Will recent reform increase competition?

A New Law for the Bond Rating Industry

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The Securities and Exchange Commission continues to struggle with mutual fund and corporate governance issues and with disputes as to whether the Sarbanes-Oxley Act went too far or not far enough. There is another important domain of the SEC, however — its regulation of the bond rating industry — where recent legislation has significantly changed the landscape and offers the possibility of a more open regulatory regime and a more competitive industry. Unfortunately, progress is not a foregone conclusion.

With little fanfare last September, President Bush signed the Credit Rating Agency Reform Act of 2006. The act could well be as important for the development of U.S. capital markets as any likely reform of Sarbanes-Oxley. Consider the fact that, at the end of September 2006, there was over $8 trillion of corporate, state and local government, and asset-backed structured finance bonds outstanding — much of it rated by only a (literal) handful of bond rating companies.

A full understanding of the significance of the new law requires a brief recounting of the bond rating industry's history and the SEC's haphazard regulation of this industry over the past 31 years.

BACKGROUND

The bond rating industry is nearing the celebration of its 100th birthday. John Moody, in 1909, was the first to issue publicly available bond ratings. Poor's Publishing was second in the business in 1916; Standard Statistics followed in 1922. (The two companies merged in 1941, forming S&P, which was absorbed by McGraw-Hill in 1966.) In 1924, Fitch Publishing made its entrance into the industry.

The value of the ratings companies for investors was clear: the ratings provided extra voices of expertise and assessment for bond investors as to which companies were good credit risks and which ones were not so good. Consistent with this view, the standard business model at the time was for the ratings companies to sell their ratings (in thick ratings manuals) to investors.

The 1930s brought the first major change that affected the industry. At the beginning of that decade, bank regulators began to make judgments about the soundness of banks based on the quality of the corporate bonds in which the banks had invested — quality as demarcated by the ratings companies. By 1936, regulators had settled on a requirement (which is still in place today) that banks could not invest in bonds that were below "investment grade" (i.e., below a "BBB" rating, which was and still is S&P's designation of "investment grade"). These changes in bank regulation were followed in the 1930s and 1940s by changes in state regulatory requirements for insurance companies that linked those firms' capital requirements to the ratings of the bonds in the companies' investment portfolios.

These changes in financial institution regulation are understandable. Bank and insurance regulators were using the judgments of the rating industry to help the regulators make judgments about the safety of their regulated institutions. But these changes also had a major implication: there were now major categories of bond investors who were being forced to heed the ratings of the bond rating companies — and thus issuers of bonds were forced to obtain ratings if they wanted

