SEC Roundtable to Examine Oversight of Credit Rating Agencies
Washington D.C., April 15, 2009

# Competition in the Credit Rating Industry:

### Are we asking the right questions and getting the right answers?

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**Summary of Rapid Ratings' Position**

The Amended Rules and Re-Proposed Rules released in December and this Roundtable event provide a strong indication that the SEC wishes to promote competition in the ratings business. But there are a number of obstacles which will impede future progress:

First, the SEC is sending mixed signals about where it will draw the final line with respect to the treatment of (1) small versus large rating agencies, and (2) Issuer-Paid versus Subscriber-Paid Credit Rating Agencies ("CRAs"). Until those uncertainties are cleared up in a manner which does not disadvantage the small, Subscriber-Paid rating agencies, it is likely that many potential entrants will not apply for Nationally Recognized Statistical Rating Agency ("NRSRO") status. A particular concern for us is the threat of having our revenue-base cannibalized by being forced to disclose our ratings for free. The SEC questions whether the disclosure of historical rating actions by Subscriber-Paid CRAs could be damaging to these entities' revenue models (which are based on selling subscriptions to this data). Our current and historical ratings are highly predictive and have continuing commercial value in a broad range of areas.

Second, there is a fundamental link between effective competition in the rating industry and the production of more accurate ratings. The current focus on accuracy is inadequate. Currently, S&P, Moody's and Fitch produce about 98% of all ratings and earn 94% of all ratings revenue,[2] but that oligopolistic structure has not given us the accurate ratings we need. Commissioner Kathleen Casey has noted that: "the longstanding, deeply entrenched incumbents in this space, which have some of highest profit margins in the U.S., or anywhere in the world for that matter, have not retained their outsized market share by virtue of issuing high-quality ratings. In the past, quality has never been necessary."[3] That should now be changing but using additional monitoring of the Issuer-Paid CRAs will hardly stoke the fire. Unless the protection of the oligopolistic structure is systematically reduced, then more accurate ratings will only slowly be introduced into the market. The DBRS complaint last month about its treatment by the Fed under the TARP program and the subsequent related letter of concern sent by Connecticut's Attorney General provides an excellent example of how hard this transition will be.

Third, the SEC still has not addressed the empirical reality of conflict of interest as it pertains to Subscriber-Paid rating agencies. The simple point is that conflict of interest arises when rating agencies are paid by issuers for rating those issuers, develop personal relationships with issuers, receive confidential information from issuers, provide additional consulting services to issuers, or help arrangers develop new products and then rate them. Speaking only for Rapid Ratings, this does not even remotely describe our business model. Our business model is arms-length. For Rapid Ratings there is no conflict

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[1] Rapid Ratings International Inc is located in New York City. Its business model is based on subscribers (such as creditors, investors, regulators, lenders etc) rather than issuers and on proprietary software rather than analysts.

[2] Mco_mkt_shares.PNG (5KB, MIME type: image/png)

[3] Commissioner Kathleen L. Casey, *U.S. Securities and Exchange Commission*, Remarks at "The SEC Speaks in 2009" Wash., D.C., Feb. 6, 2009

of interest. We are not paid by issuers; we use software not analysts to assess companies' risk; we do not talk to issuers when rating the company; we do not offer issuers consulting services; we do not help design financial products with issuers or investment banks; and we do not use inside or non-public information. Because the process is automated, we never make a rating adjustment to suit a subscriber, and we have never been asked by a subscriber to make an adjustment. We market facts based on the integrity of our process. Ironically, the US ratings industry survived with a Subscriber-Paid business model from 1907 to 1970 without charges of conflict of interest.

Fourth, additional uncertainty arises because (1) Congress has indicated an interest in getting involved again, given the credit crises; (2) the SEC needs to ultimately act on the Re-Proposed Rules; and (3) various bills and initiatives are in play that could force the use of Subscriber-Paid CRAs[4].

Given the above, Rapid Ratings believes that watching, waiting and competing from outside the NRSRO framework is currently a more appropriate course of action and protects shareholder value from the current contingent liabilities associated with being an NRSRO. As the landscape becomes clearer and the dust settles, we can make a decision that best positions us to grow.

