Financial and Economic Crisis – Law Firms

Reforming The Major Credit Rating Agencies: What Hath The SEC Wrought?

Jeff Kaiser

NAVIGANT CONSULTING, INC.

The three major Credit Rating Agencies ("CRAs") – Standard and Poor's, Moody's Investors Service and Fitch Ratings – have been subject to scalding criticism for issuing misleading ratings favoring structured investment products like mortgage-backed securities that were issued by firms which paid the credit agencies fees for rating their products. They are accused of fanning the flames of the credit crisis by promoting investor confidence in structured products that were subsequently downgraded or went into default, and which then created enormous problems for the financial institutions holding such structured assets in their portfolios. As these assets lost much of their value, many affected institutions suddenly were without sufficient capital to conduct regular business operations. Some (like Lehman Brothers) filed for bankruptcy, some (like Bear Stearns and Merrill Lynch) sold themselves to banks to survive and many banks, in turn, sought capital infusions from the government while greatly restricting their lending practices, thus limiting the amount of credit available to individuals and businesses around the world. The Securities and Exchange Commission ("SEC") recently proposed new rules to foster increased transparency, accountability and competition in the credit rating industry. What many may not realize, however, is that the major CRAs owe their pivotal importance in the marketplace to the SEC and that they are, in many respects, creatures of the regulatory scheme promulgated by that agency.

The rules that the SEC is now scrambling to introduce are, in effect, an acknowledgement that the agency's favored treatment of the major CRAs caused some of the market conditions that led to the current credit crisis and that action must be taken to protect the integrity of ratings information in the marketplace. The evolving SEC response to this issue will help determine the quality of the information that investors will have in assessing the creditworthiness of bonds issued by companies, governments and those on Wall Street who, with the help of positive credit ratings, successfully securitized subprime residential mortgages. Such reforms, in turn, should dramatically reduce the opportunity for fraud on investors by casting a bright light on the heretofore secretive bond rating process and limiting the opportunities for self-dealing and collusion between the major CRAs and bond issuers.

It behooves anyone who relies upon the credit risk assessments of CRAs, including the executives and directors of public companies who have input into investment decisions involving company assets and employee benefit plans, or who may have occasion to direct a bond issuance for the purpose of raising capital, to be aware of both the CRAs' troubled history and the SEC's recent reforms – reforms that are intended to ensure that credit ratings promulgated by the CRAs are independent and accurate, rather than "made to order."

***Jeff Kaiser** has more than 18 years of experience in both civil and criminal fraud investigation and litigation focusing on healthcare and other financial frauds. Mr. Kaiser has extensive experience in government investigations directed at major corporations, including large financial institutions that are facing official inquiries under the federal-fraud and abuse laws. Prior to joining Navigant Consulting, Mr. Kaiser was a federal prosecutor for more than nine years specializing in healthcare investigations as an Assistant United States Attorney in both the Southern and Eastern Districts of New York. Mr. Kaiser was Deputy Chief of Public Integrity and Chief of Health Care Fraud Prosecutions in the Eastern District of New York.*

A (Very) Brief History Of The Credit Rating Industry

The credit rating industry can trace its history back to 1909, when John Moody published the first publicly available bond ratings, mainly concerning railroad bonds.[1] In 1936, bank regulators issued a requirement prohibiting banks from investing in speculative securities that were below "investment grade," as determined by recognized rating manuals. As banks began relying on credit agency determinations in making investment decisions, so did many other market participants. And so began what some have termed the delegation or "outsourcing" by regulators of judgments concerning the creditworthiness of bonds, with the result that judgments rendered by CRAs regarding which bonds were "investment grade" and could be properly included in the portfolios of financial institutions, arguably attained the force of law.

The SEC vastly enhanced the standing of the CRAs in 1975 when, in connection with setting minimum capital requirements for securities firms, it created an entirely new category known as the "nationally recognized statistical rating organization" ("NRSRO"). The three major CRAs (Moody's, Standard & Poor's and Fitch) were immediately granted NRSRO status, and the SEC required that NRSRO ratings be used in determining the capital requirements of all broker-dealers. The SEC effectively insulated the three major CRAs from competition by acting as a barrier to NRSRO eligibility, while simultaneously mandating reliance by securities firms on the ratings promulgated by those same CRAs. In addition, the CRAs changed their business model from "investor pays" to "issuer pays," requiring those entities issuing bonds to pay the CRAs to rate their products. This change created an obvious conflict of interest, whereby entities that were not happy with an agency's bond rating could shop their bonds to another agency.