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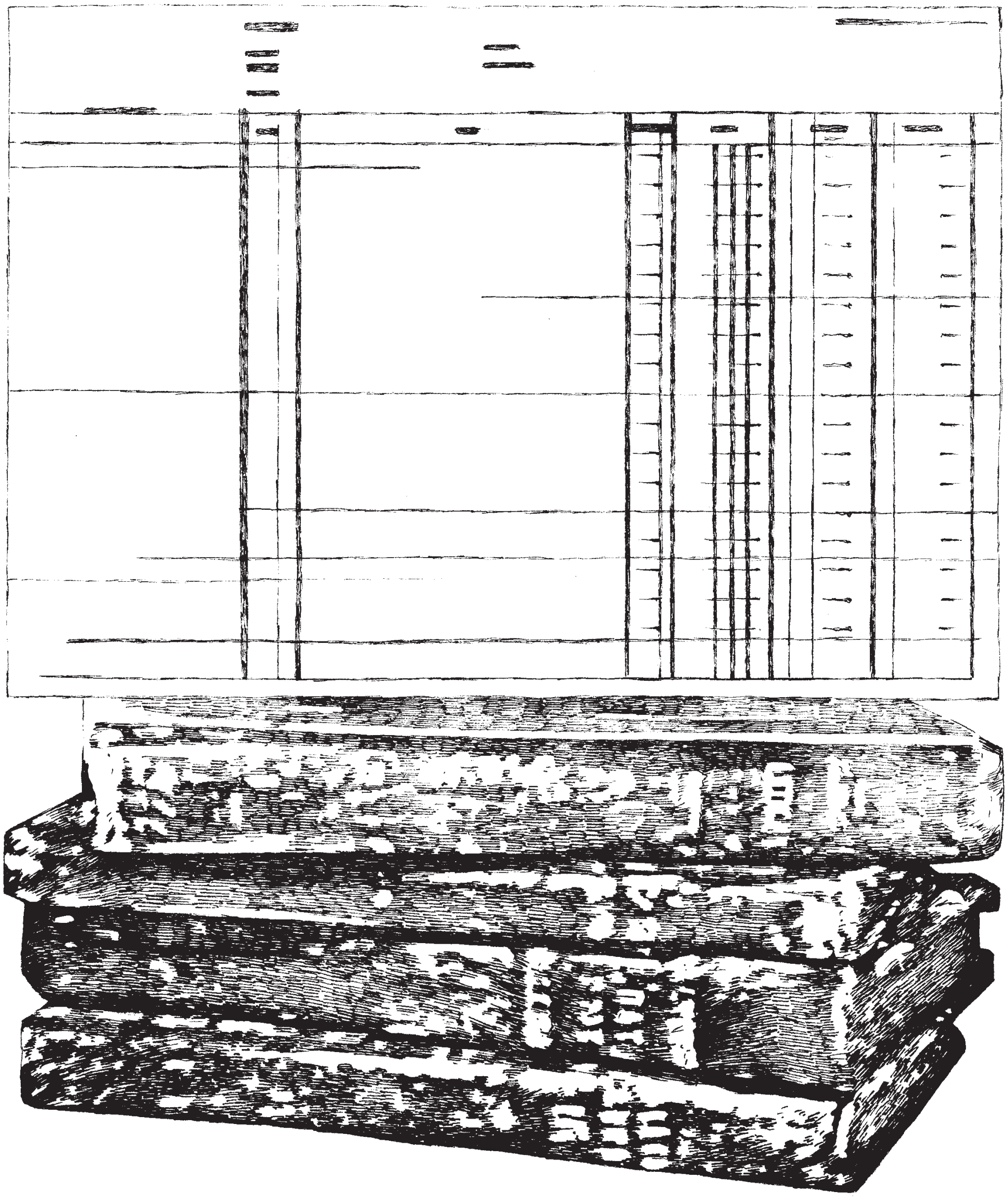

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their bonds to be eligible for bank and insurance company portfolio investments.

A less charitable interpretation of these changes would be that the bank and insurance company regulators were now delegating to the rating companies their regulatory decisions about the soundness of their regulated financial institutions.

Which bond rating companies' ratings should be heeded? That level of specificity remained vague. Instead, there were only references to "recognized rating manuals." Apparently, everyone involved understood that these referred to Moody's, S&P, and Fitch.

The next major change for the industry came in the early 1970s, when the industry changed its business model from the "investors pay" model to an "issuers pay" model. It appears that the low-cost photocopying revolution of the previous decade had instilled fears in the rating companies that too many investors would obtain their information through cheap photocopies (say, from friends or libraries) rather than by buying the rating companies' manuals themselves. Also, the Penn-Central bankruptcy of 1971 may have heightened the bond market's sensitivity to creditworthiness and increased issuers' willingness to pay for the certification of their credit quality that the bond rating companies provided. And the change may also have reflected the rating companies' belated realization that they had a captive market of issuers who could ill afford not to obtain ratings.

ENTER THE SEC

The other major change of the 1970s occurred in 1975. The SEC proposed that broker-dealers be subject to minimum capital requirements and that those requirements be linked to the quality of the bonds that the broker-dealers held in their portfolios. The SEC wanted to use bond ratings as the basis for those quality determinations—just as the bank and insurance company regulators had done decades earlier.

To its credit, the SEC noticed and took seriously the "whose ratings?" question. After all, if there was no clear designation as to whose ratings could be used for these regulatory purposes, then what would prevent the bogus XYZ Rating Co. from offering to provide AAA ratings to any company willing to pay XYZ's price and then the broker-dealers' being able to claim that XYZ's ratings were "reputable"?

