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# **Ruined in a Conventional Way: Responses to Credit Ratings' Role in Credit Crises**

*David J. Matthews\**

“A ‘sound’ banker, alas!, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way along with his fellows so that no one can really blame him.”

—JOHN MAYNARD KEYNES, *The Consequences to the Banks of the Collapse of Money Values*, in *ESSAYS IN PERSUASION* 168, 176 (1963).

## I. INTRODUCTION

In 2007, abuses in the U.S. mortgage industry precipitated a financial crisis that led regulators in the United States and in the European Union to reexamine credit rating agencies. Asset-backed securities bearing agency ratings helped spread the effects of the crisis to diverse institutional investors, including European banks. This article traces debt securities and ratings from the rise of the mortgage securitization industry to the European and U.S. responses following the 2007 meltdown and concludes that ratings-focused regulatory changes are only a first step in avoiding similar financial crises. The market incentives, risk misperception, and risk spreading that attend complex finance in the global market require further improvements to capital adequacy requirements, credit rating practices, and market participants' understanding of investor psychology.

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## II. SUBPRIME, RMBS, AND RATINGS

### A. Subprime Mortgage Lending

During the past twenty years, the mortgage industry reached many consumers whose credit profiles would previously have precluded access to credit.<sup>1</sup> This extended reach came from specialty consumer finance firms<sup>2</sup> that target customers unable to secure prime loans.<sup>3</sup> Prior to the 2007 credit crises, much of the specialty market comprised “subprime” loans. The term connotes lending to borrowers whose employment history, savings, credit history, or other characteristics create a higher expectation in the lender of loan default as compared to prime borrowers.<sup>4</sup> A greater historical rate of default means subprime loans are issued with higher average interest rates and origination fees than prime loans.<sup>5</sup> This added cost to the borrower yields significant disparities: “[s]ubprime borrowers spend nearly thirty-seven percent of their after-tax income on mortgage payments . . . roughly twenty percentage points more than prime borrowers spend.”<sup>6</sup> Despite these and other drawbacks, increased loan product diversity promoted home ownership.<sup>7</sup>

U.S. federal legislation in the late twentieth century indirectly helped create and nourish the subprime mortgage industry.<sup>8</sup> The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Alternative Mortgage Transactions Parity Act of 1982 helped diversify the

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<sup>1</sup> See David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 992–94 (2006).

<sup>2</sup> *Id.* at 994.

<sup>3</sup> Prime market originators lend to consumers who present “low risk” of defaulting on loans, as judged using factors including sound employment history, savings, and credit history. *Id.* at 993. Such originators “set interest rates below the market-clearing rate to attract borrowers who present low risks of default.” Kathleen C. Engel & Patricia C. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1278 (2002).

<sup>4</sup> See Reiss, *supra* note 1, at 994. A year in the public lexicon has altered the term “subprime” such that it is now synonymous with predatory, irresponsible lending practices.

<sup>5</sup> See Rick Brooks & Constance Mitchell Ford, *The United States of Subprime*, WALL ST. J., Oct. 11, 2007, at A1.

<sup>6</sup> *Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Financial Institutions: Hearing Before the H. Subcomm. on Fin. Inst. and Consumer Credit*, 110th Cong. 7 (2007) [hereinafter *Subcomm. Hearing*] (statement of Sheila C. Bair, Chairwoman, FDIC).

<sup>7</sup> “America’s overall rate of homeownership has risen from sixty-four percent to sixty-nine percent since the mid-1990s; among blacks it has gone from forty-two percent to forty-eight percent.” *A Special Report on the World Economy: On Credit Watch*, ECONOMIST, Oct. 20, 2007, at 33 [hereinafter *Credit Watch*].

<sup>8</sup> See Engel & McCoy, *supra* note 3, at 1275–76.

mortgage market beyond fixed rate amortizing mortgages by permitting lenders to offer adjustable-rate mortgages (ARM) and interest-only mortgages.<sup>9</sup> The Federal Housing Enterprise Financial Safety and Soundness Act of 1992 directed the Department of Housing and Urban Development (HUD) to significantly increase the volume of low-to-moderate income home loans purchased by Government-Sponsored Enterprises (GSEs).<sup>10</sup> Any kind of loan that GSEs are willing to purchase is necessarily one that lenders will strive to originate.<sup>11</sup> While GSEs face restrictions on the loans they may purchase, enough subprime loans conformed to those restrictions to convince the two home loan GSEs—Federal Home Loan Mortgage Association and Federal National Mortgage Association—to begin purchasing subprime loans in 1997 and 1999, respectively.<sup>12</sup> The GSEs' guidelines for purchasable loans are influential because many loan originators will strive to meet those guidelines with a view to selling loans to the GSEs.<sup>13</sup>

During the late 1990s, the U.S. Department of Justice combated predatory lending practices that were endemic to the subprime market.<sup>14</sup> The Department's prosecution of predatory lenders was largely effective in steering the industry away from predatory lending practices,<sup>15</sup> but any such success was tempered during the current decade by increasingly irresponsible (if not predatory) practices<sup>16</sup> that harmed a wide swath of consumers.<sup>17</sup> The harm was so widespread because of expansion in the subprime lending market.<sup>18</sup> Non-prime loans composed sixteen percent of

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<sup>9</sup> *Id.* at 1275.

<sup>10</sup> *Id.* at 1276. GSEs are “[p]rivately held corporations with public purposes created by the U.S. Congress to reduce the cost of capital for certain borrowing sectors of the economy. Members of these sectors include students, farmers and homeowners.” Government-Sponsored Enterprise (GSE), <http://www.investopedia.com/terms/g/gse.asp> (last visited Nov. 23, 2007).

<sup>11</sup> See Engel & McCoy, *supra* note 3, at 1276; Reiss, *supra* note 1 at 1012.

<sup>12</sup> See Reiss, *supra* note 1, at 1010–11.

<sup>13</sup> *Id.* at 1012.

<sup>14</sup> See U.S. Dep't of Justice, Letter from the Dep't of Justice Regarding Predatory Lending (Robert Raben, Assistant Att'y Gen. of the United States, June 5, 2000), available at <http://banking.senate.gov/docs/reports/predlend/doj.htm> (listing many onerous loan terms and practices investigated by the Department as well as relevant prosecutorial actions taken between 1996 and 1999).

<sup>15</sup> Predatory lending practices primarily involved marketing to consumers based on minority ethnicity and/or old age, typically through geographic concentration. See U.S. DEP'T OF HOUS. AND URBAN DEV., SUBPRIME LENDING, <http://www.hud.gov/offices/theo/lending/subprime.cfm> (last visited Nov. 12, 2007).

<sup>16</sup> See *infra* Part III.

<sup>17</sup> During this decade, subprime lending moved beyond its earlier concentration in low-income urban communities and “rose sharply in middle-class and wealthier communities.” Brooks & Ford, *supra* note 5.

<sup>18</sup> *Subcomm. Hearing, supra* note 6, at 6–7 (statement of Sheila C. Bair, Chairwoman,

all U.S. loans in 2004 and twenty-nine percent in 2006.<sup>19</sup> Among the most popular products this decade have been hybrid-ARM loans that offer a low interest rate for two or three years (during which time a borrower could be expected to refinance or sell on the thriving housing market and pay the lender a loan “pre-payment” fee) followed by twenty-seven or twenty-eight years of much higher, periodically-adjusting interest rates.<sup>20</sup>

### B. Residential Mortgage-Backed Securities (RMBS)

Securitization is a method of financing that is popular for its advantages over traditional debt and equity financing.<sup>21</sup> In traditional financing, investors must monitor the issuing company because its performance influences the value of the company’s issuances.<sup>22</sup> The cost of monitoring itself depresses issuances’ values.<sup>23</sup> Instead, an originating company’s receivables, which have value independent of company performance,<sup>24</sup> can be transferred to a special purpose vehicle (SPV)<sup>25</sup> or a bank conduit created to acquire receivables.<sup>26</sup> The SPV or conduit sells securities representing interests in the proceeds of the receivables.<sup>27</sup> In the case of interest-bearing receivables such as mortgage payments, the originator benefits from the spread between the securities’ and receivables’ interest rates.<sup>28</sup> The securities are structured into tranches that signify different levels of investment risk tailored to investors’ appetites.<sup>29</sup> As the

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FDIC) (“Intense lender competition, historically low interest rates, rapid home price appreciation, and, crucially, investor demand for mortgage [paper] facilitated the dramatic growth in the subprime market between 2003 and 2005.”); concerning investor demand for “mortgage paper,” *see infra* Part II.B.

<sup>19</sup> Brooks & Ford, *supra* note 5.

<sup>20</sup> *Id.* “[A]pproximately 1.7 percent of U.S. households” secure hybrid-ARMs today. *Subcomm. Hearing, supra* note 6, at 6 (statement of Sheila C. Bair, Chairwoman, FDIC).

<sup>21</sup> BERNHARD BERGER, DUTY OF CONFIDENTIALITY AND ITS IMPACT ON ASSET SECURITIZATION IN THE BANKING BUSINESS 6–7 (Stämpfli Verlag AG Bern 2002).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> An SPV is a separate company created by the originating company for the purpose of holding receivables and other assets and issuing securities backed by such assets. Engel & McCoy, *supra* note 3, at 1274. Assets so held can be more highly valued by investors because SPVs are separate from originating companies and are therefore not subject to an originator’s bankruptcy risk. *See* A. Brent Truitt & Bennett J. Murphy, *Bankruptcy Issues in Securitizations*, in *SECURITIZATIONS: LEGAL & REGULATORY ISSUES 2-1, 2-2* (Patrick D. Dolan & C. VanLeer Davis III eds., 2000).

<sup>26</sup> Timothy C. Leixner, *Securitization of Financial Assets*, in *INTERNATIONAL ASSET SECURITIZATION AND OTHER FINANCING TOOLS 1, 4* (Dennis Campbell & Susan Meek, eds., 2000).

<sup>27</sup> Engel & McCoy, *supra* note 3, at 1274.

