walk away without paying a dime."¹⁰⁵ Inherent in the issuer-pays model are conflicts of interest, though the agencies are firm believers in their ability to manage the conflicts. A group managing director at Moody's stated in a Senate hearing that Moody's has "successfully managed related conflicts of

¹⁰⁰ Buttonwood, *supra* note 21, at 77. Refer to the pictorial in Part IIIA for a graphical representation of the inter-workings of the ratings market.

¹⁰¹ Dawn Kopecki, *The Credit Ratings Blame Game*, BUSINESSWEEK, Oct. 1, 2007.

¹⁰² Buttonwood, *supra* note 21, at 77

¹⁰³ Aaron Lucchetti, *Ratings Firms' Practices Get Rated*, WALL ST. J., Sept. 7, 2007, at C1.

¹⁰⁴ Impact of Credit Agencies, *supra* note 23, at 10 (statement of Senator Wayne Allard).

¹⁰⁵ *Id.* at 10.

interest and provided the market with objective, independent, and unbiased credit opinions.”¹⁰⁶

In the current sub-prime mortgage crisis, the ratings agencies gave investment grade ratings to CDOs, which included many of the late- to-default mortgages.¹⁰⁷ The investment grades allowed Wall Street to sell the bonds to the market, potentially easier than they would have been able to without investment grade rating.¹⁰⁸ Additionally, while individual investors saw their home values sharply decline while their mortgage interest rates rose, “Moody’s net income rose from \$289 million in 2002 to \$754 million last year.”¹⁰⁹

The problem with the issue-backed, credit rating agencies is that in this type of system the issuers are the ones paying the agencies to rate their investments and then pay a fee on top of the rating charge.¹¹⁰ The investors are the ones using this information to decide how to invest their monies, though, not the issuers. The rating agencies argument, however, as articulated by Vickie Tillman, Executive Vice-President of S&P’s credit marketing services, purports that there is no evidence is available to show agencies acting in the interests of the issuers.¹¹¹ She touts her agency’s methodology of letting the issuers structure the deals, and then using criteria that are “publicly available, non-negotiable and consistently applied” to the transactions.¹¹² An analyst at Moody’s Investor Services, Teresa Wyszomierski, Vice President of Structured Finance Derivatives, also commented, maintaining that Moody’s “methodologies and models for rating structured finance obligations are published on the their website and are fully transparent, thereby making any digression immediately obvious to market participants.”¹¹³

Even though the ratings firms may argue their ratings have nothing to do with the fees they are paid, the simple matter that they are paid by firms for the ratings they give is enough to raise questions in terms of the firms’ reliability and independence. Though the ratings agencies disclose the amounts they bring in to rate bonds, there needs to be transparency in terms of whether those that sell more deals, generating more profits for the ratings firms, also get better ratings.¹¹⁴ Admittedly, there is no evidence

¹⁰⁶ Kopecki, *supra* note 101.

¹⁰⁷ Lucchetti, *supra* note 103, at C1.

¹⁰⁸ *Id.* at C1.

¹⁰⁹ Buttonwood, *supra* note 21, at 77.

¹¹⁰ Norris, James. *Rating Agencies: Heads I win, Tails you Lose*, GLOBAL INVESTOR, Sept. 2007.

¹¹¹ Vickie Tillman, *How S&P Protects Integrity of Credit Ratings*, WALL ST. J., Sept. 17, 2007, at A15.

¹¹² *Id.*

¹¹³ Teresa Wyszomierski, *Moody’s Credit Ratings are Never ‘Compromised’*, WALL ST. J., Sept. 4, 2007, at A15.

¹¹⁴ Lucchetti, *supra* note 103, at C1.

currently of this treatment, but there is also a lack of real investigation and oversight of the agencies' processes at the same time.¹¹⁵

The fact that there is a lesser known role of the ratings agencies of helping the issuers place the best investments together in order to get the highest potential rating for the investment to be marketable is problematic.¹¹⁶ Working in combination, the ratings firms and issuers should not be able to scam the market. The ratings agencies should maintain their independence, accepting payments from issuers regardless of what the potential rating might be and only accepting securities and investments for ratings consideration only when fully complete. Investors should know this information, and yet it is often kept under wraps for fear of investors losing confidence in the rating system. If investors lose confidence, the markets for the new investments dry up, issuers become less willing to pay for ratings, subsequently hurting revenue at both the ratings firms and at Wall Street firms.¹¹⁷

VI. POTENTIAL SOLUTIONS TO THE PROBLEMS

CRARA is not enough to fix the current problems within the ratings firms and processes themselves. Originally, CRARA was aimed at garnering more competition among the ratings firms by opening up the NRSRO designation for potentially more market participants and giving the SEC the ability to inspect the books and policies governing the ratings firms.¹¹⁸ However, even if the SEC were to find something wrong in the system, the SEC is prohibited from second-guessing rating decisions.¹¹⁹

Congress should not wait to see in a few years how the 2006 CRARA will impact the financial markets and credit rating agencies. Previous inaction on the parts of the SEC and Congress should motivate "Congressional committees into remedying the abusive practices of the credit-rating agencies."¹²⁰ More agencies need to enter the market. While arguments could be made that more agencies would create incentive for issuers to shop around for firms with the weakest standard, investor confidence and agency reputation would be at stake, thus eliminating the potential for shopping.¹²¹

Three years of experience, as required by CRARA and the SEC, could very well serve to be impossible for new NRSRO applicants. The

¹¹⁵ *Id.*

¹¹⁶ Aaron Lucchetti & Serena Ng, *Credit and Blame: How Rating Firms' Call Fueled Subprime Mess*, WALL ST. J., Aug. 15, 2007, at A1.