In response, the SEC decided to create a wholly new regulatory category: "nationally recognized statistical rating organizations" (NRSROs). The three rating company incumbents—Moody's, S&P, and Fitch—were immediately "grandfathered" into the NRSRO category, and only the NRSROs' ratings would be valid for the determination of the broker-dealers' capital requirements.

Though NRSRO was hardly a household phrase, even within the narrow context of the Washington alphabet soup of agencies and programs, the NRSRO designation nevertheless spread as the means by which bond ratings could be used for regulatory purposes. The bank and insurance company regulators adopted it, as did other financial regulators, and the SEC came back to it when designating safety standards for money market mutual funds in the early 1990s.

The NRSRO designation, however, had become a significant regulatory barrier to entry into the bond rating business and a significant regulatory protection for the incumbents. To be sure, bond rating was never going to become an atomistically competitive industry. Economies of scale and the importance of reputation in ratings meant that the numbers of ratings firms would be relatively small. But the necessity of obtaining an NRSRO designation before a rating firm could expect to get the attention of issuers (or of regulated financial firms that would want to invest in rated bonds) surely made entry more difficult.

As a corollary to this protection for incumbents, it was impossible to know whether the rating firms were meeting a market test. Regulated financial institutions were forced to heed the NRSROs' ratings, regardless of what those institutions thought of the accuracy of the NRSROs' opinions concerning credit quality. Hence, issuers were forced to pay for the NRSROs' ratings if they wanted their bonds to be eligible to be held by those financial institutions.

Compounding the problem was the SEC's lack of transparency in the NRSRO designation process. The SEC never provided a statement of the qualifications for being designated as an NRSRO; there was no regulatory procedure for the designation. (In 1997, the agency proposed regulations that would define an NRSRO, but it never followed through with final regulations.) Instead, an applicant would request the designation and could then wait for an indefinite period that could stretch for years. If the SEC staff decided that the designation was warranted, the applicant would receive a "no action" letter from the staff; the letter promised that the Division of Market Regulation would not recommend enforcement action against any broker-dealer that used the applicant's ratings for determining its capital requirements. The SEC did not even issue a press release at these times (and additionally insisted in the no-action letter that the applicant not market itself as an NRSRO).

For the next 25 years, from 1975 through 2000, the SEC designated only four additional firms as NRSROs. But mergers among them and with Fitch reduced the net number of NRSRO firms back to the original three — Moody's, S&P, and Fitch — by 2000.

ENRON, SARBANES-OXLEY, AND AFTER

This opaque regulatory protection system for bond rating incumbents was little known, even by knowledgeable Washington insiders, and might have remained largely undiscovered had Enron not cratered in November 2001. However, in the wake of the Enron failure and other corporate scandals, the financial press uncovered the fact that Moody's and S&P had maintained "investment grade" ratings on Enron's debt until five days before Enron's bankruptcy filing. Congressional hearings followed, and the SEC's NRSRO designation "system" (and its opaqueness) received attention, as did the potential for conflicts of interest in the issuer-pay model, since a bond rating firm might threaten an issuer with a poor rating unless the latter paid the rater a sufficient fee or agreed to purchase other (e.g., consulting) services from the rater.

The Sarbanes-Oxley legislation of 2002 contained a specific provision that required the SEC to submit a report within 180 days that "studied the role and function of rating agencies in the operation of the securities market," including "any barriers to entry into the business of acting as a credit rating agency, and any measures needed to remove such barriers."

If the SEC had been inclined to do so, this report could have provided the agency with the opportunity to rethink the entire NRSRO system and its consequences for the structure and behavior of the bond rating industry. But, not too surprisingly, the SEC took a pass. After holding two days of public hearings in the fall of 2002, the agency submitted to Congress in January 2003 a bland report that raised a number of questions and issues but that offered no vision of how to proceed. In addition, as a way to buy time and reduce congressional heat, the SEC authorized a new NRSRO in early 2003 (Dominion Bond Rating Services, a Canadian firm) — but persisted in its opaque process of the "no action" letter.