<sup>28</sup> Leixner, *supra* note 26, at 3–4.

<sup>29</sup> *See Credit Watch, supra* note 7.

receivables payments come in, their cash flows first satisfy the obligations issued from the least risky, most senior tranche and then satisfy each junior tranche's obligations in succession.<sup>30</sup> The securities are structured with the expectation that incoming payments will satisfy the obligations of every tranche and, often, leave excess cash flows that accrue to the issuer.<sup>31</sup>

Market conditions in the 1970s and 1980s encouraged the securitization of residential mortgages. A shortage of capital for mortgage origination during the 1970s led the Federal Home Loan Mortgage Association to begin buying loans for securitization.<sup>32</sup> The private sector followed suit in the 1980s, and "by 1993, sixty percent of home-mortgage loans were securitized."<sup>33</sup> Securitization financing has effectively eliminated liquidity restraints on lenders, meaning specialty finance companies need little capitalization to originate and sell loans.<sup>34</sup> These companies can take out warehouse lines of credit with large, established banks and use the cash to originate and securitize loans, profiting from the interest spreads between the warehouse lines and the mortgage-backed securities. The transition from traditional "originate and hold" mortgage lending—whereby banks and thrifts held their originations to maturity—to the loan securitization model has had enormous impact on global financial markets. Private debt securities issuances across the world are "far bigger than stock markets."<sup>35</sup>

### C. Ratings of RMBS

Each tranche of an RMBS issuance is rated by one or more of a handful of financial analysis businesses commonly referred to as "credit rating agencies" (CRA). In securitization, ratings are opinions as to the issuance's "credit risk."<sup>36</sup> Investment grade ratings are crucial to the

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<sup>30</sup> *Hearing on The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 5 (2007) [hereinafter *CRA Hearing*] (statement of Michael Kanef, Asset Backed Finance Rating Group Managing Director, Moody's Investors Service) (hearing text unavailable; individual statements and testimony collected at <http://banking.senate.gov/index.cfm?FuseAction=Hearings.Home>).

<sup>31</sup> See Leixner, *supra* note 26, at 2. The issuer may also sell the right to receive any residuals.

<sup>32</sup> Engel & McCoy, *supra* note 3, at 1273.

<sup>33</sup> *Id.* "[T]he RMBS market has increased by more than 500% from 1984 through the early 2000s." Reiss, *supra* note 1, at 1008.

<sup>34</sup> Engel & McCoy, *supra* note 3, at 1274. "Most subprime lenders are nonbank entities that emerged as the result of securitization." *Id.* at 1279.

<sup>35</sup> *When it Goes Wrong* . . . ECONOMIST, Sept. 20, 2007, [http://www.economist.com/finance/displaystory.cfm?story\\_id=9830765](http://www.economist.com/finance/displaystory.cfm?story_id=9830765) (last visited Nov. 23, 2007) [hereinafter *When it Goes Wrong*].

<sup>36</sup> *CRA Hearing*, *supra* note 30, at 6 (statement of Michael Kanef, Asset Backed Finance Rating Group Managing Director, Moody's Investors Service) ("Moody's estimates the

marketing success of RMBS issuances, so originators structure issuances to achieve those ratings by making changes required by CRAs.<sup>37</sup>

CRAs require “credit enhancements,” which are traits of RMBS issuances historically seen to reduce risks to investors.<sup>38</sup> One significant credit enhancement is the over-collateralization (O/C) tranche, which will account for a historically-expected level of defaults (prior to the credit crisis, typically five to ten percent) on the receivables by using a larger asset pool than would be needed if zero defaults occurred.<sup>39</sup> In the initial receipt of proceeds from the receivables, the O/C tranche is filled before all other tranches; it will only need “topping off” in later rounds of proceeds if payment defaults or delinquencies cause some or all of the five to ten percent buffer in that tranche to trickle down to subsequent tranches. The investors’ tranches do not begin to see losses unless the extent of defaults overpowers the O/C tranche. That is why the historical default rate was long thought to be a key evaluative factor in assigning ratings.<sup>40</sup>

With traditional corporate debt issuances, a sophisticated investor may or may not rely on CRA ratings and may be able to assess the issuer’s creditworthiness independently.<sup>41</sup> With respect to structured finance issuances, however, the CRA rating takes on a gatekeeper role akin to audits and analyses performed in connection with equity financings because informational asymmetry hampers an investor’s effective evaluation of underlying mortgage pools.<sup>42</sup> The underlying pools present payment risks unrelated to the issuer’s or originator’s creditworthiness, which means that traditional ratings (which only evaluate an issuer’s creditworthiness) are perhaps ill-suited to performing the gatekeeper role for RMBS.<sup>43</sup> In recognition of this, ratings of RMBS are indeed not traditional. Fitch Ratings employs a volatility scale to represent its assessment of “the potential impact of interest rate movements and other market risks on individual tranches of issuances,”<sup>44</sup> while Standard & Poor’s affixes an “r” symbol to ratings of issuances that are subject to market risks.<sup>45</sup> None of

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amount of cumulative losses that the underlying pool of mortgage loans is expected to incur over the lifetime of the loans.”).

<sup>37</sup> BERGER, *supra* note 21, at 10–11.

<sup>38</sup> Leixner, *supra* note 26, at 6–7.

<sup>39</sup> *Id.*

<sup>40</sup> See Reiss, *supra* note 1, at 1014.

<sup>41</sup> *CRA Hearing*, *supra* note 30, at 2 (statement of John C. Coffee, Jr., Professor, Columbia Law School).

<sup>42</sup> *Id.*

<sup>43</sup> See Amy K. Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well-placed Reliance or Free-market Interference?*, 20 SETON HALL LEGIS. J. 293, 304 (1996).

<sup>44</sup> *Id.* at 305.

<sup>45</sup> *Id.*

this ensures that investors, even sophisticated ones, know or care about any difference between ratings of creditworthiness and systemic market risk.

### III. THE 2007 CREDIT CRISIS: CAUSES AND EFFECTS

#### A. Causes

Subprime lending was always characterized by higher loan risk profiles than traditional mortgage lending, but recent years saw a proliferation of loans that strain credulity. Loan products with low two or three year introductory rates were well-suited to the housing boom, as speculators and other borrowers could reasonably expect to sell or refinance the mortgaged properties before rates reset at far higher, variable rates.<sup>46</sup> Lenders often received pre-payment fee income from these sales and refinancings.

The goal of securitization encouraged origination volume over quality, since securitization structures could account for and buffer against historically-expected levels of defaults. The drive for origination volume pushed down required borrower credit score requirements, relaxed income documentation requirements, pushed up loan-to-value ratios, and spurred such innovations as loans with terms longer than thirty years and piggy-back loans, wherein a second-lien loan covers a borrower's down payment.<sup>47</sup> Drastically reduced documentation requirements likely produced fraudulent loan applications. Indeed, this type of loan came to be known as the "liar loan."<sup>48</sup> Piggyback loans attached to approximately fifty percent of subprime first-lien loans in some states in recent years.<sup>49</sup>

The recent housing downturn has meant that borrowers who qualified only at introductory teaser rates could not likely sell or refinance before a hybrid loan rate reset.<sup>50</sup> In the case of real estate speculators—especially those who had put no money down—the easy choice was to walk away from properties once delinquency and default became real possibilities. From the lenders' point of view, delinquency and default had apparently stopped being something to fear and started being risk factors to account for in securitization structures. Loan pools were sold without recourse into SPVs and bank conduits, so many originators had neither the desire nor the right to alter loan terms for struggling borrowers.

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<sup>46</sup> Allan N. Krinsman, *Subprime Mortgage Meltdown: How did it Happen and How will it End?*, J. STRUCTURED FIN., Summer 2007, at 13, available at <http://www.stroock.com/SiteFiles/Pub533.pdf>.

<sup>47</sup> *Id.* at 14.

<sup>48</sup> *Id.* at 15.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at 14.



Before the full extent of subprime problems was well-known, the housing market downturn only served to increase competition among mortgage lenders for a shrinking pool of borrowers in order to meet the asset-unflagging investor demand for RMBS.<sup>51</sup> Those same investors were convinced that securitization could effectively nullify risk by spreading it across the RMBS market.<sup>52</sup> Securitization did spread risk, but it also diluted responsibility. Principal-agent problems were inevitable when one middleman was replaced with several.<sup>53</sup> On the one end, originators were able to meet investor demand while quickly unloading risky loans off their balance sheets; on the other end, investors ignored their inability to perform monitoring because they could not resist the yields.<sup>54</sup> High ratings for senior tranches allowed many RMBS issuances to carry relatively low interest rates, which in turn allowed the underlying loans to be originated at lower interest rates than would have been possible had lenders used only traditional debt financing.<sup>55</sup> These factors forced origination standards down as the pool of qualified borrowers shrank.<sup>56</sup>

## B. Effects

### 1. Early Signs

[D]elinquency and default rates were higher than anticipated. [G]ains-on-sale accounting falsely inflated the industry's overall profits. Investors noticed these trends: MBS prices dropped sharply . . . . Without the connection to the capital markets through securitization, subprime originators had fewer sources of liquidity. Simultaneously, warehouse lenders, aware of the situation, called many of their lines of credit from the subprime originators, further limiting the liquidity available to originate subprime loans. [S]everal large subprime lenders suffered from these trends. Some companies went out of business while others were purchased by mainstream lenders.<sup>57</sup>

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<sup>51</sup> Krinsman, *supra* note 46, at 14.

<sup>52</sup> Jason Dean & Peter Stein, *The Man Who Saw it Coming*, WALL ST. J., Aug. 29, 2007, at C2. "[T]he Wall Street firms and securitization . . . created the desire for a very high-risk product . . ." *Subcomm. Hearing, supra* note 6, at 34 (statement of Steven L. Antonakes, Commissioner of Banks, Massachusetts Division of Banks).

<sup>53</sup> *When it Goes Wrong, supra* note 35.

