Commentary: Credit Rating is a Case Study in Regulatory Reform

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When the storm broke, blame for the ongoing financial crisis initially rained down upon the credit rating agencies, or as they are known in the federal securities laws, Nationally Recognized Statistical Rating Organizations (NRSROs). There were good reasons for this outrage. Triple A ratings granted or confirmed only a few months or even weeks before the crisis struck were quickly downgraded on hundreds of debt securities as the default rates on subprime mortgages climbed. As a result, the value of AAA-rated mortgage-backed securities lost 70% of their value within one year. The greatest challenge of the economic recovery remains what to do with all the junk that used to be AAA.

The process for delivering credit ratings, it turns out, was rotten to its core. The agencies came to view ratings, paid for by issuers, as a source of profit, rather than a service intended to provide an impartial, unvarnished view to debt purchasers. Conflicts of interest abounded, rendering relationships among issuers and credit rating agencies cozy, rather than arms' length. Ratings consequentially evolved into little more than brand advertisements offering all of the disclosure value of a highly tuned Madison Avenue pitch.

Notwithstanding these "defects," it has become fashionable to blame the victim. Ratings became profit centers because they were used by investors to value debt securities. Since it turns out this reliance was misplaced, it can be argued that investors relied too heavily on ratings to determine the likelihood that an issuer would repay its debts.

The difficulty with this argument is that the SEC also relied on the ratings issued by NRSROs. A number of regulations promulgated under the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940 make reference to credit ratings. For example, participants in an offering of debt securities that have received an NRSRO's highest ratings are not prohibited from trading the offered securities during the period immediately following the offering, a rule intended to prevent market manipulation. The theory in Regulation M under the Securities Act is that the market for highly-rated debt securities is not likely to be manipulated by after market trading, in contrast to their less highly-rated cousins.

Last July, the SEC proposed to remove references to ratings in these rules and, in some cases, substitute other metrics. Among the many rules affected by this proposal, the SEC proposed to exempt debt securities issued by Well-Known Seasoned Issuers from the anti-manipulation rule of Regulation M, rather than rely on credit ratings. Broker-dealers would no longer be able to rely on credit ratings to make net capital calculations under the Exchange Act, and instead would be required to make independent assessments of the value of debt securities. Mutual funds would no longer be permitted to rely on credit ratings to satisfy diversification requirements under the Investment Company Act.

Each of these proposals was met with strong opposition. Comments to the proposal complained that the SEC was substituting a bright-line test with a subjective standard that would be difficult and costly to implement.

This was, of course, the objective of the proposed rule-making. Their entire purpose was to cause investors and industry participants to think about their investments in debt securities, rather than rely blindly on a credit rating. But careful and prudent consideration, that highly-touted fiduciary behavior, does not come cheap.

So, the SEC is back to the drawing board. A few days ago, over a year after the initial proposal, the SEC announced that it was delaying the proposed rule-making and seeking additional comments.

I doubt that as a people we are prepared to relinquish our reliance on credit ratings. In a companion concept release, the SEC would require more disclosure about the frailty of ratings. In a world where investors are unwilling to think for themselves about the securities in which they invest, more disclosure will not make them stop, look and listen. I submit this is not a problem that can be cured by disclosure.

For the solution, we must listen to the voices of our Depression era forbears.

The Congress of 1934 understood that the twin evils that had caused so much economic calamity were “pools” and “puts.” In our time, credit ratings were corrupted by the variety of pools that issue asset-backed securities.

The run of the mill corporate issuer is limited in its ability to influence credit ratings. Its ability to pay is a function of profit-making capacity, which in turn, depends on business operations. Downgrades in the corporate world are not surprising because an issuer’s common stock generally plummets immediately when earnings disappoint, long before its debt securities are downgraded.

In contrast, the issuer of asset-backed securities has flexibility to structure its pool of assets in ways that will garner a higher credit rating. Since an issuer's ability to sell asset-backed securities is directly related to their credit rating, the issuer has an enormous incentive to negotiate with the credit rating agencies to determine what it will take to get the desired rating before the securities are issued. To compound the problem, because these pools do not issue tradable common stock, there is very little to warn investors that a potential downgrade is imminent.

There is no need to throw the baby out with the bath by prohibiting reliance on credit ratings for the debt securities issued by operating businesses. All we need do is end this reliance for asset-backed securities and other structured finance products where overwhelming incentives exist to corrupt the credit rating process.

It is pleasant to imagine a world where investors take the time to consider all of their investments with care, read all available disclosure, and make an independent determination as to their value. But, that is not the world we live in. In the real world, investors look for short cuts as a proxy for prudence. It is therefore necessary to protect the integrity of these short cuts from corruption.