Rating the Regulators

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On October 22, current and former CEOs of the ratings agencies were called to testify in front of the House Committee on Oversight and Government Reform. Their incompetence was laid bare, and it is hard to imagine they left the hearing with more than a scintilla of self-respect intact.

The ratings agencies' failings were exposed: conflicts of interest, sloppy procedures, broken risk management models, and an incredible level of incompetence among their staffs.

None of this is news. Those familiar with the history of the ratings agencies might have found these hearings highly amusing, but they would not have left feeling they'd learned any new information.

We are not offering the agencies any excuses or forgiveness. But these hearings make it painfully obvious that another major player shares responsibility for their failings — the regulators themselves.

Regulators have known for a long time that the agencies were broken, but they did nothing to address the problem.

The agencies have been around for over 100 years, assessing the creditworthiness of corporations and their ability to service debt. A key step in elevating the stature of the agencies was taken in 1975, when the SEC began using the agencies' ratings in its rules. The SEC adopted the term Nationally Recognized Statistical Rating Organization (NRSRO) for determining capital requirements for broker-dealers.

The NRSRO concept was gradually expanded by both the SEC and Congress to other regulatory purposes, including banking capital requirements and securities issuance.

Periodically, usually in conjunction with major corporate failures, the SEC has reviewed the role of the agencies. For example, in 1988, an SEC report that investigated the failure of Washington Public Power Supply System ("WPPSS") bonds said that "limitations in the rating process may have contributed to the continued high ratings of the WPPSS bonds."

In 1994, the SEC solicited public comment on the appropriateness of the NRSRO designation. It received 25 responses which "generally supported the continued use of the NRSRO concept." The Securities Industry Association (SIA), one of the 25 commentators, rejected the use of statistical techniques and advocated the continued use of the NRSRO designation because it "would give broker-dealers an objective, simple standard for determining the capital value of a debt instrument under the rule. In contrast, a modeling approach involves a possibly intricate statistical configuration." The recent wave of failures among financial firms has proven that the NRSRO designation has done virtually nothing to provide an "objective, simple standard" — at least not a reliable one.

In 1997, the SEC considered proposals that would have tightened the standards and approval processes that applied to the NRSRO designation. Among other things, it would have incorporated a process whereby the SEC could withdraw the NRSRO designation. The Commission did not act on these proposals until 2006.

In 2002, the SEC again reviewed the role of the credit ratings agencies, specifically the issue of whether the NRSRO designation was preventing competition and inhibiting new entrants from entering the ratings business. It concluded that it would "conduct a public examination of the potential need for greater regulation in this area."

Since 1975, there has been only one piece of legislation affecting the ratings industry: the Credit Ratings Agency Reform Act (Rating Agency Act), which passed in 2006. It clarified the guidelines for attaining the NRSRO designation, thereby enabling greater competition in the ratings industry. At the same time, however, the SEC was specifically prohibited from regulating the NRSRO's ratings methodologies.

In September of 2007, the SEC again examined the ratings industry, reviewing the Rating Agency Act's implementation. This was in response to the subprime crisis which, by that time, was rapidly unfolding. The SEC noted that it was "examining whether these NRSROs were unduly influenced by issuers and underwriters of RMBS [residential mortgage backed securities] to diverge from their stated methodologies and procedures for determining credit ratings in order to publish a higher rating."

The SEC has always been aware of a fundamental conflict of interest embedded in the ratings industry: Ratings agencies are paid the by the issuers of the securities they are rating. The SEC has required the NRSROs to disclose these conflicts of interest, but has done nothing to mitigate their adverse consequences.

In the 33 years since the creation of the NRSRO designation, however, regulators have failed to confront and address the structural problems that permeate the ratings industry. Conflicts of interest have become more intense, and the “issuer pays” business model has cost investors incalculable amounts of money through the imperfect analysis offered by the ratings industry.

There are now 10 NRSROs. Two of them, Moody’s and Standard and Poor’s, control approximately 90% of the industry. For this duopoly, ratings have been an incredibly lucrative business. Moody’s, for example, has had one of the top profit margins of companies in the S&P 500 over the last several years.

Fixing the ratings industry will not be easy, although a number of thoughtful comments were made during the Congressional hearings. The most direct approach is to eliminate the NRSRO designation altogether and completely open the competitive landscape in the ratings industry. The drawback to this approach is large degree of uncertainty it would create in the marketplace. Of course, in today’s world, where ratings provide questionable predictive value, this uncertainty may be the lesser of two evils. The NRSRO designation, if properly administered, should be a “seal of approval” like the USDA’s meat designations — that analogy was used in the hearings — and should ensure a minimal level of accreditation.

A more palatable approach is to ban the model where issuers pay to have specific issues rated. Instead, issuers would pay to have all issues, or all of a certain class of issues, rated. This should eliminate the process of “ratings shopping,” where issuers take issues to various agencies and pay for ratings only if they are assured of desired results.

Proponents of this approach use the USDA analogy. The current practice in the ratings industry is like having meat packers pay the USDA to rate individual pieces of steak. In such a case, the meat packers would have the USDA inspect and rate only the cuts of meat that could get the seal of approval. Instead, the USDA inspects and rates the meat packers and all the pieces of meat they produce, which creates an incentive for the packers to employ the best standards throughout their operations.

This approach represents a big threat to Moody’s and S&P. They would be forced to rate all issues in a category, and they would also be open to greater competition from other agencies, like Fitch and Egan Jones. Moody’s and S&P each spend about $1 million a year in lobbying fees, so we can expect them to fight any such initiative vigorously.

Don't expect the ratings industry to reform on its own. We can't afford to let regulators wait another 33 years to address the industry's long-standing structural problems. Let's hope the current crisis finally forces the improvements this industry desperately needs.

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