<sup>54</sup> *Id.*

<sup>55</sup> *CRA Hearing, supra* note 30, at 8 (statement of Senator Bunning).

<sup>56</sup> *When it Goes Wrong, supra* note 35.

<sup>57</sup> U.S. DEP'T OF HOUSING AND URBAN DEV. OFFICE OF POL'Y DEV. AND RES., SUBPRIME MARKETS, THE ROLE OF GSEs, AND RISK-BASED PRICING (Kenneth Temkin et al., Mar. 2002 at 10-11), available at <http://www.huduser.org/Publications/pdf/subprime.pdf>.

Though the above was written in 2002 to describe events in 1997 and 1998, the authors could have been recounting the events of 2007. The difference is that immediately prior to the 2007 crisis, the subprime market was far larger and more entrenched in the greater financial system, so the current woes are felt more widely than during the 1997–98 down cycle. An October 2005 edition of stock advisor Christopher Wood’s investment newsletter advised readers to “sell all exposure to the American mortgage securities market.”<sup>58</sup> Investors in Credit Suisse Group’s December 12, 2000 \$340.7 million collateralized debt obligation (CDO) (which is a package of debt securities from different sources and, often, underlying asset types)<sup>59</sup> would have appreciated that advice. Despite much of the CDO having received triple-A ratings from the leading CRAs, increasing defaults on the underlying securities caused losses totaling \$125 million by the end of 2006.<sup>60</sup>

In May 2006, U.S. subprime lender Ameriquest, since defunct, effected massive layoffs and closed over two hundred retail locations.<sup>61</sup> By March 13, 2007, “thirteen percent of subprime borrowers were delinquent on their payments by sixty days or more.”<sup>62</sup> In late 2006, Goldman Sachs began pursuing an aggressive course of reducing its inventory of RMBS and mortgage loans and hedging against losses in the mortgage market.<sup>63</sup> Late 2006 and early 2007 saw a marked increase in (previously rare) early payment defaults, reflecting the pronounced inadequacy of underwriting for many loans originated in 2006—most early payment defaults occurred in loan profiles that featured multiple risk characteristics (a characteristic called “risk layering”), e.g., a piggy-back combined with reduced documentation.<sup>64</sup>

Around 2005, CDOs came to replace other types of investors as the major purchaser of the more subordinated, riskiest, highest-yield RMBS

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<sup>58</sup> Dean & Stein, *supra* note 52.

<sup>59</sup> See *Measuring the Measurers: Rating Agencies*, *ECONOMIST*, June 2, 2007, at 77 [hereinafter *Measuring the Measurers*].

<sup>60</sup> Richard Tomlinson & David Evans, *CDOs Mask Subprime Loan Losses*, *INT’L HERALD TRIBUNE*, June 1, 2007, at 17.

<sup>61</sup> *Ameriquest Closes 229 Offices, Lays Off 3,800*, *E. BAY BUS. TIMES*, May 3, 2006, <http://www.bizjournals.com/eastbay/stories/2006/05/01/daily26.html>.

<sup>62</sup> Krinsman, *supra* note 46, at 14.

<sup>63</sup> Jenny Anderson & Landon Thomas, Jr., *Goldman Sachs Rakes in Profit in Credit Crisis*, *N.Y. TIMES*, Nov. 19, 2007, at A1 (indicating that the dump and hedge strategy of Goldman Sachs has placed the firm in a position of relative strength compared to other Wall Street firms).

<sup>64</sup> Krinsman, *supra* note 46, at 5 (indicating that early payment defaults are a form of loan sale recourse trigger and are defined between loan sellers and purchasers, typically as “loans that become past due by two or more payments within the first three or four months after origination.”).

debt tranches.<sup>65</sup> The repackaging undertaken by CDOs meant that a large amount of BBB-rated RMBS debt purchased from diverse sources could be restructured into new tranches including AAA senior tranches on the assumption that historical default rates would leave at least the AAA tranches safe. Without any fundamental change in the underlying assets, the newly-AAA debt could now be purchased by institutions whose investment options were limited by safety and soundness regulation. This was mere alchemy. The precipitous rise in defaults did indeed reach many AAA CDO tranches.

## 2. Market Effects: United States

In the United States, problems in the subprime market have had deleterious effects on subprime borrowers and lenders, prime borrowers and lenders, RMBS issuers and purchasers, and conduit and CDO creators and investors.<sup>66</sup> The rapid increase in early payment defaults triggered loan repurchase obligations and gave large institutional lenders cause to pull warehouse lines of credit to originators.<sup>67</sup> By mid-summer 2007, dozens of subprime lenders were bankrupt, out of business,<sup>68</sup> acquired, or struggling to obtain alternative financing.

Wall Street firms other than Goldman Sachs were hit hard: two Bear Stearns hedge funds had leveraged their investors' money to buy into CDOs backed by subprime RMBS and the collapse of those funds nearly sank the firm.<sup>69</sup> Compared with third quarter 2006, third quarter 2007 profits were down 73.8% at Bear Stearns, 76.7% at JPMorgan Chase, and 83.45% at Citigroup.<sup>70</sup> The major firms cut more than 24,000 jobs in 2007 through November.<sup>71</sup> Compounding the damage to banks that issued CDO debt were credit enhancements called liquidity puts, which were essentially refund guarantees used to increase credit ratings and attract more investors.<sup>72</sup> The crisis has so far yielded over \$45 billion in large bank

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<sup>65</sup> See Mark H. Adelson & David P. Jacob, *The Sub-prime Problem: Causes & Lessons*, (unnumbered working paper, Adelson & Jacob Consulting, LLC, Working Paper, Jan. 8, 2008), available at [http://www.adelsonandjacob.com/pubs/Sub-prime\\_Problem-Causes\\_&\\_Lessons.pdf](http://www.adelsonandjacob.com/pubs/Sub-prime_Problem-Causes_&_Lessons.pdf).

<sup>66</sup> Brooks & Ford, *supra* note 5, at A16 (stating “[S]ubprime loans burrowed into the heart of the American financial system.”).

<sup>67</sup> Krinsman, *supra* note 46, at 16.

<sup>68</sup> *Id.*

<sup>69</sup> Matthew Goldstein & David Henry, *Bear Bets Wrong*, BUS. WK., Oct. 22, 2007, at 52.

<sup>70</sup> Duff McDonald, *Big Swinging A: Merrill Lynch's Stan O'Neal Became the First Wall Street CEO to Lose His Job Over the Credit Crisis*, N.Y. MAGAZINE, Nov. 12, 2007, at 18.

<sup>71</sup> Lisa Kassenaar, *At Subprime Conference It's Too Early to Tell Who'll Survive (Update I)*, BLOOMBERG, Nov. 20, 2007, [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acYywk3n\\_iL8](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acYywk3n_iL8).

<sup>72</sup> David Henry, *This Disaster was Guaranteed*, BUS. WK., Dec. 10, 2007, at 26.

writedowns.<sup>73</sup> As of November 2007, Citigroup was projected to write down an additional \$15 billion from CDO losses.<sup>74</sup> These losses, as well as sizable losses reported by Merrill Lynch, come chiefly from AAA-rated CDO debt.<sup>75</sup>

### 3. Market Effects: Europe

Since RMBS were packaged into CDOs sold across the globe, many funds and banks abroad have significant exposure to U.S. subprime mortgages.<sup>76</sup> Of \$1.5 trillion in outstanding CDO value worldwide, between \$500 billion and \$600 billion is backed by some type of mortgage-backed security.<sup>77</sup> At the start of the crisis, many abroad felt certain the effects would be limited to the United States.<sup>78</sup> All were disabused of that notion when regional German bank IKB needed an €18.1 billion bailout from a consortium of German state banks in early August 2007.<sup>79</sup>

For the bulk of its eighty-three years, IKB generally limited its business to *Mittelstand* financing.<sup>80</sup> In 2002, the bank embraced a new business model wherein it created a structured investment vehicle (SIV), which is a kind of conduit designed to issue short-term paper to fund CDO purchases; the bank set up a second SIV for the same purpose in June 2007.<sup>81</sup> The short-term paper proceeds came from various sources, including a Minneapolis school district and the city of Oakland, California.<sup>82</sup> These and other investors stopped buying (or “rolling”) the short-term paper once they learned that their returns depended on CDOs backed in part by RMBS.<sup>83</sup> With no new funding (and with no investors

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<sup>73</sup> Kassenaar, *supra* note 71.

<sup>74</sup> Kosuke Goto & Stanley White, *Yen Trades Near 1 1/2-Year High Versus Dollar on Debt Losses*, BLOOMBERG, Nov. 22, 2007, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=anX3.pPcZQy8> (“The dollar has lost 9.9 percent against the euro and 7.8 percent against the yen this year as two rate cuts by the Federal Reserve,” made in response to the subprime crisis, “dimmed the allure of U.S. assets.”).

<sup>75</sup> Peter Eavis, *Cure for Pain*, FORTUNE, Nov. 29, 2007, available at <http://money.cnn.com/2007/11/28/magazines/fortune/fortune500/eavis.creditfix.fortune/index.htm>.

<sup>76</sup> See Jenny Anderson & Heather Timmons, *Why a U.S. Subprime Mortgage Crisis Is Felt Around the World*, N.Y. TIMES, Aug. 31, 2007, at C1, C5.

<sup>77</sup> *Id.*

<sup>78</sup> Peter Gumbel, *Subprime on the Rhine*, CNN MONEY, Sept. 4, 2007, <http://money.cnn.com> (search “subprime on the rhine” and then follow “Subprime on the Rhine” hyperlink).

<sup>79</sup> See Carrick Mollenkamp et al., *How Subprime Mess Ensnared a German Bank*, WALL ST. J., Aug. 10, 2007, at A1.

<sup>80</sup> *Id.*

<sup>81</sup> Gumbel, *supra* note 78.

<sup>82</sup> Mollenkamp, *supra* note 79.