**1. From Sarbanes-Oxley to a multi-trillion dollar disaster – the search for ratings accuracy**

Before we know whether or not we have the right regulatory answers for dealing with NRSROs we need to know whether or not we have been asking the right questions. That is always the critical issue. So let's examine the original objectives.

Based on past evidence, it would seem that the demand for accuracy in corporate reporting and corporate ratings has been moving to centre stage. In the aftermath of the collapse of Enron and WorldCom, The Sarbanes-Oxley Act in July 2002 was intended to protect investors by "improving the accuracy and reliability of corporate disclosures." Moreover, Section 702 of Sarbanes-Oxley called for the SEC to conduct a study of the role and function of credit rating agencies in the operation of the securities market, including "any impediments to the accurate appraisal by credit rating agencies" of security issuers, along with a review of barriers to competition and measures to remove such barriers; any measures to improve the rating agency transparency; and any conflicts of interest in the operation of credit rating agencies and measures to prevent such conflicts or ameliorate their consequences.

And four years later we witnessed the passage of the Credit Rating Agency Reform Act of 2006 ("CRARA") whose purpose is "to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry."

But has something been lost in transition? In the SEC's Dec. 3, 2008 release of the Amended Rules and and Re-Proposed Rules there is little mention of rating accuracy and the competition problems are not being forcefully addressed. Rather, the focus is on addressing "concerns raised about the policies and procedures for, transparency of, and potential conflicts of interest relating to ratings of residential mortgage-backed securities backed by subprime mortgage loans and collateralized debt obligations linked to subprime loans." So why the change?

Accurate early warnings are not something the Big 3 CRAs can provide, despite these current and proposed reforms because they offer ratings, by and large, with a focus on stability rather than accuracy, despite some recent downgrades. More accuracy can be achieved through effective

[4] One that would enforce the use of a Subscriber-Paid rating for every bond issue, another that would create a soft-dollar" type pool of fees to be allocated to CRAs by institutional investors, etc.

competition, notably zero barriers to entry in the ratings arena and no regulatory or oligopolistic barriers to entry and growth for Subscriber-Paid rating agencies relative to Issuer-Paid rating agencies.

**2. Why are we in another crisis involving Issuer-Paid rating agencies soon after the passage of the Credit Rating Agency Reform Act which was designed to deal with deficiencies among S&P, Moody's and Fitch after the collapse of Enron, Global Crossing and WorldCom?**

Because they hold a "special place" in the market: Henry Waxman, Chairman of the House Oversight Committee gave one reason for the new crisis on October 22, 2008: "The story of the credit rating agencies is a story of a colossal failure. The credit rating agencies occupy a special place in our financial markets. Millions of investors rely on them for independent objective assessments. The rating agencies broke this bond of trust, and Federal regulators ignored the warning signs and did nothing to protect the public."[5] Warnings we should have received which were not received from both the dominant rating agencies and the regulators.

**3. What were the deficiencies in the Credit Rating Agency Reform Act of 2006?**

The Credit Rating Agency Reform Act had several deficiencies:

- **Backward-looking problem-solving focus:** Some of the problem solving was backward looking rather than forward looking: despite warnings, asset backed securities had not imploded and hence were not a focal point of attention, and the CRARA restricted new applicants to apply by asset class, meaning there were no immediate threats to the Big 3 for structured products ratings.
- **Short-sightedness:** While CRARA identified some key rating agency weaknesses, notably poor transparency and conflict of interest, it did not go far enough in addressing those issues. These areas became the focus of attention in 2008.
- **Ignored some significant weaknesses** among rating agencies because some major weaknesses are not in ratings practices but are in the industry structure and the quality of competition. First, the structure of the industry hinders effective competition between Issuer-Paid and Subscriber-Paid rating agencies. Increasing the quantity of Subscriber-Paid NRSROs will not solve that problem. Competition must be "effective". This means barriers to entry and to growth should not be erected or sustained by government regulations and that any market barriers such as market share dominance should be policed by anti-trust authorities to ensure that there are no anti-competitive practices. Second, while the intent of the legislation was to improve accuracy, this did not arise. The principal problem is that accuracy will be improved most by Subscriber-Paid rating agencies which have no conflict of interest (in the case of Rapid Ratings at least), and especially those which have the right tools.