A few months later, the SEC followed its bland report with an equally bland "concept release" in June 2003 that invited public comment on the same set of questions and issues. Though the SEC duly raised the question of whether the NRSRO designation was a barrier to entry, it seemed more intent on dealing with the opaqueness of the designation and with the conflict-of-interest issues — i.e., the agency was in a common (for Washington) interventionist and regulatory mode.

In early 2005, the SEC designated a fifth NRSRO (A.M. Best, a specialist rater of insurance companies) — still using its opaque procedures. And in April of 2005, it again (following its unsuccessful 1997 effort) issued a proposed regulation that would establish criteria for designating NRSROs.

THE SEC MINDSET

Although an excellent case could be made for the SEC to abandon the entire NRSRO framework and let the financial markets themselves decide which bond rating firms (if any) are worthy of attention (and let financial regulators withdraw the safety-determination delegation that they began in the 1930s), this has clearly not been the agency's intent. Instead, the SEC's regulatory mindset was thoroughly revealed by the agency's decision to go forward with an attempt at an NRSRO definition (rather than abandoning the framework), as well as the specifics of the definition that the agency proposed.

The SEC proposed to define an NRSRO as an entity that:

- issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments;
- is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and
- uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with these procedures.

With respect to the first criterion, the SEC explained that "publicly available" ratings would mean that the NRSRO's ratings "must be disseminated on a widespread basis at no cost." With respect to the second, the SEC explained that "generally accepted in the financial markets" meant that the NRSRO's ratings should be linked "to the views of the predominant users of securities ratings." With respect to the third, the SEC explained that "systematic procedures," would encompass:

- the experience and training of a firm's rating analysts;
- the average number of issues covered by analysts;
- the information sources reviewed and relied upon by the credit rating agency and how the integrity of information utilized in the ratings process is verified;
- the extent of contacts with the managements of issuers, including access to senior level management and other appropriate parties;
- the organizational structure of the credit rating agency;
- how the credit rating agency identifies and manages or proscribes conflicts of interest affecting its ratings business;
- how the credit rating agency monitors and enforces compliance with its procedures designed to prohibit the misuse of material, nonpublic information; and
- the financial resources of the credit rating agency.

To see the flaws in this approach, consider the value that an effective bond rating service offers to the financial markets: The bond ratings help lenders (bond investors) pierce the fog of asymmetric information so as better to determine the creditworthiness of potential borrowers (bond issuers), while also providing the opportunity for the more creditworthy borrowers to stand out from (and pay lower interest rates than) their less creditworthy peers. Since the event that most attracts a lender's attention is the default of a borrower (and then, given default, the size of the shortfall in repayment), default predictions are at the core of an effective rating service. This is, effectively, the "output" on which the financial markets focus.

If the SEC were efficiency-minded in its approach to defining and designating NRSROs, it would similarly have focused on outputs. Instead, however, its criteria focused on "inputs." The agency's explanation of the first criterion indicates that the SEC was intent on dictating the business model for the ratings business and that this model was the current issuer-pay model of the incumbent NRSROs (rather than alternative models, such as the "subscriber-pay" model of some smaller non-NRSRO rating firms). The agency's explanation for the second criterion would create a "Catch 22" problem because it is the incumbents (with their NRSRO designation) who can most readily catch the attention of issuers and investors. And the agency's explanation for its third criterion clearly indicates that it wanted to focus on inputs (e.g., the training of analysts) and to dictate the business model (e.g., contacts with management). Further, a focus on "the average number of issues covered by analysts" could perversely penalize a rating firm's greater efficiency in the ability of its analysts to cover a larger number of bond issues and issuers.

One additional feature of the proposed definition is worthy of note: the proposal was silent as to whether the proposed criteria would be applied to incumbents as well as to new applicants. Yet, without some system for periodic re-evaluations of incumbents, the SEC risked creating a system that would initially approve "qualified" applicants who could then become as slipshod as they pleased with no fears of subsequent revocation of the designation.

Mercifully, the SEC never issued a final set of criteria.

An excellent case could be made for the SEC to abandon the entire NRSRO framework and let the financial markets themselves decide.