<sup>83</sup> *Id.*

willing to purchase the current CDO holdings), IKB's SIVs were soon unable to meet their outstanding short-term paper obligations.<sup>84</sup> This situation is an unfortunate example of how crisis spreads. While subprime defaults were certainly higher than expected, it was not RMBS or CDO under-performance that sank IKB or its SIVs. Rather it was investors' rush to disassociate from all subprime exposure. The same problem hit German state bank Sachsen LB later in August 2007.<sup>85</sup>

Most *Landesbanken* were created in the nineteenth century to finance local business.<sup>86</sup> These institutions are smaller than their international competitors and have had trouble with European Union integration, which required German states to rescind guarantees that had previously reduced the banks' costs of capital.<sup>87</sup> After losing those guarantees, the SIV strategy used by Sachsen LB and IKB was so common among the *Landesbanken* that these banks held almost one quarter of the approximately \$510 billion that European banks had in conduits funding long-term investment using short-term paper.<sup>88</sup>

With so much long-term investment funded with short-term paper, investor skittishness stood to cause widespread harm. The August 2007 bank run suffered by the United Kingdom's North Rock Bank, which had used conduit funding, illustrates the contagion's effect.<sup>89</sup> Aside from conduit problems, the general dearth of liquidity has stifled European banking. BNP Paribas suspended investment funds totaling €1.5 billion in early August.<sup>90</sup> Deutsche Bank's inability to sell its loans on the secondary market resulted in a third quarter 2007 pre-tax loss of €179 million.<sup>91</sup> Economic growth was forecasted to slow across Europe,<sup>92</sup> particularly in the United Kingdom.<sup>93</sup> Following Swiss Reinsurance Company's \$1.08

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<sup>84</sup> *Id.*

<sup>85</sup> Ivar Simensen & Ralph Atkins, *Subprime Exposure Drags Down German Banks*, FIN. TIMES, Aug. 21, 2007, available at <http://www.ft.com> (search "simensen subprime german banks" and then follow "Subprime Exposure Drags Down German Banks" hyperlink).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> *Credit Watch*, *supra* note 7.

<sup>90</sup> Will Andrews, *Subprime: the Ugly American Hits Europe*, BUS. WK., Aug. 9, 2007, available at <http://www.businessweek.com> (search for "subprime ugly american" and follow first result hyperlink).

<sup>91</sup> John O'Donnell, *Crisis Rocks Deutsche Bank but No Nasty Surprises*, REUTERS, Oct. 31, 2007, <http://www.reuters.com> (search "o'donnell crisis rocks deutsche" follow first result hyperlink).

<sup>92</sup> EUR. COMM'N, AUTUMN ECON. FORECAST 2007-2009: GROWTH MODERATING, IP/07/1666 (Nov. 9, 2007), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1666> ("[g]rowth in the European Union economy is expected to decelerate from 2.9% in 2007 to 2.4% in both 2008 and 2009.").

<sup>93</sup> EUR. COMM'N, ECON. FORECAST AUTUMN 2007 111, available at <http://ec.europa.eu>

billion loss owing to credit default swap payments tied to the crisis, the euro “fell against 10 of the world’s 16 most-actively traded currencies.”<sup>94</sup>

#### IV. ORGANIZATIONAL, POLITICAL, AND CRITICAL RESPONSES TO RATINGS

Much of the criticism levied at CRAs stems from the seeming obviousness of the underlying problems: because of widespread irresponsible lending practices, historical default rates were insufficient indicators for determining appropriate O/C levels in RMBS. In reality, early payment default rates proved sufficient to drain all value from some RMBS and destroy investor confidence in the rest. If the CRAs were unable to spot this when initially rating the bonds issued off mortgage pools and were so slow to downgrade the ratings, ask the detractors, how could the CRAs possibly be trusted to provide accurate assessments?

##### A. In the United States

Does the fact that RMBS issuers pay for ratings create a conflict of interest? Is any AAA rating of subprime RMBS or subprime-related CDOs legitimate? Are CRAs too slow to downgrade previously-rated securities? These are among the questions raised in the commentary and investigations regarding the role of CRAs in the credit crisis.<sup>95</sup>

Once problems extended beyond borrowers and lenders and started to harm large banks’ conduits,<sup>96</sup> the Securities and Exchange Commission (SEC) and the President’s Working Group on Financial Markets began new investigations<sup>97</sup> and both houses of Congress conducted related hearings.<sup>98</sup> Members of the financial services industry, academia, and the press raised the questions outlined above and suggested responses and solutions.

Much of the CRAs’ profits come from structured finance ratings paid for by a handful of investment banks that sell CDO issuances.<sup>99</sup> These

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/economy\_finance/publications/european\_economy/forecasts\_en.htm (“growth in the UK economy is expected to slow to 2.2% in 2008.”). Annual growth in the United Kingdom has recently held at approximately 3%. Kerry Capell, *Britain’s Coming Credit Crisis*, BUS. WK., Sept. 17, 2007, available at [http://www.businessweek.com/magazine/content/07\\_38/b4050069.htm](http://www.businessweek.com/magazine/content/07_38/b4050069.htm).

<sup>94</sup> Goto & White, *supra* note 74.

<sup>95</sup> See *CRA Hearing*, *supra* note 30, at 2 (statement of Vickie A. Tillman, Executive Vice President, Standard & Poor’s).

<sup>96</sup> See Daniel Gross, *Protecting Paulson’s Pals*, SLATE, Oct. 16, 2007, <http://www.slate.com/id/2175724>.

<sup>97</sup> *CRA Hearing*, *supra* note 30, at 2 (statement of Christopher Cox, Chairman, U.S. Securities and Exchange Commission).

<sup>98</sup> See *Subcomm. Hearing*, *supra* note 6; *CRA Hearing*, *supra* note 30.

<sup>99</sup> *CRA Hearing*, *supra* note 30, at 5 (statement of John C. Coffee, Jr., Professor, Columbia Law School).

issuers typically use multiple CRAs and can move business between them without the SEC scrutiny, publicity, and adverse consequences that would attend a change in outside auditor.<sup>100</sup> These circumstances may lead to conflicts of interest.<sup>101</sup> There are calls for business practice and disclosure changes akin to those that reformed the accounting industry earlier this decade.<sup>102</sup> U.S. Senator Charles Schumer advocates a return to the investor-funded ratings model, presumably to remove potential conflicts of interest.<sup>103</sup>

Critics point to both the tardiness and the market harms of the summer's downgrades of previously-rated RMBS and CDOs as further evidence of CRAs' blameworthiness. Moody's July 2007 downgrade of billions worth of CDOs stoked the crisis.<sup>104</sup> Tardy downgrades may be another by-product of the close relationship between issuer and rater. CRAs earn no additional fees for monitoring and downgrading previously-rated securities; in fact, doing so only stands to harm the issuer-rater relationship.<sup>105</sup> The prospect of market punishment is real: since its July 2007 downgrades, Moody's has seen a precipitous drop in RMBS rating market share from seventy-five to twenty-five percent, legitimizing CRAs' fear of market penalties for downgrades.<sup>106</sup> Because of this fear, downgrades are typically tardy and are little more than "lightly premature obituaries for terminally ill bonds."<sup>107</sup> One hedge fund manager wondered "[i]f the rating agencies will downgrade only when we can all see the losses, then why do we need the rating agencies?"<sup>108</sup>

Some question the validity of the initial investment-grade ratings for subprime RMBS. In February 2007, market researcher Josh Rosner predicted significant losses owing to the inapplicability of CRAs' historical data-based evaluation models to pools of liar loans and piggyback mortgages.<sup>109</sup> Professor White testified that investment grade ratings had

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<sup>100</sup> *Id.* at 6.

<sup>101</sup> *Id.*

<sup>102</sup> Aaron Lucchetti & Kara Scannell, *Moody's, S&P Answer Critics Over Bond Calls – Rating Firms to Explain Their Mortgage Miss: Reforming the System*, WALL ST. J., Sept. 26, 2007, at C1.

<sup>103</sup> See *Credit Rating Agencies Defend Track Record*, MSNBC, Sept. 26, 2007, <http://www.msnbc.msn.com/id/20992048>; *infra* Part V.

<sup>104</sup> *CRA Hearing*, *supra* note 30, at 5 (statement of John C. Coffee, Jr., Professor, Columbia Law School).

<sup>105</sup> *Id.*

<sup>106</sup> *Id.* at 6.

<sup>107</sup> *Id.*

<sup>108</sup> Bethany McLean, *Ratings Agencies Under Fire*, CNN MONEY, Aug. 21, 2007, [http://money.cnn.com/2007/08/20/magazines/fortune/ratings\\_agencies.fortune/index.htm](http://money.cnn.com/2007/08/20/magazines/fortune/ratings_agencies.fortune/index.htm).

<sup>109</sup> *Id.*

been overly optimistic.<sup>110</sup>

## B. In the European Union

German Chancellor Angela Merkel and French President Nicolas Sarkozy have called for a regulatory reaction to CRAs' perceived failings<sup>111</sup> and exerted pressure on European Union Internal Markets Commissioner Charlie McCreevy and other officials to investigate the role of CRAs in the credit crisis.<sup>112</sup> German Finance Minister Peter Steinbrück has highlighted the conflict of interest created by CRAs' role in helping to structure RMBS and CDO securities and expressed concern about the bank conduits, which are outside supervisory authorities' purview.<sup>113</sup> European Central Bank President Jean-Claude Trichet has also advocated CRA regulation.<sup>114</sup>

Mr. McCreevy, who as Internal Market Commissioner may propose European Union-wide financial regulations,<sup>115</sup> has stated his investigation will concentrate on the same issues raised by critics of the United States: conflicts of interest, downgrade tardiness, and rating methodology.<sup>116</sup> Additionally, he has requested that the Committee of European Banking Supervisors evaluate the place of ratings in upcoming European banking regulations.<sup>117</sup> McCreevy, recognizing that many characteristics of the market and of structured finance products contributed to the crisis, has criticized bank conduits and investors for mispricing risk and ignoring repeated warnings as years of low interest rates softened inhibitions and promoted herding behavior.<sup>118</sup> McCreevy's approach has been to seek consensus with U.S. regulators on how to approach the CRA problems.<sup>119</sup>

Along those lines, the International Organization of Securities Commissions (IOSCO) is studying implications of the crisis for regulators and CRAs. IOSCO will focus on rating methodology and reevaluate its 2003

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<sup>110</sup> *CRA Hearing*, *supra* note 30, at 1 (statement of Lawrence White, Professor, New York University Stern School of Business).

