

# The Regulation of the Bond Rating Industry: Past, Present, and Future?

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# Overview

- Why bond rating firms?
- Market structure
- Business model
- The origins
- The road to SEC regulation
- The consequences of SEC regulation
- The road to new legislation
- The current situation
- A better course of action
- Conclusion

# Why bond rating firms?

- They are part of the efforts of lenders/borrowers to deal with problems of asymmetric information
  - Who is most likely to pay me back?

# Market Structure

- Moody's, S&P, and Fitch are the dominant firms
  - Economies of scale, “network” effects surely mean that this industry would not be atomistic; but
  - SEC regulation 1975-2006 surely exacerbated dominance
- There are a few smaller rating companies in the U.S.
- There are securities analysts
- There are rating companies in other countries

# The Business Model (1)

- Prior to the early 1970s, rating firms sold ratings to investors
- Since early 1970s, the major rating firms instead have charged fees to issuers for a “solicited rating”
  - Issuers get the opportunity to “tell their story” to the rating firm
  - Issuers could instead pay nothing and receive an “unsolicited rating”
  - Nearly every corporate issuer chooses to pay
  - All structured finance ratings are solicited

# The Business Model (2)

- The reasons for the change in their business model in the early 1970s
  - Rating firms feared cheap photocopies
  - Rating firms realized that issuers needed ratings in order to have their bonds bought by regulated financial institutions (see below)
- The smaller rating firms still sell their ratings to investors

# The Business Model (2)

- Potential conflicts
  - Do issuers shop for ratings?
  - How involved are the ratings firms in the structuring of rated bonds?
  - Do the issuers “pay” to get higher ratings?
  - Do the raters threaten lower ratings unless the issuers pay?
  - “We wouldn’t want to risk our reputation”
  - That’s what Arthur Anderson used to say

# The Origins

- John Moody began publishing (and selling to investors) railroad bond ratings in 1909
  - Moody's was bought by Dun & Bradstreet in 1962, spun off in 2000
- Poor's followed in 1916; Standard in 1922;
  - S&P merged in 1941; McGraw-Hill bought S&P in 1966
- Fitch entered in 1924
  - Bought by IBCA in 1997, which was owned by FIMALAC
- They were meeting a market test!

# The Road to Regulation (1)

- In 1931 the OCC told banks that bonds in their portfolio that were below “investment grade” (below BBB) would have to be marked to market
  - As determined by “recognized rating manuals”
  - OCC’s intent was to discourage banks from holding low-quality assets (that would be inadequate to support their deposit liabilities)
- In 1936 the OCC told banks that they could not hold bonds that were below “investment grade”
  - This is still the case
- State insurance regulators in 1930s and 1940s linked insurance companies’ capital requirements to the ratings on the bonds that they held
- Financial regulators had de facto outsourced to bond raters important safety-and-soundness decisions
  - Which bond raters?

## The Road to Regulation (2)

- In 1975 the SEC wanted to establish capital requirements for broker-dealers and wanted to link the required capital to the quality (as determined by bond ratings) of their bond holdings
- The SEC realized that “whose ratings” needed clarification
  - Could a broker-dealer claim that the AAA “ratings” of even a bogus rating company were OK to use?
- The SEC created the NRSRO category and immediately “grandfathered” Moody’s, S&P, and Fitch

# The Road to Regulation (3)

- The SEC designated an additional NRSRO in 1981 and in 1982, and again in 1991 and in 1992
  - By 2000 they had all merged into Fitch
- The SEC never formally defined the criteria for designating NRSRO
  - The SEC proposed a definition in 1997, never issued a final regulation
- The SEC's decisions were opaque
  - New NRSROs were revealed through “no action letters”

# The Consequences (1)

- The NRSRO designation is now in widespread use by financial regulatory agencies
  - They have delegated – outsourced -- their safety-and-soundness judgments to the NRSROs
- Major bond investors – banks, insurance companies, pension funds, MMMFs, etc. – are required to heed the ratings of a handful of NRSROs
  - As a consequence, the bond markets more generally must heed those NRSROs

# The Consequences (2)

- The NRSRO designation restricted entry into bond rating
  - Economies of scale, brand-name reputation are powerful forces that make entry difficult anyway
  - NRSRO made entry more difficult: How easily could a non-NRSRO get the attention of issuers, users?
- The NRSRO designation potentially discouraged innovation
  - How would someone with a better idea for assessing credit quality propagate that idea?
- The NRSRO designation potentially distorted capital markets
  - The capital markets were forced to pay attention to NRSROs' judgments, even if those judgments are bad