¹¹⁷ Lucchetti & Scannell, *supra* note 60, at A1.

¹¹⁸ Kopecki, *supra* note 101.

¹¹⁹ *Id.*

¹²⁰ *The Great Global Meltdown of 2007 – Brought to you Courtesy of the SEC*, *supra* note 70.

¹²¹ Buttonwood, *supra* note 21, at 77.

SEC and Congress need to reevaluate the application process for a NRSRO designation. This is not a recommendation to allow just any company the designation, as the designation does connote authority and power above the rest. Instead, this is a call for the barriers of entry to be lowered while the standards for ratings are raised exponentially. The SEC and Congress need to permit more NRSRO designations with the caveat that the designation can and will be revoked at the SEC's sole discretion. Obtaining the NRSRO designation should not be the key to entry into the market; a credit rating agency keeping the designation, however, is where all of the SEC power should lie.

Transparency and better monitoring on the part of the SEC is essential to a new CRARA. Agencies should be forced to follow the securities and bonds once they are rated so that it will be clearer if and when to downgrade these securities later on.¹²² While this is less lucrative for the ratings agencies, this will help to improve investor confidence and the firms' reputations in the long run.¹²³ Currently, CRARA does not permit the SEC to extend its authority into the substance of each agency's ratings—namely, procedures and methodologies.¹²⁴ Admittedly, a balance is needed so to not undermine the foundational business model and still permit the agencies to make money. While it is not recommended for the SEC to mandate a national rating system, allowing the SEC to become more involved in the process would thwart conflicts of interest and promote competition within the industry.¹²⁵

Processes could also be put into place to make the regulations less dependent on the ratings, using instead market values.¹²⁶ However, prices can be volatile, and that might require banks to hold more reserves to guard against price moves. For example, it would not make sense to say that the securities are more accurate than the market. If a security is trading at 80 cents on the dollar, it is no use saying that S&P rates it AAA; the extra \$0.20 will not magically appear because an agency says so. Additionally, changing the entire system of rating investments would prove to undermine any amount of residual investor confidence in the U.S. financial markets.

Another potential option for change in the current investment ratings system would be to revert to the subscriber model of rating agencies. Prior to 1975, rating agencies were not issuer-backed. Instead, they were subscriber-backed with investors, those using the ratings to

¹²² *Id.*

¹²³ *Id.*

¹²⁴ Impact of Credit Agencies, *supra* note 23, at 11 (statement of Senator Mel Martinez).

¹²⁵ Impact of Credit Agencies, *supra* note 23, at 11 (statement of Securities and Exchange Commission Chairman Christopher Cox).

¹²⁶ Frank Partnoy, *How and Why Credit Rating Agencies are not like Other Gatekeepers*, San Diego Legal Studies Paper No. 07-46, available at <http://ssrn.com/abstract=900257> (last visited on 9/21/08).

determine where to invest their monies, paying the credit rating agencies. This methodology would allow for a greater independence on the part of the credit rating agencies, while also instilling confidence in investors with more control in their hands.

The SEC also needs to reevaluate its system of granting an NRSRO statute to a credit rating agency. Competition in the credit rating market is the biggest key factor to helping solve the current lack of confidence in the marketplace. While perhaps a naive hope, competition should be based on performance of the agencies.¹²⁷ Previously, the SEC has not provided the market, nor has it had access to the historical default rates for accuracy of securities rated by the designated NRSROs.¹²⁸ The SEC should mandate reporting from the credit agencies of the progress of their ratings, to subsequently track the default rates and each agencies correlative rating. By providing greater transparency, the SEC will open the marketplace to those competitors providing reliable ratings and information to the marketplace.

Lastly, it is not recommended for investors to pursue legal retaliation against the credit rating agencies for their inability to correctly assess the situation. In 2003, the ratings agencies deflected lawsuits through relying on their motto that the ratings are simply opinions of the potential for default and should not be seen as guarantees.¹²⁹ As to their opinions, the credit ratings agencies can rely on the First Amendment for protection.¹³⁰ Unless evidence were to surface proving the agencies “knowingly deceived its clients,” any prosecution would fail.¹³¹

VII. CONCLUSION

In order for the credit rating agencies to truly have the impact envisioned by the SEC restoration of confidence is essential. Awaiting the results of the CRARA, without more implementation and caution for the current faults in the system will feed into the slow, non-reactional bureaucracy that exists currently. Oversight needs to be implemented and maintained so that investors at home and abroad will have confidence in a system restored.

¹²⁷ Impact of Credit Agencies, *supra* note 23, at 17 (statement of Senator John Sununu).

¹²⁸ Impact of Credit Agencies, *supra* note 23, at 17 (statement of Securities and Exchange Commission Chairman Christopher Cox).

¹²⁹ James Norris, *Rating Agencies: heads I win, tails you lose...*, GLOBAL INVESTOR. September 2007.

¹³⁰ Yael Bizouati, *A Matter of Opinion: Rating agencies are under the gun, but proving wrongdoing will be difficult*, INVESTMENT DEALERS DIGEST. Sept. 10, 2007.

¹³¹ Norris, *supra* note 129.