<sup>111</sup> Adam Cohen, *Trichet: Wants Further Study of Ratings Agencies*, DOW JONES NEWSWIRES, Oct. 2, 2007, available at 10/2/07 ODJSELECT 09:29:04 (Westlaw).

<sup>112</sup> *McCreevy Puts Pressure on Rating Agencies*, IRISH INDEP., Sept. 13, 2007, available at <http://www.independent.ie/business/european/mccreevy-puts-pressure-on-rating-agencies-1078683.html> [hereinafter *McCreevy Pressure*].

<sup>113</sup> Cohen, *supra* note 111.

<sup>114</sup> *Id.*

<sup>115</sup> *McCreevy Pressure*, *supra* note 112.

<sup>116</sup> See Charlie McCreevy, *Current Issues in the EU Banking Sector* (Sept. 27, 2007) (transcript available at [http://ec.europa.eu/commission\\_barroso/mccreevy/allspeeches\\_en.htm](http://ec.europa.eu/commission_barroso/mccreevy/allspeeches_en.htm)).

<sup>117</sup> *McCreevy Pressure*, *supra* note 112.

<sup>118</sup> *McCreevy Warns of 'Recessionary Effect' of Credit Crisis*, IRISH TIMES, Sept. 15, 2007, available at 2007 WLNR 18044538.

<sup>119</sup> Cohen, *supra* note 111.



Credit Rating Agency Code of Conduct.<sup>120</sup> During the crisis, the Committee of European Securities Regulators (CESR) extended a pre-existing review of CRA conduct, evaluation models, and conflicts of interest.<sup>121</sup> CESR Secretary General Fabrice Demarigny made the significant point that no current EU laws directly govern CRAs.<sup>122</sup> The 2003 IOSCO Code of Conduct has been voluntarily adopted by the major CRAs but is not part of any Member State's national law.<sup>123</sup>

Parliamentary treasury committee hearings in the United Kingdom made a splash as Members of Parliament, reacting angrily to the Northern Rock troubles, made disparaging remarks about CRA representatives and showed ignorance about the role of ratings.<sup>124</sup> Meanwhile, the United Kingdom's own securities regulator, the Financial Services Authority (FSA), said through a spokesperson that some of the criticism is unfounded and that AAA securities, including those backed by subprime mortgages, have not defaulted in significant numbers.<sup>125</sup> Interestingly, the former U.S. Federal Reserve Chief, Alan Greenspan, might be inclined to agree with the surly Members of Parliament. Mr. Greenspan gave an interview to the *Frankfurter Allgemeine Zeitung* in which he opined that the CRAs "don't know what they're doing."<sup>126</sup>

### C. CRAs' Answers

The CRAs have answered many of the criticisms and have attempted

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<sup>120</sup> Michiyo Nakamoto, *Regulators to Probe Rating Agencies*, FIN. TIMES, Nov. 9, 2007, available at <http://www.ft.com> (search "nakamoto regulators probe" and follow third result hyperlink).

<sup>121</sup> Lorraine Mallinder, *Rating Agencies Under EU Spotlight*, EUR. VOICE, Sept. 6, 2007, <http://www.europeanvoice.com/archive/article.asp?id=28772>.

<sup>122</sup> *Id.*

<sup>123</sup> Communication from the Commission on Credit Rating Agencies (EC) 2006/C 59/02 of Mar. 11, 2006 [hereinafter Commc'n from the Comm'n], at 5–6.

<sup>124</sup> Jennifer Hughes, *MPs Gain No Credit with Abuse of Ratings Agencies as a 'Shower'*, FIN. TIMES, Nov. 15, 2007, available at <http://www.ft.com> (search "hughes mps shower" and follow second result hyperlink).

<sup>125</sup> Elaine Moore, *Rating the Credibility of Credit Agencies*, FIN. TIMES, Nov. 16, 2007, available at <http://www.ft.com> (search "moore rating credit agencies" and follow first result hyperlink).

<sup>126</sup> "Die Ursache des Problems war, dass die Leute glaubten, die Ratingagenturen verstanden etwas vom ihrem Geschäft. Die wissen aber nicht, was sie tun [The chief problem was, people thought the ratings agencies understood something about their business. Turns out, they don't know what they're doing]." Norbert Kuls & Claus Tigges, *Alan Greenspan: „Die Ratingagenturen wissen nicht was sie tun“*, FRANKFURTER ALLGEMEINE ZEITUNG, Sept. 22, 2007, <http://www.faz.net> (search "greenspan wissen nicht" and follow second result hyperlink). Mr. Greenspan also stated that, when it comes to accurately pricing structured securities, "[j]etzt weiß jeder, dass das wahrscheinlich gar nicht möglich ist [now everyone knows that's probably impossible]." *Id.*

to adapt their evaluation models<sup>127</sup> to account for “ahistorical behavioral modes” that are newly prevalent among mortgage consumers.<sup>128</sup> Echoing the FSA’s statement that defaults have not been widespread, Standard & Poor’s presented its data on U.S. RMBS default rates to the September 26, 2007 Senate Hearing.<sup>129</sup> The data held that, through September 15, 2007, default rates were approximately 7%, spread across the rating levels (including a 0.04% default rate for AAA securities).<sup>130</sup> Standard & Poor’s asserted that, to the extent early payment defaults rose precipitously, ratings could not have reflected such a risk because of the aforementioned ahistorical behavioral modes.<sup>131</sup> Ms. Tillman asserted that, in essence, CRAs could not be blamed for borrowers’ irrational behavior.<sup>132</sup> Tillman pointed to quickly-escalating and wholly unexpected numbers of borrowers who choose to pay off credit card debt before home loan debt and who have debunked lending truisms such as the idea that borrowers who reside in the mortgaged property repay more consistently than those who reside elsewhere,<sup>133</sup> and that borrowers with high credit scores repay more consistently than borrowers with low credit scores.<sup>134</sup>

Testimony from Moody’s Investors Service focused on the agency’s disclaimers and warnings to investors and Moody’s reliance on the accuracy of information provided by issuers.<sup>135</sup> Mr. Kanef stated that the company has “discouraged market participants from using our ratings as indicators of price, as measures of liquidity, or as recommendations to buy or sell securities” because ratings are designed to address only credit risk.<sup>136</sup> Ratings’ quality is nullified by any errors or misrepresentation in data furnished by issuers, and Kanef suggests that the need for increased diligence on his company’s part is unnecessary because “accuracy of information disclosed by originators and underwriters in connection with each transaction is subject to federal securities laws and regulations

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<sup>127</sup> Saskia Scholtes, *Moody’s Alters its Subprime Rating Model*, FIN. TIMES, Sept. 25, 2007, <http://www.ft.com> (search “saskia moody’s alters” and follow first result hyperlink).

<sup>128</sup> *CRA Hearing*, *supra* note 30, at 5–6 (statement of Vickie A. Tillman, Executive Vice President, Standard & Poor’s).

<sup>129</sup> *Id.* at 6.

<sup>130</sup> *Id.*

<sup>131</sup> *Id.* at 5–6.

<sup>132</sup> *Id.*

<sup>133</sup> *CRA Hearing*, *supra* note 30, at 5–6 (statement of Vickie A. Tillman, Executive Vice President, Standard & Poor’s).

<sup>134</sup> *Id.* at 12.

<sup>135</sup> *See CRA Hearing*, *supra* note 30 (statement of Michael Kanef, Asset Finance Group Managing Director, Moody’s Financial Services).

<sup>136</sup> *Id.* at 3. *Compare id.* (stating that ratings address only credit risk) *with* Rhodes, *supra* note 43, at 304–06 (describing structured products ratings innovations made by Fitch and S&P in response to such non-credit risks as interest rate, market, and cash flow risk).

requiring accurate disclosure.”<sup>137</sup> Despite this reliance on issuer information, Moody’s has published reports on lax origination standards and inflated housing prices since 2003.<sup>138</sup> The company felt it could issue investment grade ratings in spite of those problems because it increased the levels of credit enhancements required for such ratings.<sup>139</sup> The ratings firm fell victim to its own foresight, as the spike in defaults in early 2007 seemed to Moody’s to be adequately buffered by credit enhancements, and the company made no downgrades until collateral deterioration overran estimates in May.<sup>140</sup> Respecting the explanations set out by Tillman and Kanef, SEC Chairman Cox deferred judgment pending investigation.<sup>141</sup>

## V. WHAT IS TO BE DONE? LOOKING AT CRA HISTORY, PAST REGULATORY ACTION, AND INVESTOR PSYCHOLOGY

### A. CRA Development and Liability

#### *1. Development*

Capital markets existed three hundred years before ratings.<sup>142</sup> During that time, most debt was sovereign.<sup>143</sup> Outside capital markets, however, trade credit ratings (reflecting trade debtors’ creditworthiness) developed and thrived in the nineteenth century U.S. mercantile trade.<sup>144</sup> As the U.S. railroad bond market grew, the size and fragmentation of the United States created informational asymmetries that could be solved by an adapted version of the mercantile credit ratings.<sup>145</sup> The railroad ratings evolved to be encapsulated in single rating symbols, which John Moody began selling in 1909.<sup>146</sup> The bond rating industry grew from that point forward with low

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<sup>137</sup> *CRA Hearing*, *supra* note 30, at 8 (statement of Michael Kanef, Asset Backed Finance Group Managing Director, Moody’s Financial Services).

<sup>138</sup> *Id.* at 17.