**The complex competition issue: how intractable is it?**

**Background:** Since 1975, NRSRO usage requirements have been embedded in a web of US regulations and laws[6] (at least 8 Federal statutes and 41 regulations and over 100 state acts and regulations). The

[5] http://oversight.house.gov/documents/20081022102221.pdf; *Credit Rating Agencies And The Financial Crisis*, Wednesday, October 22, 2008, House of Representatives Committee on Oversight and Government Reform. Washington, D.C.

[6] NRSRO-related laws affect behavior with respect to setting haircuts for determining risk-adjusted asset backing for broker/dealers; restrictions on regulated investors' portfolio holdings of higher risk securities; exemptions for asset backed securities; enhancement of risk sensitivity for bank lending under the Basel II framework; margin borrowing decisions etc. (Securities Exchange Act of 1934, Rule 15c3-1, Investment Company Act of 1940, Rule 2a-7, Rule 3a-7, 70 Federal Register, pp.

incentive for preserving the status quo is massive: "because so many regulations affecting institutional investors incorporate NRSRO ratings, issuers must seek out ratings from one of the NRSROs – Moody's, S&P or Fitch" to ensure full capital market access.[7] This path dependence[8] is reinforced by overseas regulations and practice. Australia, Canada, Japan, EU members and the Eurobond market require the usage of *approved,* grandfathered rating agencies under specified conditions. Only Big 3 rating agencies currently have the scale and scope to be active in all those markets. Further, Big 3 usage is embedded in Libor[9] markets (short-term interbank lending incorporates a risk premium based on counterparty credit ratings). Libor, the global benchmark for short-term interest rates, is used in interest rate contract settlements on overseas futures and options exchanges notably Deutsche Term Börse, Euronext, LIFFE, SIMEX and TIFFE) and in most OTC and lending transactions.[10] This global path dependence on Issuer-Paid rating agencies is deepening significantly not simply because of market use but because of increased regulatory requirements. So at this stage calls for less regulatory intervention and less use of ratings are likely to be rebuffed, despite their value.

US anti-trust laws have had the same basic objective for over 100 years: "to protect the process of competition for the benefit of consumers, making sure there are strong incentives for businesses to operate efficiently, keep prices down, and keep quality up."[11] Given our current multi-trillion dollar crisis can it really be said that the dominant Issuer-Paid rating agencies have provided highly quality, efficient services? What has been the impact of the new NRSROs on S&P, Moody's and Fitch market shares? All of them, except Egan-Jones, Lace and Realpoint, are Issuer-Paid, and most issuers don't want slight variations (of Issuer-Paid agencies) of what they already pay for. Total revenue for the small rating agencies is presently minimal versus about $4.5-$5 billion for S&P, Moody's and Fitch combined. The reality is that the seven NRSRO newcomers[12] since 2002 are small players servicing niche markets: a first or second opinion on Canadian or Japanese issues in the US market; insurance; and banking. The big market for the future is ratings for subscribers (that is, investors, creditors, lenders, regulators etc). But there are still impediments to market entry and growth. The competition problem in the ratings industry is seemingly intractable, which is surprising given the reputational damage suffered by the Big 3 CRAs this decade.

How entrenched is the mindset that, despite mistakes, only the services of S&P, Moody's and Fitch should be used? Take the case of DBRS, the Canadian-owned rating agency. In March 2009, less than 30 days ago, ex-Moody's employee Daniel Curry, now the US President of Canadian-owned DBRS, filed a formal complaint with the Federal Reserve in Washington because of its anti-competitive bias: "asset-backed securities are only eligible to participate in the Fed's new Term Asset-Backed Securities Loan Facility if they receive a AAA-ratings from Standard & Poor's, Moody's or Fitch." [13] The seriousness of this case and its illustration of the defense of the status quo despite significant failings by the Big 3 CRAs

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61068-78, Secondary Mortgage Market Enhancement Act of 1984, Pub.L.No.98. 440, Regulation T 12C.F.R.Part220.2, Investment Advisers Act 1940).

[7] Financial Oversight of Enron op. cit.

