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Securities and Exchange Commission
Roundtable on Issues Related to the Oversight of Credit Rating Agencies
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I want to thank the Commission for inviting me to speak at this important roundtable. I have been writing about the deep flaws in our system of credit ratings for more than a decade, and I am grateful for this opportunity to share what I believe should be done to repair this seriously broken system. I am particularly grateful to be on a panel with Larry White and Alex Pollock, who I believe represent the majority views of economists and the private financial sector, respectively.

In my view, the central problem is not that the major rating agencies, particularly Moody's and S&P, have been hopelessly incompetent, inaccurate, and conflicted in their assessments of credit risk, particularly in the structured finance area. All of those diagnoses are correct, of course. The recent performance of the major agencies is an embarrassment for our capital markets. But these are symptoms, and too much focus on symptoms ignores the underlying disease.

Instead, the key issue continues to be the overdependence on credit ratings. I have called the regulatory overdependence on ratings "regulatory licenses." The idea of a "regulatory license" is just like any license – a driver's license, for example. It is a permit to participate in some regulated activity. Rules that depend on ratings are regulatory licenses, keys that unlock the financial markets. One example is Rule 2a-7, which requires that money market funds buy only highly rated bonds. Another is the Talf. There are many regulatory licenses embedded in our state and federal laws and rules, so many that it is hard even to count or find them.

The disease has spread, like cancer. Today, private contracts, investment guidelines, and loan documents also depend on credit ratings. Market participants rely on credit ratings, even when they know better.

The result of overdependence on ratings is that credit rating agencies no longer play the role John Moody's envisioned during the early twentieth century. They are not information intermediaries who survive and prosper based on the quality of their ratings. Instead, they have shifted from selling information to selling regulatory licenses. The dysfunctional result is that they are no longer constrained by reputation. They can issue low quality ratings, but market participants still will pay for them. Indeed, they must pay for them, because of regulations that depend on ratings. Without a rating, many issuers will be locked out of the markets.

The overdependence on ratings began after the 1929 crash, and was furthered by the Commission, which since the 1970s has adopted various regulations that depend on ratings. After the Commission created the NRSRO designation, overdependence on ratings spread – again the metaphor is a cancer – through our laws and regulations, and then through investment guidelines and private contracts. The result is that the credit rating process is not just dysfunctional, but diseased.

What can be done? There should be two priorities, which I label "oversight" and "accountability." First, with respect to "oversight," there should be an independent credit rating agency oversight board, with authority not only over the substance of the ratings process, conflicts, disclosure, and pay, but also the much-needed transition away from regulatory reliance on ratings. This board must be truly independent, with separate funding and strict prohibition of rating agency involvement, and it should be charged primarily with encouraging substitutes for ratings, including both market measures and judgment.

Market measures are a particularly attractive substitute for ratings. For example, bond credit spreads and credit default swap spreads have been much more timely and accurate indicators of credit risk than ratings. There are many sources: Markit, Kamakura, and Ed Altman are prominent examples. The key is that these substitutes are based on market data, and are not insulated by a web of regulation.

Second, credit rating agencies must be accountable. Moody's and S&P have used an aggressive First Amendment campaign to insulate themselves from liability for behavior that would have led to damages for any other gatekeeper. At minimum, credit rating agencies should be treated like other gatekeepers, including bankers, accountants, and lawyers. When any gatekeeper commits fraud, breaches an agreement, or is reckless or negligent in conducting its business, it should be held accountable.

Unfortunately, Moody's and S&P in particular have been unaccountable. They participated in creating monstrous structured finance transactions with absurdly high ratings based on models and assumptions they knew or should have known were unreasonable. They helped design, structure, and monitor the instruments at the center of this crisis. They must pay the price when they play such a role.

Last year, the Commission conducted an extensive investigation of the major agencies, and made some of the results of the investigation public. I encourage the Commission to release all of the information obtained from that investigation, either on its own or pursuant to Freedom of Information Act requests. I hope the Commission is in the process of bringing enforcement actions against the agencies based in part on the investigation. Investors are waiting to see these actions. I have been trying to help private litigants with claims against the major agencies, and have been advising journalists and Congressional staff members in this area. But the Commission has a mother lode of evidence from its investigation, and we need it. I trust we will see that evidence, and action based on that evidence, soon.

In any event, Congress already has begun debating the extent to which the rating agencies should be held accountable as gatekeepers, and courts have recognized the errors in previous cases. Rating agencies should not be exempt from securities fraud liability, and they should not enjoy any special privilege over other gatekeepers in Section 11 of the Securities Act of 1933, Regulation FD, or elsewhere.

The best solution would be for the government to eliminate all regulatory licenses and leave a competitive credit rating business subject to the same constraints as any other industry. Unfortunately, that does not appear to be possible or likely, at least in the short run. An interim second-best solution is for the major rating agencies to be subject to extensive oversight and accountability, with incentives for regulators and market participants to shift reliance away from ratings to market-based measures of credit risk. The recent financial crisis should, at minimum, produce these two reforms. If not, we will have suffered for no reason, the dysfunctionality related to ratings will resurface, and in a few years we will revisit another financial crisis dominated by highly dysfunctional ratings-driven transactions.

Thank you.