<sup>139</sup> *Id.* (“Our loss expectations and enhancement levels rose by about thirty percent over the 2003 to 2006 time period.”).

<sup>140</sup> *Id.*

<sup>141</sup> *Id.* at 2 (statement of Christopher Cox, Chairman, U.S. Securities and Exchange Commission).

<sup>142</sup> Richard Sylla, *An Historical Primer on the Business of Credit Rating*, in *RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM* 19, 20 (Richard M. Levich et al. eds., 2002).

<sup>143</sup> *Id.* at 21.

<sup>144</sup> Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 *WASH. U. L.Q.* 619, 636-37 (1999) [hereinafter *Siskel and Ebert*].

<sup>145</sup> *See id.*; Sylla, *supra* note 142, at 22.

<sup>146</sup> *Siskel and Ebert*, *supra* note 144, at 637-38.

entry and exit barriers.<sup>147</sup> These low barriers promoted rating accuracy, as did the ease (relative to today) of independent analysis and verification by other market participants.<sup>148</sup> During the following decades, large financial institutions used ratings “merely as a check on their own findings,” while smaller institutions relied heavily on ratings of credit risk in their purchasing decisions.<sup>149</sup> Following a business lull during the economically-stable 1940s and 1950s,<sup>150</sup> CRAs “exploded in size” from the mid-1970s on.<sup>151</sup> Significantly, it was in the mid-1970s that CRAs switched from investor-subscription to issuer fee payment models, in large part because of free-rider problems created by the advent of low-cost photocopying.<sup>152</sup> The increasing complexity of financial instruments from that point forward created further informational asymmetries that both investors and issuers depended on CRAs to remedy.<sup>153</sup> For the complex instrument issuances to grow in number and profitability, issuers needed the CRAs to promote investor confidence. Issuance, investment, and the rating business fattened in this environment.<sup>154</sup>

## 2. Past Failures and Liability

Crises involving putative ratings errors are an old hat.<sup>155</sup> The alarming news is that their frequency has accelerated in the era of global finance.<sup>156</sup> Significant recent crises include the Orange County bonds crisis,<sup>157</sup> the Asian flu,<sup>158</sup> and the Enron scandal.<sup>159</sup> These and other crises have tested the liability of CRAs.

Those agencies with a special SEC-granted recognition status<sup>160</sup> are

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<sup>147</sup> *Id.* at 639–40.

<sup>148</sup> *Id.*

<sup>149</sup> *Id.* at 644.

<sup>150</sup> *Id.* at 646.

<sup>151</sup> *Siskel & Ebert, supra* note 144, at 648.

<sup>152</sup> Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, in *RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM* 41, 47 (Richard M. Levich et al. eds., 2002).

<sup>153</sup> *See* Reiss, *supra* note 1, at 1007.

<sup>154</sup> *Id.*

<sup>155</sup> TIMOTHY J. SINCLAIR, *THE NEW MASTERS OF CAPITAL: AMERICAN BOND RATING AGENCIES AND THE POLITICS OF CREDITWORTHINESS* 157 (2005) (defining “rating crisis” as “the public perception of acute rating agency failure.”). “The first major rating crisis of modern times was the Penn Central Railroad bankruptcy of June 1970. The failure of Franklin National Bank . . . sparked another significant rating crisis in 1974.” *Id.*

<sup>156</sup> *Id.*

<sup>157</sup> *Id.* at 158.

<sup>158</sup> *Id.* at 162.

<sup>159</sup> *Id.* at 169.

<sup>160</sup> *See infra* Part V.B.

exempt from expert liability under Securities Act Section Eleven,<sup>161</sup> and the line of U.S. cases testing CRA civil liability has, to date, favored CRAs.<sup>162</sup> CRAs have achieved dismissal or greatly reduced settlement payments in crisis-related legal actions by arguing that ratings are protected speech and are disclaimed.<sup>163</sup>

Civil liability of CRAs to issuers or investors in Germany is governed by the presence or absence of contractual relationships.<sup>164</sup> Liability in the United Kingdom factors in contractual relationships, but the central question is one of the duty of care.<sup>165</sup>

## B. Prior Official Action

### 1. In the United States

A central feature of the relationship between regulators and CRAs, and of the ratings industry itself, has been the use of agency ratings for regulatory purposes. Federal and state regulators in the United States have used ratings in this manner since the 1930s.<sup>166</sup> The very fact of this regulatory use means that the market is not the sole judge of ratings' worth.<sup>167</sup> When the SEC opted in 1975 to use ratings in its regulations, it specified certain CRAs whose ratings would suffice and designated those firms "Nationally Recognized Statistical Ratings Organizations" (NRSRO).<sup>168</sup> The SEC thereafter "recognized" any additional NRSROs through no-action letters.<sup>169</sup> Even though the SEC is the only body conferring NRSRO status, that designation has been used in a wide variety of regulations and legislation concerning financial safety and soundness.<sup>170</sup>

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<sup>161</sup> Frank Partnoy, *The Paradox of Credit Ratings*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65, 78 (Richard M. Levich et al. eds., 2002).

<sup>162</sup> *Id.* at 79; Carsten Thomas Ebenroth & Thomas J. Dillon, Jr., *The International Rating Game: An Analysis of the Liability of Rating Agencies in Europe, England, and the United States*, 24 LAW & POL'Y INT'L BUS. 783, 832-33 (1993).

<sup>163</sup> Partnoy, *supra* note 161, at 79.

<sup>164</sup> See Ebenroth & Dillon, *supra* note 162, at 788.

<sup>165</sup> *Id.* at 832.

<sup>166</sup> Sylla, *supra* note 142, at 36.

<sup>167</sup> See White, *supra* note 152, at 44.

<sup>168</sup> *CRA Hearing*, *supra* note 30, at 3 (statement of Lawrence White, Professor, New York University Stern School of Business).

<sup>169</sup> *Id.*

<sup>170</sup> See SEC. & EXCHANGE COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS at 7 n.16 (Jan. 2003) [hereinafter *SEC 2003 Report*] (listing eleven legislative and regulatory uses of the NRSRO designation). The Sarbanes-Oxley Act of 2002 directed the SEC to produce this report in light of concerns over CRAs' performance in the Enron scandal. SINCLAIR, *supra* note 155, at 171.

The nature of the CRA product has thereby fundamentally changed: “[i]ssuers pay rating fees, not to facilitate access to the capital market, but to purchase a privileged status for their securities from the regulator. As a result, licensed rating agencies will have a product to sell regardless of the analytic quality of their ratings . . . .”<sup>171</sup>

There are complaints about the efficacy of the NRSRO recognition process. Between the advent of the NRSRO designation (then granted to three firms) and 1992, only four new entrants were so designated.<sup>172</sup> Mergers returned the total number of NRSROs to three by 2000, and there were no further recognitions until 2003.<sup>173</sup> This, combined with the issuer regulatory access incentive, has protected the market share of those three initial NRSROs. The bar to market entry is extremely high, because while the SEC’s recognition decisions do consider a CRA’s operational capacity and reliability, the central factor is national recognition in the United States.<sup>174</sup> Of course, national recognition is nearly impossible to achieve without NRSRO status. Despite these concerns, the SEC declined to implement alternatives it considered in 1993.<sup>175</sup>

The regulatory scheme is not necessarily fatal to ratings’ market usefulness. A regulatory license incentive for issuers does not explain the fact that usual practice for issuers is to purchase two ratings, nor that the market values doubly-rated securities more than singly-rated ones.<sup>176</sup> Indeed, two ratings are usually purchased from the most expensive CRAs (Moody’s and Standard & Poor’s).<sup>177</sup> The market reacts better to such issuances (and even to issuances rated only by one of those two CRAs) than to issuances rated by Fitch.<sup>178</sup> Issuers pay for these expensive ratings even when the issuances are not expected to achieve the ratings levels pondered in the relevant regulatory scheme.<sup>179</sup>

Following and upon the basis of the SEC’s 2003 report, the U.S. Congress enacted the Credit Rating Agency Reform Act of 2006.<sup>180</sup>

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<sup>171</sup> Richard Cantor, *Moody’s Investors Service Response to the Consultative Paper Issued by the Basel Committee on Bank Supervision “A New Capital Adequacy Framework,”* 25 J. BANKING & FIN. 171, 179 (2001).

<sup>172</sup> *CRA Hearing*, *supra* note 30, at 3 (statement of Lawrence White, Professor, New York University Stern School of Business).

<sup>173</sup> *Id.*

<sup>174</sup> *See SEC 2003 Report*, *supra* note 170, at 9.

<sup>175</sup> *Id.* at 10 (The SEC had considered eliminating the NRSRO designation from SEC rules or retaining the designation and asserting greater, more direct oversight of CRAs).

<sup>176</sup> *See* Stéphane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 MCGILL L.J. 617, 634 (2006).

<sup>177</sup> *See* Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 66 (2004).

<sup>178</sup> *Id.*

<sup>179</sup> *Id.*

<sup>180</sup> Credit Rating Agency Reform Act of 2006, Pub.L. 109-291, § 1, Sept. 29, 2006, 120

Pursuant to this Act, which amended Section Fifteen of the Exchange Act, the SEC proposed and adopted Rules 17g-1 through 17g-6.<sup>181</sup> These Rules require periodic status reapplication by current NRSROs, prescribe record-keeping requirements to assist the SEC in future investigations into whether CRAs follow requirements of the Act and internal guidelines, require CRAs to submit audited financial statements to show that they have sufficient resources and to list their largest customers so that the SEC can evaluate possible conflicts of interest, and guard against partiality by prohibiting misuse of non-public information and other abusive practices and by requiring disclosure of conflicts of interest.<sup>182</sup>

## 2. In the European Union

The European Commission first reviewed the role of CRAs in the wake of the Enron scandal.<sup>183</sup> In 2004, the European Commission and European Parliament were again stirred to analyze issues related to CRAs, this time by the Parmalat scandal, resulting in several EU legislative measures with “major implications” for CRAs.<sup>184</sup>

These measures, part of the Commission’s Financial Services Action Plan (FSAP), included a Market Abuse Directive, addressing conflicts of interest and other forms of market abuse;<sup>185</sup> a Capital Requirements Directive, specifying banks’ capital requirements “based on the new international capital requirements framework agreed [upon] by the Basel Committee on Banking Supervision;”<sup>186</sup> and a Markets in Financial Instruments Directive, which also addressed conflicts of interest by prohibiting CRAs from providing bundled investment services without authorization.<sup>187</sup> The Commission declined to address the European Parliament’s concern over rating industry competition because “excessive market fragmentation could have adverse consequences” as “agencies may face undue pressure to issue favorable ratings in order to attract clients.”<sup>188</sup> Prior to the 2007 crisis, the Commission had determined that no more legislation was needed.<sup>189</sup>

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Stat. 1327.