NEW LEGISLATION

Without new scandals, congressional attention mostly shifted elsewhere. But, thanks to the continued interest in the issue by some House Republicans (especially Rep. Michael Fitzpatrick of Pennsylvania and Rep. Richard Baker of Louisiana), NRSRO reform legislation was introduced in the House in 2005 and was passed by the chamber in the summer of 2006. The Senate accepted most of the House's provisions but made some significant modifications and passed its version in September. The House acceded to the Senate's version, and President Bush signed the Credit Rating Agency Reform Act of 2006 on September 29.

The act begins inauspiciously, promising too much to too many: "An Act 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." However, the legislation then substitutes for the SEC's opaque NRSRO designation system a relatively transparent and open registration system: any credit rating firm that has been issuing ratings for at least three years can apply to the SEC to be registered as a NRSRO; the current NRSRO incumbents must also apply.

The new law tries to avoid specifying any particular business model by stating that the basis for the ratings can be "either a quantitative or qualitative model, or both" and that the company can receive "fees from either issuers, investors, or other market participants, or a combination thereof." The law adds that the SEC's rules that implement the act "shall be narrowly tailored," and "neither the Commission nor any State… may regulate the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings."

In its registration application, the applicant must provide:

- its short-, mid-, and long-term credit ratings performance measurement statistics;
- its procedures and methodologies;
- its policies and procedures to prevent the misuse of material, nonpublic information;
- its organizational structure;
- whether it has a code of ethics (and if not, why not);
- any conflicts of interest;
- what categories of debt it intends to rate;
- a list (on a confidential basis) of the 20 largest issuers and subscribers that use its services;
- certifications by at least 10 institutional investors (on a confidential basis) that they have used its ratings (i.e., considered the ratings in arriving at their investment decisions) for at least three years; and
- any other information that the SEC may decide (through a formal rulemaking procedure) is appropriate.

Within 90 days of receiving the application, the SEC must either grant registration or must institute proceedings to determine whether registration should be denied; the latter proceedings must be concluded within 120 days. After an applicant is granted registration, its application information (except for the confidential portions) becomes public.

An NRSRO must update its application information if it becomes "materially inaccurate," and the NRSRO must annually certify that its application information remains accurate or list any material changes. The SEC can revoke the registration of any NRSRO that fails to adhere to its application provisions.

In its more prescriptive sections, the new law requires NRSROs to establish written policies and procedures to prevent the misuse of material, nonpublic information; to establish written policies and procedures to address and manage any conflicts of interest; and to designate a compliance officer. Further, the law prohibits NRSROs from conditioning ratings (or their levels) on an issuer's purchasing other services from the NRSRO.

The SEC is instructed to issue rules that implement all of the provisions of the act within 270 days of enactment.

WHITHER NRSRO REGULATION?

A glass-is-half-full optimist could argue that the transparent and relatively open registration procedures, plus the act's clear intent to prevent the SEC from designating the business model for the bond rating industry, portends greater ease of entry into the rating business. More entry should mean greater competition and a greater likelihood of new ideas and new methods filtering into the industry. To be sure, abandonment of the entire NRSRO structure would have been preferable. Still, that was an unrealistic pipedream, and the new law's open and transparent registration regime is far preferable to the SEC's heretofore closed and opaque regulatory regime.

A glass-is-half-empty pessimist could respond that the new law enshrines the NRSRO category rather than killing it off; that the category's persistence means that financial regulators will continue to delegate safety judgments to the NRSROs. What is more, the act's requirement that the NRSROs provide their procedures and methodologies to the SEC may, if the information is made public, erode the NRSROs' intellectual property and undermine future investments in that direction. Finally, the act's prescriptive provisions, which reinforce the SEC's predilection for protecting incumbents and prescribing the business model for NRSROs in ways that favor incumbents, will provide the SEC with plenty of opportunities to stultify competition and create mischief.

This is a dispute that only the passage of time will clarify. A first glimpse should be provided around the end of June 2007, when the SEC's implementation regulations are promulgated. But a real assessment will have to await a few years of experience with the SEC's registration practices and enforcement under the act.

The outcome could well have a significant influence on the health and efficiency of U.S. debt markets for decades to come. R

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