Credit Ratings Offer No Guarantees on this Seal of Approval

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The Good Housekeeping Seal of Approval promises consumers a refund or replacement for defective products within two years of purchase. The "NRSRO Seal of Approval," bestowed for generations upon debt securities, unfortunately, does not.

NRSRO stands for "nationally recognized statistical ratings organizations." For many years, there were two—S&P and Moody's. Today, there are a few more players.

Debt traders have long used the "seal of approval" of an NRSRO credit rating as a substitute for the hard work involved in trying to determine the value of a security. For securities with investment grade ratings, market participants found no need to "look under the hood." If it was called a Porsche, it must have a Porsche engine. Debt traders used credit ratings as a basis for buying and as a basis of standardizing the price of a security...anything in the highest four categories of debt traded at the same price, regardless of the issuer. In other words, all triple-A debt was priced the same, regardless of issuer. The price of a particular debt security might change only if the market expected the security's rating to change.

Rating agencies have historically been unregulated. Rating agencies have resisted regulation based on freedom of the press, calling themselves "newspapers" that reported the "news." Yet the expectations created over credit ratings were so strong that they influenced the market, even though rating agencies weren't regulated, their procedures weren't disclosed or consistently followed (or perhaps didn't exist), their internal rating processes weren't documented, and conflicts of interests were abundant. Issuers would push to get their debt into certain categories, with the help of credit analyst or legal juggling and, in some cases, by paying the amount necessary to get the desired rating.

Without realizing the ramifications of its actions, the SEC gave sanctity to the NRSRO seal of approval by granting special treatment to certain ratings. Access to certain SEC rules and forms was based on the privileged status of investment grade or other "highest ratings" categories. For example, issuers with debt securities rated investment grade were permitted to use a short-form registration statements, and the Net Capital Rule dictated haircuts based on being in one of the highest rating categories.

Now, some of our Porsches have stalled, and we look under the hood to find, in some cases, not the 480-hp turbo engine that we expected, but a mouse on a wheel and a slew of inappropriately rated subprime mortgages. The astronomical rates of defaults in subprime mortgages in recent years and the widespread downgrades by the rating agencies have finally enlightened investors and regulators as to the lack of reliability of the credit ratings issued by NRSROs.

Notwithstanding the rating agencies' resistance, in September 2007 Congress authorized the SEC to register and regulate NRSROs. The SEC has finally realized that credit ratings need to be scrutinized, and not relied upon as indicative of the value of a security. After examining the credit rating process, the SEC has proposed a series of reforms to the credit rating process in an effort to curb practices that contributed to the recent credit market crisis. While these reforms are mostly of interest to debt traders, equity traders should find this of some interest as well, because the trickle-down effect of mislabeled debt affects everyone in times of market turmoil.

The SEC's reforms cover three main areas. The first set of proposed rules would impose additional requirements for NRSROs directed at reducing conflicts of interest in the credit rating process, fostering competition among NRSROs, and increasing transparency and accountability through enhanced disclosures. For example, to help prevent conflicts of interest, NRSROs would be prohibited from accepting gifts or entertainment over $25, and rating analysts would be prohibited from negotiating the fee and structuring the transactions they rate. The rules also would require a NRSRO to make publicly available all information provided to and used by the NRSRO in determining a rating, so that other NRSROs could rate the instrument as well.

The second group of rules is designed to improve investor understanding of the risk characteristics of structured finance products. The proposed rules would require differentiation in the ratings for structured products and bonds, whether through use of different symbols or otherwise disclosing the differences in a report.

Third, the SEC proposes to strip references to ratings from many of its rules and forms in order to eliminate over-dependence on credit ratings and encourage investors to make independent judgments about the creditworthiness of a security. While references to NRSROs in the SEC rules were originally intended to provide a clear reference point to both regulators and market participants, a key disadvantage of these reference points has now appeared. The use of NRSROs as reference points has been viewed as an endorsement of the quality of the ratings and resulted in undue reliance by market participants.

A lesson to be learned from this is that whenever the market becomes too reliant on a symbol of merit, clever deal makers and their enterprising lawyers will find a way to exploit that symbol…to substitute a mouse on a wheel for the turbocharged engine. Over-reliance on any symbol of merit invites the unscrupulous to exploit the lazy and the gullible.

The question is whether the new rules will work as the SEC intends. Will debt market participants view the new rules as restoring the quality and creditability of the ratings, so that they can once again rely on the "new & regulated" credit ratings as a guarantee of quality? Or will the new disclosures required of rating agencies cause debt traders to view the new "Seals of Approval" with the skepticism they deserve?

The SEC rule proposals are open to public comment. Comments can be e-mailed to the SEC or posted electronically on their website (with reference to Releases 34-57967, IC-28327, 33-8940 and 34-58070).

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