<sup>181</sup> See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, SEC Rel. No. 34-55231 (proposed Feb. 2, 2007) (codified at 17 C.F.R. pts. 240 & 249b).

<sup>182</sup> *Id.* at 11–13.

<sup>183</sup> Comm’n from the Comm’n, *supra* note 123, at 2.

<sup>184</sup> *Id.*

<sup>185</sup> *Id.* at 3.

<sup>186</sup> *Id.* at 4.

<sup>187</sup> *Id.* at 5. The FSAP is in the process of Member State adoption.

<sup>188</sup> Comm’n from the Comm’n, *supra* note 123, at 5.

<sup>189</sup> *Id.* at 6.

### C. Corrective Action

Proffered solutions are multifarious. Possible CRA-related changes could enhance the usefulness of NRSRO/ECAI designations while reducing conflicts of interest and the use of ratings in safety and soundness regulation. Others advocate market correction alone.

A logical solution to the conflict of interest created by the issuer-funded model of credit ratings might be a return to the pre-1970's investor-subscription model. However, ratings' accuracy and value increase with exposure,<sup>190</sup> so new attempts to limit their dissemination would fail practically<sup>191</sup> and in principle. If not funded by issuers or investors, ratings could be government-funded. Drawbacks to this option include inhibited innovation and the likely evolution of ratings into public guarantees against losses.<sup>192</sup> Mr. McCreevy has suggested strengthened internal controls and firewalls for CRAs akin to those prevalent in the auditing industry.<sup>193</sup> Such a governance structure would see rating assessors reporting directly to independent corporate directors so as to reduce business development pressure from management.<sup>194</sup>

The problem of NRSRO/ECAI designations is a particularly knotty one. Because these designations allowed highly-rated (yet ultimately problematic) RMBS and CDO debt to harm institutions protected by safety and soundness regulations incorporating such designations, a logical reaction might be to eliminate them. This would remove a powerful barrier to entry. As the European Commission recognized, however, CRA competition may inflate ratings.<sup>195</sup> Abandoning the designations could also promote issuers' use of sham ratings firms set up to rubber-stamp issuances.<sup>196</sup> Recent changes to the designation process in the United States<sup>197</sup> and in Europe<sup>198</sup> may be beneficial.

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<sup>190</sup> See *Subprime Ratings for Rating Agencies*, FT.COM, Aug. 16, 2007 (search "subprime rating agencies" and follow first result hyperlink).

<sup>191</sup> Issuer-funded ratings were made impracticable by free-rider problems in the 1970's. See *supra* Part V.A.1.

<sup>192</sup> *Subprime Ratings for Rating Agencies*, *supra* note 190.

<sup>193</sup> Charlie McCreevy, Address at Wachovia Bank Int'l Official Opening, (Oct. 26, 2007) (transcript available at <http://www.exchange-handbook.co.uk/index.cfm?section=news&action=detail&id=70363>).

<sup>194</sup> *Id.*

<sup>195</sup> Commc'n from the Comm'n, *supra* note 123, at 5.

<sup>196</sup> White, *supra* note 152, at 53.

<sup>197</sup> Professor White sees advantages and disadvantages to the 2006 Act's NRSRO registration and disclosure directives. The "open and transparent" registration scheme is an improvement, but exposure of CRA procedures and methods may "erode the NRSROs' intellectual property" and discourage innovation. Lawrence J. White, *A New Law for the Bond Rating Industry*, REGULATION, Spring 2007, at 48.

<sup>198</sup> The Bank of International Settlements proposes that banks themselves regularly



The designations are relevant because they are used in financial safety and soundness regulations. Such use may itself be problematic:

[T]he major rating agencies have been against the use of credit ratings in the regulatory process due to the potential impact of rating changes on financial markets, incentives to engage in ratings-shopping, the accuracy of ratings in reflecting the underlying risks, and the pressure that might be brought to bear on the agencies . . . .<sup>199</sup>

Safety and soundness regulations built on CRA ratings may promote financial system instability<sup>200</sup> and cause institutions' capital adequacy to lag behind changing market needs.<sup>201</sup> One solution is to more closely align safety and soundness regulations with market realities by basing capital adequacy requirements on investments' credit spreads rather than credit ratings.<sup>202</sup> Credit spread measurement is largely standardized and is easily updated over the life of an investment.<sup>203</sup> This may reduce the impact of multi-tiered asset repackaging whereby subordinated tranches from diverse issuances are purchased and pooled together into new tranches to produce fresh AAA-rated senior debt.

The crisis' origins in the non-prime mortgage market suggest corrective action aimed at lending practices. After years of knowing about problems in the non-prime mortgage industry,<sup>204</sup> the U.S. Congress is only now considering Truth In Lending Act amendments that would reform consumer mortgage practices across the board while giving special attention to non-prime ("high cost") mortgages by tightening limitations on interest rate adjustments and foreclosures.<sup>205</sup> Additional limitations on loan-to-value ratios may be prudent.<sup>206</sup> While these changes are overdue, reacting only to the specific asset classes that backed the offending RMBS and CDO issuances will do little to prevent issuer and investor risk misperception

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justify their risk assessments to regulators, thereby reducing reliance on ECAI assessments. White, *supra* note 152, at 53.

<sup>199</sup> Roy C. Smith & Ingo Walter, *Rating Agencies: Is there an Agency Issue?*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 290, 308 (Richard M. Levich et al. eds., 2002).

<sup>200</sup> Edward I. Altman & Anthony Saunders, *The Role of Credit Ratings in Bank Capital*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 99 (Richard M. Levich et al. eds., 2002).

<sup>201</sup> *Id.* at 100.

<sup>202</sup> Partnoy, *supra* note 161, at 80.

<sup>203</sup> *Id.*

<sup>204</sup> U.S. Dep't of Justice, Letter from the Dep't of Justice Regarding Predatory Lending, *supra* note 14.

<sup>205</sup> H.R. 3915, 110th Cong. (as passed by House, Nov. 15, 2007).

<sup>206</sup> Adelson & Jacob, *supra* note 65.

from spawning new bubbles and crises in the future.

Those who recognize the intractability of risk misperception might look askance at commentary that emphasizes market correction mechanisms. That markets now shy away from complex financial products with elusive risk and value characteristics may be a beneficial correction,<sup>207</sup> but decade intervals have historically been sufficient to recalibrate risk perception such that new crises build.<sup>208</sup>

#### D. Investor Psychology

The drive toward relaxed origination standards was revved in part by investor psychology, since investors seek cutting-edge high-yield investment vehicles. Common features of investor psychology include availability heuristics and disaster myopia, which feed an investor's propensity to "see what it wants" by applying old lessons to new circumstances, regardless of any external risk signals, and then overreacting to risk realizations. A poor credit rating traditionally has been one risk signal commonly heeded, but the securitized structures were designed to offer securities across the range of investment-grade ratings.

This article has already alluded to investor psychology in discussing the growth and collapse of the subprime-backed securities market. A brief discussion of the underlying ideas follows.

An individual unknowingly uses the availability heuristic when assessing a present situation's risk by means of association with irrelevant information sources.<sup>209</sup> Most risk is confronted without independent knowledge, requiring actors to rely on others<sup>210</sup> or on prior experience of questionable applicability. A driver who witnesses an automobile accident will, for a time, react by driving as though the probability of a second accident has increased; as the memory of the accident diminishes, so shall the perceived risk.<sup>211</sup> On a grander scale, there is disaster myopia, which is

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<sup>207</sup> See *CRA Hearing*, *supra* note 30, at 11 (statement of Lawrence White, Professor, New York University Stern School of Business) ("[T]he financial markets will find ways of fixing problems so that they are less likely to occur in the future."); Eavis, *supra* note 75 ("The new era of banking we're moving into will result in banks doing more business on balance sheet . . ."); Malcolm D. Knight, General Manager, Bank for Int'l Settlements, Address at the Group of Thirty International Banking Session: The Evolving Structure of the World Economic System (Oct. 22, 2007).

<sup>208</sup> See SINCLAIR, *supra* note 155, at 157–70 (surveying credit crises over the past three decades).

<sup>209</sup> See Richard J. Herring, *Credit Risk and Financial Instability*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 345, 355 (Richard M. Levich et al. eds., 2002).

<sup>210</sup> Cass R. Sunstein, *The Laws of Fear* 10 (John M. Olin Law & Econ. Working Paper No. 128, 2d Series, June 16, 2001).

<sup>211</sup> Herring, *supra* note 209, at 355.

“[t]he tendency for the subjective probability of a disaster to decline during long periods in which no disaster has occurred.”<sup>212</sup> An implication of disaster myopia is that, in periods of benign financial conditions, lenders can be counted on to reduce capital positions and relax lending criteria.<sup>213</sup> Once adverse conditions return, “highly publicized events” cause excessive fear of statistically small risks.<sup>214</sup> Crisis blooms once fears about short-term debt liquidity spread to and devalue putatively similar instruments.<sup>215</sup> Regulation that can manage and react to fear is essential to financial market health. This aim must be balanced against the idea that even irrational fear serves an important purpose in regulatory schemes: widespread fear promotes issue saliency, which is “the bane of special interest influence.”<sup>216</sup>

## VI. CONCLUSION

Regarding CRAs, regulatory and legislative investigation and action over the past decade has focused on improving integrity and accuracy of ratings. Current efforts to reform the mortgage industry inspire hope that as many consumers as is responsibly sustainable by the market can become homeowners. Removing restrictions on institutional investors’ abilities to purchase RMBS would provide maximum efficiency to securitization, which is the specialty consumer finance industry’s primary method of financing. However, public policy also requires protection for those whose pensions and other savings are funneled into institutional investment structures and, thereafter, into RMBS and CDOs.