[8] Arthur, W. Brian. (1989). "Competing Technologies, Increasing Returns, and Lock-In by Historical Events," 97 *Economic Journal* 642-65. Path dependence arises from "sensitive dependence on initial conditions" and "lock-in by historical events." Path dependence leading to inefficient results is "third degree path dependence" Liebowitz, S. and Stephen. Margolis*, (1996) Path Dependence, Lock-In, and History*, *U.T. Dallas.* Path dependence protects the status quo.

[9] London Interbank Offer Rate.

[10] http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=141; European Central Bank, The Euro Bond Market Study, December 2004, Frankfurt.

[11] http://www.ftc.gov/bc/antitrust/antitrust_laws.shtm

[12] A.M. Best Company, Inc., DBRS Ltd., Egan-Jones Rating Company, Japan Credit Rating Agency, Ltd., LACE Financial Corp., Rating and Investment Information, Inc., Realpoint LLC, Moody's Investors Service, Inc., Standard & Poor's Ratings Services and Fitch, Inc.

[13] http://online.wsj.com/article/BT-CO-20090326-708802.html.

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were underlined by Connecticut Attorney General Richard Blumenthal in a letter to Ben Bernanke, the Chairman of the Federal Reserve, on April 6, 2009:

> "I write to express my deep concern about the ratings eligibility criteria for the Federal Reserve's anticipated $1 trillion lending initiative….[and] the Federal Reserve's policy of preferring Standard & Poor's, Moody's Investor Services and Fitch Ratings…. The Federal Reserve should not be favoring large market participants, whose mistakes helped precipitate the current crisis, over smaller ones seeking to break into the market."

Even though DBRS is an NRSRO, it was excluded by the Fed. So even when latecomers get into the NRSRO club they are outsiders. This type of behavior sends a very clear signal to investors and issuers that the Big 3 rating agencies are *primus inter pares* or first among equals. Is that effective competition? If the playing field does not promote effective competition inside the club, imagine what it is like outside the club for other competitors of the club. The negative consequences of Investor-Paid rating agency mistakes can be overridden by imperfect regulations.

**Competition and CRA Policy Development:** The recent Amended Rules and Re-Proposed Rules make some headway at creating greater transparency in the ratings process, reducing conflicts such as "ratings shopping" and providing greater access to information used to rate structured products. But, there are problems with how this process is evolving and it is inadvertently hindering competition when the SEC is trying to foster it. What does it mean to have competition in the ratings market? We must have competitors to the Big 3 CRAs, but we do not just need more in quantity, we need more in quality and accuracy.

Competitors also have to have a different revenue model – being paid by issuers is clearly a flawed system and the Subscriber-Paid model is un-conflicted. The SEC has posed many questions in the Re-Proposed Rules suggesting the Subscriber-Paid model carries conflicts. While in the extreme it would be possible to conflict an analyst-based, Subscriber-Paid CRA, this cannot conceivably be compared to the clear, demonstrated and admitted conflicts of the Issuer-Paid model.

Many of the historical barriers remain today – the conflicted, Issuer-Paid revenue model of the largest agencies, elements of the CRARA that require applications by asset class and requirement that actually block de novo players. And there are new barriers in the works – SEC rule amendments out for comment (for a surprising second time!) that would require Subscriber-Paid CRAs to provide their content for free in the interests of fixing a marketplace broken by the Issuer-Paid CRAs. There are also other costs of complying with the NRSRO designation. The barriers to entry and growth in the ratings market for new entrants are mounting, not shrinking.

Through NRSRO rules CRAs are now regulated by the SEC. Fundamental to fixing the broken rating agency paradigm and increasing competition are two key elements: 1) Addressing the conflicts of interest in the incumbent CRAs and their resulting questionable ratings, and 2) creating an environment and regulatory structure that fosters competition and does not create disincentives. To do the latter, the SEC must strive to make the NRSRO status desirable for new players. In evaluating current developments, Rapid Ratings is skeptical about applying for NRSRO status. There is too much uncertainty over what it will mean to be an NRSRO and the associated direct and indirect costs. The SEC must realize that it is on the verge of making the NRSRO status a disincentive to "competition" in the sense used by the SEC (e.g. more NRSROs) and yet another barrier to entry in the ratings business. The SEC needs to ensure that potential NRSROs see the designation as an asset, not a contingent liability, if it wants to have substantially more NRSRO applications.