The Need for Regulation

The risks inherent in relying exclusively on a small group of government-favored CRAs became evident with the collapse of Enron and Worldcom. The CRAs came under fire for being slow to recognize the weakened financial condition of both those companies, and for maintaining "investment grade" ratings on Enron's bonds until five days before the company declared bankruptcy.[2] These events spurred new regulation in the form of the Credit Rating Agency Reform Act of 2006 ("Reform Act"), the main purpose of which was to promote accountability, transparency and competition in the insular credit rating industry.[3]

The Reform Act, however, was insufficient to prevent the credit crisis debacle that was built, in large part, on the favored credit ratings that the major CRAs bestowed on mortgage-backed securities that subsequently went belly-up and led to the demise of venerable financial institutions like Bear Stearns and Lehman Brothers.

The New Rules

Following promulgation of the initial rules under the Reform Act, the SEC conducted in-depth examinations of the CRAs that revealed significant problems relating to: (1) the CRAs' practices relating to conflicts of interest, (2) the absence of written procedures for rating MBS and CDOs, (3) the failure to disclose or document the rating process and (4) the failure to have effective procedures for monitoring ratings after they are initially set.[4] Based in part on these findings, the SEC in June 2008 proposed rule amendments to "address the role of rating agencies in the troubled structured finance market and to advance the Rating Agency Act's goals of enhancing transparency, competition and accountability."[5]

Final rule amendments adopted by the SEC,which can be found at http://sec.gov/rules/final/2009/34-59342.pdf, became effective on April 10, 2009. Subsequently, on September 17, 2009, the SEC also unanimously voted to "adopt or propose measures intended to improve the quality of credit ratings by requiring greater disclosure, fostering competition, helping to address conflicts of interest, shedding light on rating shopping, and promoting accountability.[6]

All of the rule amendments and proposed rule amendments by the SEC are intended to promote greater visibility into the credit rating process so that the users of credit ratings, as well as the SEC, are better able to assess the quality of that process and determine whether those ratings, especially for structured finance products, have been compromised by conflicts of interest. The new disclosure and recordkeeping requirements are expected to enhance competition among NRSROs by allowing newly minted NRSROs access to information that will enable them to develop credit ratings and test their accuracy in the marketplace. In addition, certain disclosure requirements contained in proposed new rules could reveal whether some firms have engaged in "ratings shopping" by requiring disclosure of whether "preliminary ratings" were obtained from other rating agencies.

The Impact Of The New Rules From A Fraud Perspective

The new rules should make it far more difficult for issuers and CRAs to engage in "sweetheart" deals, whereby mortgage-backed securities and other structured finance products are given glowing ratings in return for an issuer shopping its products with a particular CRA. Similarly, it should complicate the efforts of those who would seek to mislead investors concerning the true investment risk represented by such products. The information required under the new rules will enhance the SEC's ability to investigate whether the CRAs are following their own rating methodologies or are being unduly influenced by factors unrelated to the analytical process; whether there have been an excessive number of credit rating changes or material changes in a credit rating that could suggest inappropriate influences; and whether there are conflicts of interests that may be undermining the integrity of the credit rating process. Mandating greater visibility into the business arrangements between CRAs and issuers necessarily reduces the likelihood of fraud, which is not a human endeavor that thrives in sunlight. Furthermore, one cannot "buy" or "sell" a credit rating and hope to get away with it if the information needed to prove the manipulation is available to the SEC and even to one's competitors in the marketplace.

In sum, the new regulatory regime should be a significant step forward in protecting individual and institutional investors, as well as banks and other corporations around the world, that rely on credit ratings in making risk assessments and selecting "investment grade" securities for purchase. It is fair to ask, however, whether recent history exposing the potential for conflicts involving issuers and CRAs and which many insist resulted in "rosy" credit risk assessments for structured finance products, imposes a fiduciary obligation on those relying on credit ratings, including the officers and directors of public companies, not to accept such ratings at face value, but rather to perform greater due diligence in order to ensure that the credit risks those ratings are supposed to represent actually comport with reality.

---

[1] *Statement of Lawrence J. White, Professor of Economics at the NYU Stern School of Business, submitted to the "Roundtable to Examine Oversight of Credit Rating Agencies," U.S. Securities and Exchange Commission, April 15, 2009, at pp. 3-5*

[2] *Statement of Lawrence J. White,* supra, *at p. 5.*

[3] See *SEC Briefing Paper: Roundtable to Examine Oversight of Credit Rating Agencies, at p. 6* (http://sec.gov/spotlight/cra-oversight-roundtable/briefing-paper.htm).

[4] See *"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, Office of Economic Analysis, http://www.sec.gov/news/studies/2008/craexamination070808.pdf.*

[5] *Commissioner Kathleen L. Casey, "In Search of Transparency, Accountability, and Competition: The Regulation of Credit Rating Agencies," February 6, 2009, at p. 3. (http://sec.gov/news/speech/2009/spch020609klc.htm).*

[6] *SEC Press Release, "SEC Votes on Measures to Further Strengthen Oversight of Credit Rating Agencies," dated September 17, 2009.*

Please email the author at jeff.kaiser@navigantconsulting.com with questions about this article.