National and, one hopes, international regulatory action can reverse the current trend of state-level anti-predatory lending acts creating regulatory burden options for lenders and allowing pockets of irresponsible lending to flourish. However, barring certain institutional investors from purchasing RMBS would interfere with the origination financing needed for maximum home ownership. Instead, protecting both the homeowners and the investors could be achieved through national regulation concerning lending, aimed at rooting out the irresponsible practices that initiated devaluation of RMBS and CDOs this year. This may be combined with a re-examination of how NRSRO designations in the United States and cognate designations internationally are used in safety and soundness regulations. Allowing rating firms to flourish or wither on the strength of their own market performance rather than on the momentum of their regulatory licenses may improve their performance.

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<sup>212</sup> *Id.*

<sup>213</sup> *Id.* at 358.

<sup>214</sup> Sunstein, *supra* note 210, at 9.

<sup>215</sup> See SINCLAIR, *supra* note 155, at 162.

<sup>216</sup> Steven A. Ramirez, *Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence*, 42 WASHBURN L.J. 31, 36–37 (2002).

It is important to address both the underlying origination practices and the RMBS/CDO rating practices, because tinkering with only one or the other has proved inadequate. Those who would prevent the next credit crisis must contend with the idea that there is always another bubble a decade away. Curbing disaster myopia can lessen the swing between the wider financial market's feast and its subsequent famine when a bubble inflates and bursts. Financial institutions' memories must be lengthened so that risk perception can take into account those crises that occurred before current management was in place. Transaction analysis, particularly when dealing with complex new structures, must account for herding behavior and justification heuristics, and must be subject to evaluation independent of profit centers. Widespread familiarity with investor psychology heuristics can work hand-in-hand with changes in capital adequacy requirements and in ratings practices to promote financial stability and responsibility.

#### VII. 2008 UPDATE: FRAGMENTED REGULATORY RESPONSE

The seriousness and the visibility of the crisis' effects caused a proliferation of input and proposals from regulators in the United States and in Europe. What followed amounted to a scrum by regulators seeking to assert and increase regulatory authority over all actors involved in the crises, including CRAs. The situation has led CRA representatives to warn against a lack of global regulatory consistency.<sup>217</sup> If recent history is any guide, the CRAs' complaints are valid, as the process of harmonization and equivalence has been arduous and lengthy (and incomplete) in the securities and accounting contexts.<sup>218</sup> There is little reason to believe, especially in light of the balkanized regulatory response so far, that new CRA regulatory regimes across the globe will achieve harmonization or equivalence more efficiently.

Neither is market correction alone a satisfactory tack. A popular index of subprime-backed securities, the ABX index, was a market innovation that exacerbated the crisis through the availability heuristic.<sup>219</sup> The ABX index gave those with subprime securities exposure a risk signal that, when inserted into the availability and herding heuristics, led investors and

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<sup>217</sup> Tony Barber, *EU Turns Up Heat on Rating Agencies*, FIN. TIMES, July 7, 2008, <http://www.ft.com> (search "EU turns up heat on rating agencies" and follow first result hyperlink).

<sup>218</sup> See Tzung-bor Wei, *The Equivalence Approach to Securities Regulation*, 27 NW. J. INT'L L. & BUS. 225 (2007) (examining international regulatory competition, harmonization, and equivalence in securities and accounting contexts).

<sup>219</sup> See Seran Ng, Carrick Mollenkamp & Scott Patterson, *A 'Subprime' Gauge, in Many Ways?*, WALL ST. J., Dec. 12, 2007, <http://online.wsj.com/article/SB11974129672621875-email.html>.

warehouse lenders to pull out unnecessarily. One wonders if the crisis would have been milder if not for this faulty risk recalibration and others like it.

Market correction alone is also faulty because it would not lead CRAs to correct legitimate operational problems. News reports revealed instances of bowing to customer pressure to make changes in ratings or in rating personnel,<sup>220</sup> legitimizing fears that the issuer-funded model has fundamentally and harmfully altered the rating industry. In an example of local government actions with global implications, the New York Attorney General has surmounted a collective action problem to address issues that have stymied the SEC, Congress, and the European Commission. The attorney general's settlement with CRAs requires all NRSROs to alter their practices at the same time. This simultaneousness is vital because the changes are unlikely to sit well with CRAs' customers.<sup>221</sup> It is important to leave customers no choice; otherwise the most responsible CRA—the one making necessary fundamental corrections to operations—would immediately become the least successful.

Investor groups want an entirely new regulatory body to oversee the CRAs.<sup>222</sup> This is unsurprising since the inception of a new agency presents a chance for regulatory capture. At present, the regulatory power is thinly spread across several agencies, chief among them the SEC. Each of these agencies is now trying to arrogate more power from the others. In this climate, investors face great uncertainty and risk of loss. With a fledgling agency in charge of the ratings industry, these investor groups stand a far greater chance of controlling the agenda.

The prospect of any single interest group seizing the regulatory agenda, however, is even smaller because of the situation in Europe, where Mr. McCreevy has recommended a form of CRA registration akin to the NRSRO designation in the United States.<sup>223</sup> Member State finance ministers are eager to show they are *doing something* to make it up to their

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<sup>220</sup> See Aaron Lucchetti, *At Request of Bond Issuers or Bankers, Credit-Rating Firms Switch Analysts*, WALL ST. J., May 23, 2008 at C1.

<sup>221</sup> See *Securitization Update: SEC Proposes Rule Changes Relating to Credit Ratings on Asset-Backed Securities*, Mayer Brown, June 25, 2008, available at <http://www.mayerbrown.com/publications/article.asp?id=5003&nid=6> (The settlement terms combat ratings shopping by requiring CRAs to charge for ratings services performed on prospective issuances even if issuers then decide to use a different CRA for the ultimate rating, and by requiring CRAs to disclose information about all securities submitted for review, including ones that never end up being issued. The settlement terms also seek to improve asset quality by having CRAs create and disclose mortgage reviewing criteria and requiring CRAs to demand more thorough representations and warranties from issuers regarding assets).

<sup>222</sup> Aaron Lucchetti, *Finance Group Questions Bond-Rating Proposals*, WALL ST. J., July 7, 2008, at C3.

<sup>223</sup> Barber, *supra* note 217.

people—those taxpaying bodies politic who have effectively been made unwilling hedge counterparties, with billions of euros in public bailouts going to a handful of banks in the commercial paper trap.<sup>224</sup>

The CRAs are cooperating with the diverse regulators, complaining only about the specter of an unnavigable morass of inconsistent laws and regulations.<sup>225</sup> The complaint is valid and the morass is almost inevitable. The process of international regulatory harmonization and equivalence in securities and accounting contexts has been lengthy and arduous, and has still not rounded some of the rough edges left during the post-Enron rush to *do something*.<sup>226</sup> There is nothing to indicate the CESR, the Federal Reserve Board, the EC, the FDIC, the SEC, and IOSCO will begin demonstrating a (heretofore absent) regard for concerted action and investor psychology.

The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission issued joint recommendations aimed at helping large financial institutions manage the sizable reputational risks associated with creating and offering more rarefied structured finance products (dubbed Complex Structured Finance Transactions, or CSFTs).<sup>227</sup> The joint statement recommends that financial institutions avoid some incentive problems by having formalized approval processes for CSFTs that involve evaluation by upper-level personnel outside CSFT profit centers.<sup>228</sup> In a nod to some psychology and incentive problems, the joint statement entreaties financial institutions to not place great stock in the assessments offered by counterparties or counterparties' counsel, or in the fact that competitors are offering similar products or that other institutions are willing to participate in the CSFT under consideration.<sup>229</sup> Defeating psychology and incentives requires an ethics-focused culture vigorously enforced by internal audit with the full backing of senior and board management. The interagency statement merely provides guidance, but these or similar recommendations may end up carrying the force of law.

Modeling errors,<sup>230</sup> analyst reassignments, and corner-cutting show

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<sup>224</sup> See, e.g., *Die Bürger übernehmen das Risiko*, 15 SPIEGEL 78, at 78 (2008) (German bank bailouts have been substantial, including €7.2 billion to IKB, €3.8 billion to WestLB, €2.8 billion to Sachsen LB, and €2.4 billion to BayernLB).

<sup>225</sup> Barber, *supra* note 217.

<sup>226</sup> See Wei, *supra* note 218.

<sup>227</sup> Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, 72 Fed. Reg. 1377 (Jan. 11, 2007).

<sup>228</sup> *Id.*

<sup>229</sup> *Id.*

<sup>230</sup> See Joanna Chung, *SEC Looks to Subprime Lessons*, FIN. TIMES, May 23, 2008, <http://www.ft.com> (search "SEC looks to subprime lessons" and follow first result

that improvement to CRA methodology is warranted, but the recurring criticism of investor reliance on ratings is suspect. The recent decades' shift in focus from banking to securities requires a larger measure of investor reliance on credit ratings. Regulations' use of NRSRO and ECAI designations has increased that reliance. Recommendations like those in the interagency statement hit the mark because no amount of regulation can save the too-clever world of finance from itself. The self-analysis, internal oversight, and personal responsibility contemplated in the interagency statement are the best hope for overcoming the psychology and incentives that would steer this global financial system toward the next crisis.

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hyperlink); Alina van Duyn & Joanna Chung, *S&P Discloses Errors in Rating Models*, FIN. TIMES, June 13, 2008, <http://www.ft.com> (search "S&P discloses errors in rating models and follow first result hyperlink).