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Ironically, possibly because of conflicting pressures from various internal and external camps, the SEC has been giving mixed messages about both the importance of the NRSRO designation and whether the framework of the NRSRO designation is conducive for Subscriber-Paid CRAs. In June 2008, the Commission suggested removing the NRSRO designation from SEC regulations, possibly reflecting that the SEC had some responsibility for the market's overreliance on NRSRO ratings. In December 2008, when the Amended Rules were announced, this initiative was passed over. In the Re-Proposed Rules, there was no reference to this initiative. To the best of our knowledge, there has been no recent official SEC comment on this initiative. On Feb. 6, 2009 SEC Commissioner Kathleen L. Casey made the unofficial remark "It is imperative that the Commission adopt its proposal to address the oligopoly in the rating industry and the overreliance on NRSRO ratings by removing the regulatory requirements embedded in numerous SEC rules.[14]" This is a welcome but hardly consistent message.

In summary, there is a complex interplay of oligopoly market structure, brand name (reputational capital), incumbent scale and scope, regulatory recognition and protection for dominant rating agency incumbents and their Issuer-Paid rating model which is preventing effective and efficient competition and thus better solutions to the rating agency failures that helped foster the trillion dollar "colossal failure". Why should regulators and politicians accidentally reward failure and fail to remove obstacles that foster success?

**Rating accuracy:** Rating accuracy is being addressed indirectly but not directly by the SEC and seems to have not received forceful attention in the recent Amended Rules and Re-Proposed Rules. The emphasis was on changing behavior, changing processes, increasing transparency, and increasing the quantity of competitors. Accuracy was very much the policy orphan, despite some known glaring rating inaccuracies such as Enron, WorldCom and Global Crossing. But there was a more fundamental issue that was courageously illustrated by Ray McDaniel, the President of Moody's, at the October 2008 Oversight Committee hearings:

"The real problem is not that the market …underweight[s] ratings quality but rather that in some sectors, it actually penalizes quality. … It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want ratings downgrades; short-sighted bankers labor short-sightedly to game the ratings agencies."

It is surprising that this significant insight has been glossed over. The reason for this ongoing state of affairs, which is unaffected by the regulatory changes is that accuracy requires independence, objectivity and the right tools. However, the Issuer-Paid business model undermines objectivity and independence because of its inherent conflict of interest given that securities issuers pay the rating agencies. The Issuer-Paid business model by its very nature promotes rating shopping and rating inflation.

On the other hand, the Subscriber-Paid model focuses on accuracy because it is independent and objective. There is no obligation to please and retain revenue from each paying client. The problems with the Credit Rating Agency Reform Act of 2006 are embedded in the government's continuing embrace of the very business model which has led to the crisis - the Issuer-Paid business model. Has the entry of more NRSROs promoted high-quality ratings and provided a check on "slack and inferior practices"? Their impact has been modest at best. Subscriber-paid rating agencies offer the best hope for effective competition in the market because they have no conflict of interest and offer greater

[14] Commissioner Kathleen L. Casey, *U.S. Securities and Exchange Commission*, Remarks at "The SEC Speaks in 2009" Wash., D.C., Feb. 6, 2009

accuracy and significant scalability. The rules of the game still have not removed all the barriers to entry and growth for Subscriber-Paid rating agencies.

**4. If one compares the regulations approved by the SEC on Dec. 3, 2008, versus what was proposed in July 2008 and left out, are we any further ahead? Is the regulatory response commensurate with this "colossal failure?"**

The short answer is that in June 2008 the SEC considered four potential initiatives:

- **New Track Record Transparency to enhance assessment of performance accuracy:** NRSROs would be required to provide evidence of how well their ratings had anticipated defaults for different securities over the past 1, 3 and 10 years. This would also necessitate more information about ratings models, how ratings are reviewed and subsequently modified, and whether or not model or procedural changes are applied to existing ratings retroactively.
- **Reducing Conflict of Interest:** NRSROs would be prevented from rating securities they helped create by providing paid assistance to issuers, investment bankers or both, and eliminating ratings staff from fee discussions, gifts, etc.
- **Introducing a different rating scale for complex securities** (e.g. residential mortgage backed securities): To recognize their unique risks. The proposal was not adopted by the SEC in December.
- **Reduce the use of NRSRO ratings in SEC regulations.** This would reduce the market power of rating agencies and encourage investors to do more of their own research. This proposal was not adopted by the SEC. It seems that there is a global consensus for more regulation of rating agencies, but a large part of the current problems is because of the impediments to competition created by previous regulation.