# The Consequences (3)

- We don't know if the NRSROs met a market test
  - There could be better ways for the financial markets to ascertain credit quality; how could we find out?
- Doesn't the fact that a NRSRO's downgrade moved markets mean that the NRSROs were providing valuable information to the market?
  - Not necessarily! The downgrade moved a bond closer to (or across) the investment grade "can't hold" threshold; maybe that's all the market movement reflected

# The Consequences (4)

- The NRSROs were overly optimistic about sub-prime-based MBSs and CDOs
- The NRSROs have always been culturally slow to revise ratings, especially downward
  - “Rate through the cycle”
  - Don’t want to make issuers unhappy
  - Aware of the consequences
  - Hard to admit prior mistakes
- As a consequence, they were sure to be slow to recognize the deterioration of sub-prime-based securities

# The Road to New Legislation (1)

- Moody's and S&P had "investment grade" ratings for Enron five days before Enron's bankruptcy in November 2001
  - This attracted Congressional attention
  - Sarbanes-Oxley required a report by the SEC on NRSROs, issued in January 2003
  - The SEC issued a "Concept Release" in June 2003
  - The SEC designated an additional NRSRO in 2003 (DBRS) and in 2005 (A.M. Best)
- The SEC issued a new proposed definition of NRSRO in April 2005

# The Road to New Legislation (2)

- Congress passed new legislation; Pres. Bush signed it in Sept 2006
- New law preserved the NRSRO category but intended to force the SEC to be less of a barrier to entry and to be more transparent in its decisions
- The SEC designated 2 new NRSROs (JCRA, and R&I) in June 2007, just before...
- The SEC issued final regulations in June 2007

# The Road to New Legislation (3)

- The new legislation gives the SEC limited powers of oversight over the NRSROs
  - The SEC is not supposed to dictate the business model of the credit ratings firms
- The SEC designated 2 new NRSROs in Dec 2007 (Egan-Jones) and Feb 2008 (Lace Financial)
- It is unclear how the system of regulatory delegations of safety decisions will work in a world of 9 NRSROs

# The Current Situation (1)

- The Congress is very angry at everyone involved in the sub-prime mess, including the major rating firms
- The Congress is suspicious of the issuer-pays business model
  - But is the investor-pays model viable in the 21<sup>st</sup> century? For a major rating firm?
- Will the Congress legislate remedies?
  - The 2006 legislation was dormant for a few years and then suddenly was passed

# The Current Situation (2)

- The New York Attorney General has reached an agreement (June 5) with the three large NRSROs
  - More disclosure
  - Staged payments
  - Due diligence
  - Representations and warranties

# The Current Situation (3)

- The SEC has proposed (June 11) new regulations
  - More disclosure
  - More limits on conflicts
  - New procedures
  - New symbols on structured finance (or a special report)
- The SEC will propose (June 25) that the SEC reconsider its outsourcing to the NRSROs

# Does Detailed Regulation of the Credit Rating Industry Make Sense?

- Can the Congress and/or the SEC and/or the NYAG ensure more accurate ratings?
  - Will more disclosure solve the problem?
  - Will input specification ensure quality?
- Should they specify the business model?
- How will innovation occur?

# What Is a Better Course?

- Financial regulatory agencies must cease outsourcing safety-and-soundness decisions to NRSROs
  - After all, the NRSROs' judgments haven't been all that good or all that consistent
    - Same ratings, different experiences for corporates versus municipals versus structured finance
  - The regulatory agencies can develop better methods
- Then eliminate the NRSRO category
- Let the participants in the financial markets make up their own minds as to who makes good predictions as to defaults
- Let the participants in the financial markets make up their own minds as to who is unreliable because of actual or potential conflicts

# Conclusion

- The financial regulators' outsourcing of safety decisions to the bond raters, which necessitated the NRSRO structure, has been a serious mistake
- Do the financial markets really want/need the SEC or the Congress or the NYAG to be the arbiter of who can be a bond rater, what the business model should be, and/or how bond ratings should be done?
- There is a superior alternative: Let the bond market participants make up their own minds