The principal areas of focus in the December 3, 2008 SEC announcement[15] were not on rating accuracy, rather they were on increasing transparency by Issuer-Paid rating agencies and on curbing Issuer-Paid rating agency conflicts of interest to prevent ratings grade inflation. More precisely, the SEC stated that their focus was:

"to address concerns raised about the policies and procedures for, transparency of, and potential conflicts of interest relating to ratings of residential mortgage-backed securities backed by subprime mortgage loans and collateralized debt obligations linked to subprime loans…. These proposals are intended to supplement previous rules implemented by the Commission under the Credit Rating Agency Reform Act in June 2007."

The proposals to be implemented are focused on transparency and conflict of interest. To what extent will they enhance competition, reducing the strength of the existing ratings oligopoly? And to what extent will they enhance ratings accuracy? In general this effort evidences good progress but much more needs to be done because inadequate attention has been paid to developing effective competition between Issuer-Paid rating agencies and Subscriber-Paid rating agencies. This would be a major step forward in terms of enhancing competition and ensuring the prevalence of greater rating accuracy in the market. But the transparency issue needs careful attention.

**Transparency and Quality Issues:** The SEC's attempt to promote ratings quality by allowing the public to measure NRSROs' ratings is a multifaceted problem. Disclosure of ratings actions fosters accountability. The change from the June 2008 Proposed Rule Amendments to the December Amended Rules limiting this disclosure requirement to the Issuer-Paid CRAs was appropriate. It is disconcerting that in the February 2009 Re-Proposed Rules put for comment it is questioned whether this rule should now apply to Subscriber-Paid CRAs. First, this is troubling because Rapid Ratings historical ratings actions are

15 *http://www.sec.gov/news/press/2008/nrsrofactsheet-120308.htm*; Open Meeting of the U.S. Securities and Exchange Commission, Washington, D.C. December 3, 2008, Final Rules and Proposed Rules relating to Nationally Recognized Statistical Rating Organizations and Credit Ratings.

actionable, predictive measures, not backward-looking scores. They are continuously being used in the back-testing of lending, investment and counterparty risk strategies, and can be used by regulators and auditors for various screening purposes. Second and perhaps worse, the SEC's position suggests a sentiment within the Commission that is less supportive of the Subscriber-Paid CRAs' business models and belies the incontrovertible evidence that Issuer-Paid ratings are flawed in myriad ways. There is little doubt that Subscriber-Paid competition introduces credibility back into the ratings business. The SEC should be supporting this business model and be careful not to, in the interests of being overly fair to the incumbent Issuer-Paid CRAs, quash the very solutions to the problems so plaguing this industry. If there is to be credibility to the NRSRO paradigm for rating agency reform and competition, the SEC must tread cautiously here.

The SEC asks to what degree Subscriber-Paid CRAs sell historical ratings data vs current ratings and, if free disclosure is enforced, what time embargo if any should be in place. These questions arise because of the inaccuracy of the incumbent players' ratings. In contrast, Rapid Ratings' ratings are predictive. Entities that filed for bankruptcies in 2008 and thus far in 2009 saw their Financial Health Ratings decline by over 30% over the 36 months prior to their filings. That was 11% three years ago, 10% two years ago and 13% in their final year. We make our historical data available to all paying customers. Even when our data are 6, 12, 18, 24 months and older they are still extremely valuable to us and to our current and prospective customers, and providing it for free would cannibalize our revenue base.

If the SEC wonders why there weren't sufficient comments on this last year, warranting its need to solicit further input in the Re-Proposed Rules, the Commission need to look no further than the fact that there aren't many competitors in the marketplace and there are only four constituents out there: (1) the Issuer-Paid CRAs, who aren't going to comment on this because doing so only further validates the Subscriber-Paid CRAs; (2) the Subscriber-Paid CRAs, and there aren't many of us; (3) the investment community, which always prefers free data; and (4) industry and academic groups, that understandably were focused on their own messages.

The Commission says in the new Rules Amendments that it "wants further input on this [the ratings actions history] issue before deciding on whether the rule should also apply to subscriber paid credit ratings." This statement only further demonstrates the markets' (users' and regulators' alike) low standards for the quality of ratings themselves. Sadly, most ratings to which the market is accustomed, those from the large, Issuer-Paid, CRAs, are of questionable value. The expectations and standards by which people are measuring ratings is a low bar. Subscriber-Paid CRAs shouldn't be penalized for having forward-looking, actionable ratings because the standards by which we are measured are neither. We must reach for higher standards.

**Conclusions**

There are two serious unresolved conflicts in the SEC proposals in February 9, 2009 release:[16]

- *there is support for "*an exemption from coverage of the rule, or any part of the rule, for small entities. [BUT] "The Commission believes that obtaining comparable information from NRSROS regardless of size is important.

- *"*In this release, the Commission is seeking comment on whether the requirement to publicly disclose ratings action histories should be applied to Subscriber-Paid credit ratings. As indicated in questions below, the Commission is soliciting detailed information about the potential impact of applying the rule to Subscriber-Paid credit ratings. The responses to those questions will inform the Commission's deliberations as to whether this rule ultimately should be expanded to cover Subscriber-Paid credit ratings."AND "At the same time, the Commission continues to believe that its original proposal to require

[16] Federal Register / Vol. 74, No. 25 / Monday, February 9, 2009 / Proposed Rules

public disclosure of ratings action histories for all current credit ratings could provide substantial benefits to users of credit ratings.

These unresolved conflicts send mixed signals to the very companies the SEC is hoping to attract to the NRSRO designation.

In 2002, Sarbanes Oxley called for an investigation of "any impediments to the accurate appraisal by credit rating agencies of the financial resources and risks of issuers of securities" and an investigation of "any barriers to entry into the business of acting as a credit rating agency, and any measures needed to remove such barriers." Therefore, both ratings accuracy and competition in the ratings industry were principal priorities. The importance of these objectives was confirmed as the current disaster unfolded. In October 2008 former Federal Reserve Chairman, Alan Greenspan, in testimony[17] before the House Oversight Committee, spoke about the collapse of the risk management system and inaccurate credit ratings:

- "The consequent surge in global demand for U.S. subprime securities by banks, hedge, and pension funds supported by unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem."
- "Uncritical acceptance of credit ratings by purchasers of these toxic assets has led to huge losses"….
- "When in August 2007 markets eventually trashed the credit agencies' rosy ratings, a blanket of uncertainty descended on the investment community."

More recently, on March 26, 2009, Treasury Secretary Geithner in his testimony before the House financial Services Committee spoke about "pervasive failures in consumer protection" and "large amounts of leverage and risk … created both within and outside the regulated part of the financial system". He summed up his concerns by saying:

"The crisis of the past 18 months has exposed critical gaps and weaknesses in our regulatory system. As risks built up, internal risk management systems, rating agencies and regulators simply did not understand or address critical behaviors until they had already resulted in catastrophic losses." [18]

We have needed better help from the Issuer-Paid rating agencies since 2002 and we have not been getting it. But it is not just behavior that is the problem. The problem is the competitive structure of the ratings industry and the out-dated tools used by the Issuer-Paid rating agencies. The current proposed SEC regulations focus on containing and reducing the conflict of interest among, and increasing transparency regarding, Issuer-Paid rating agencies is insufficient. The fundamental cause of that conflict of interest is the Issuer-Paid business model employed by S&P, Moody's and Fitch, not their behavior.

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[17] Testimony of Dr. Alan Greenspan, Committee of Government Oversight and Reform, October 23, 2008. He also said: "In recent decades, a vast risk management and pricing system has evolved, combining the best insights of mathematicians and finance experts supported by major advances in computer and communications technology. A Nobel Prize was awarded for the discovery of the pricing model that underpins much of the advance in derivates markets. This modern risk management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today, in my judgment." Our view is that this is an analytical stretch. First, many of the financial instruments were too new to have any historical data or a useful time-series. Second, what data existed often contained no default statistics, thus making default forecasting arbitrary – but perfect for models built on unrealistic assumptions. Third, regulatory constraints in many jurisdictions such as Canada, Australia and Spain prevented many of these structured finance products from ever being legitimized in the market, indicating that a regulatory screening offers great value as a back-up in case of rating agency failure. Fourth, the oligopolistic structure of the ratings industry made it inevitable that unrealistic rating services be rushed into market, It was implicitly assumed that there was a low penalty for mistakes.

[18] Text of U.S. Treasury Secretary Timothy Geithner's testimony on regulating financial risk before the House Financial Services Committee on Thursday. _Real Time Economics_ *Economic insight and analysis from The WSJ. March 26, 2009, 9:47 AM ET*

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Sarbanes-Oxley was not the panacea we had expected. Neither was the Credit Rating Agency Reform Act of 2006. Risk management and corporate governance performances have been an embarrassment. Issuer-Paid rating agencies have not improved the accuracy of their ratings despite years of prodding by regulators which helped to foster the current global crisis. The lessons that were supposed to be learned were not learned.

We have lost sight of the emphasis on ratings accuracy that was the promise of the Sarbanes-Oxley Act in 2002. This is not a trivial issue. What is needed is effective competition between Issuer-Paid and Subscriber-Paid rating agencies because of the current path dependent process which gives the market advantage to the incumbents, the error-prone Issuer-Paid rating agencies. The consequences of rating agency failures have multiplied by a factor of at least 10 since the collapse of Enron and WorldCom. We have not been asking all of the right questions and currently we do not have all of the right answers.

The SEC review released in July 2008 discovered "significant weaknesses in ratings practices."[19] But there are also weaknesses in the Issuer-Paid business model and weaknesses in their rating tools, all of which are related. Addressing conflict of interest is a step in the right direction. But the underlying premise of the adjustments is that Issuer-Paid rating agencies are still the right solution for credit markets. How can this be true when all the commercial and academic evidence reveals that rating signals from the dominant Issuer-Paid CRAs are lagging rather than leading signals in the market? How can the market develop an effective early warning system based on signals that lag Rapid Ratings, credit default swaps, share prices, Merton structural models and other tools?

While the SEC states in its February 2009 release that “the amendments are designed to improve the overall quality of ratings and enhance the Commission’s oversight,” we believe that the likely improvement in ratings quality is overstated because of the absence of effective competition for Subscriber-Paid rating agencies, while the oversight requirement will be easily met. Ratings accuracy is driven by permitting the best tools to compete on an equal basis with the status quo tools. If this is as far as we go, then another rating industry crisis is inevitable. What more can be done? There are several options:

- **Eliminate the NRSRO designation and all regulatory reference to NRSROs.** The consensus in Washington and overseas has moved against this option, regardless of its merits.
- **Remove all entry restrictions on rating agencies but regulate rating agency performance through transparency and reporting requirements.** Option not explored yet.
- **Moral suasion**: Encourage investors to get two options for each security: one Issuer-Paid rating and a Subscriber-Paid rating. Option not explored yet.
- **Regulation:** Require regulated financial institutions bank to get two options for each security: one Issuer-Paid rating and a Subscriber-Paid rating. Option not explored yet.
- **Petition Justice Department to break up the Issuer-Paid ratings oligopoly.** Option not explored yet.

The bottom line, as Chairman Waxman said, is that there is both a regulatory failure as well as a market failure. If we get the regulations wrong, we will lock in the consequences for decades, as has been the case in the past. So we need to ask the right questions and get the right answers. Better options are needed to help us move beyond the current attempt to refresh the CRA market. Regulatory refreshing is not a commensurate response to a “colossal failure”. There is too much at stake. The stakes are now measured in the trillions, unfortunately. We must reward success not failure. Effective competition, given the right environment, can bring success.

[19] Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies, By the Staff of the Office of Compliance Inspections and Examinations, Division of Trading and Markets and Office of Economic Analysis United States Securities And Exchange Commission, July 2008.

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