TESTIMONY

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"Nationally Recognized Statistical Ratings Organizations and Investor Protection"

The massive publicity surrounding the collapse of Enron Corporation has given regulators and lawmakers a valuable opportunity to examine, and, hopefully, to correct, some of the pathologies that plague the U.S. financial system. The collapse of Enron should prompt a frank assessment at all of the institutions – corporate boards of directors, corporate board audit committees, accounting firms, stock exchanges, market analysts and credit rating agencies – that investors rely upon for protection against fraud and abusive practices. My testimony today will focus on the role of credit rating agencies, which, over time, have assumed a unique role in society as "Nationally Recognized Statistical Ratings Organizations" (NRSROs).

Most Americans think that the large, well-known credit rating organizations like Moodys and Standard and Poors are purely private enterprises: they are unaware of the fact that these organizations are, in fact, more properly viewed as quasi-governmental entities. The credit rating agencies are quasi-governmental entities because they have been given the power to grant regulatory licenses to various types of businesses. For example, the United States Treasury Department, through the Comptroller of the Currency, adopted credit ratings as the appropriate measure of the quality of national banks' bond portfolios, requiring that banks write-down the value of bonds in their portfolio that did not have sufficiently high ratings, but allowing bonds with sufficiently high ratings to be carried on the banks' books at cost.[1] Similarly, national banks long have been prohibited by the Comptroller of the Currency from purchasing securities that are not of investment grade, as determined by the rating agencies.[2]

These regulations not only have increased the demand for the services of the credit rating agencies dramatically and artificially, they also have changed the nature of the services provided by credit rating agencies. Prior to the adoption of these rules, the rating agencies rated securities only after they had been issued. These new regulations created demand for the rating agencies to rate securities *before* they were issued, and caused a significant increase in the business of credit rating agencies.[3] This work by credit rating agencies is not only directly attributable to government regulation, it places the rating agencies in the position of performing a delegated governmental function – bank monitoring and supervision – on behalf of the Comptroller of the Currency.

In addition to the banking requirements discussed above, beginning in 1973, a series of governmental regulations have further embedded the use of credit ratings into the regulatory process. The first of these regulations was promulgated by the Securities and Exchange Commission in the form of SEC Rule 15c3-1 in which the U.S. Securities and Exchange Commission stated that "to a limited extent" it had "recognized the usefulness of nationally recognized statistical rating organizations as a basis for establishing a dividing line for securities with a greater or lesser degree of market volatility."[4] Rule 15c3-1 was the first time that the phrase "Nationally Recognized Statistical Rating Organization" (NRSRO) had been used in any regulation.

Rule 15c3-1 states that the percentage of the market value of securities that can be counted towards a broker-dealer firm's net capital requirement will be determined by the credit rating assigned to the securities by the NRSROs.[5] The higher the credit rating assigned by the NRSROs, the greater the percentage of the securities value that can count towards meeting a firm's net capital requirements. Thus, credit ratings can have a significant impact on the profitability (return on capital), as well as on the viability of broker-dealer firms.

The term NRSRO is not defined anywhere, and later regulations have not attempted formally to define the term, stating only that the term should be used "as the term was used" in Rule 15c3-1. As Professor Frank Partnoy has observed, "as the initial source of the term 'NRSRO,' Rule 15c3-1 effectively froze the then-approved credit rating agencies (e.g. S&P, Moody's Duff & Phelps, and Fitch) as acceptable for rating purposes, and severely limited the possibilities for new entrants. These barriers have remained insurmountable."

So, in addition to increasing the demand for the services provided by rating agencies, and changing the nature[6] of the work provided by rating agencies, regulation also has shielded rating agencies from competition, creating the comfortable, oligopolistic environment in which the rating agencies currently operate. The most recent major example of the invidious manner in which the credit rating agencies have embedded themselves in the regulatory process concerns Regulation FD.

In the latter part of 2000, the SEC adopted Regulation FD, which bars U.S. companies from excluding the general investing public from the benefits of the information disclosed to analysts, money managers or large shareholders. Regulation FD requires companies to make broad, non-selective public dissemination of material, non-public information.

The credit rating agencies succeeded in procuring for themselves a broad exception to the provisions of Regulation FD, in the form of SEC Rule 100(b)(2). This rule exempts rating agencies from the provisions of Regulation FD as long as the information disclosed is for the purpose of developing a credit rating and the entity's ratings are publicly available.[7] This request for an exemption seems strange, incidentally, in light of the fact that the SEC already had acknowledged clearly that issuers and their officials may properly share material, non-public information with outsiders when those outsiders agree to keep the information confidential.[8]

Other regulations that increase the demand for the work of credit rating agencies include rules that: (a) determine which securities may be purchased by money market mutual funds on the basis of the rating assigned to the securities by the NRSROs (only those securities that have one of the two highest ratings for short-term debt may be included in the money market fund's portfolio); (b) permit issuers whose securities have been given investment grade ratings from the NRSROs to utilize the streamlined S-3 registration forms when issuing securities;[9] and (c) exempt persons engaged in the distribution of nonconvertible debt securities from certain anti-manipulation rules if the securities being distributed have been given an investment-grade rating by at least one NRSRO (these anti-manipulation rules generally prohibit those involved in distributing securities from buying and selling the securities during the distribution.[10]

It is not just government regulation that gives the rating agencies such power. They also derive power from extensive use in debt covenants and other financial instruments to create conditions of default: the downgrading of a rating by an NRSRO can throw a company into default under the terms of many debt covenants. But the possibility that artificial demand for the services of rating agencies has been created by regulation cannot be ignored.

As Professor Partnoy has observed, the "web of regulation" creating regulatory demand for the work of NRSROs "is so thick that a thorough review would occupy hundreds, perhaps thousands of pages."[11] One of the sad consequences of this onslaught of regulation is that they have had the cumulative effect of removing both market forces and market incentives from the work performed by NRSROs. The NRSROs incentives in today's regulatory environment are to reduce costs as much as possible, knowing that regulation guarantees a fixed, stable demand for their services. The massive fees paid to NRSROs can be viewed as a form of tax, ultimately paid by investors, but paid in the first instance by banks, mutual funds, insurance companies, securities firms, and issuers as a cost of doing business.

The regulatory subsidies given to credit rating agencies would not be particularly troubling were it not for the fact that credit ratings do not provide useful or timely information about the credit-worthiness of companies in today's markets. Academic studies tend to show that the information in credit ratings is of marginal value at best because the information contained in ratings had already been incorporated into share prices. One well-known study showed that the ratings provided by rating agencies lagged the information contained in securities prices by a full year.[12]

An unfortunate side-effect of the poor quality of credit ratings is that credit ratings have become so entrenched in both regulatory policy and market practices that they threaten to distort the process by which capital is allocated among corporations. In theory, businesses that are well-managed and well-capitalized should be rewarded by being able to obtain capital at favorable rates. Likewise, firms that are poorly managed or thinly capitalized should be disciplined by the market in the form of higher capital costs (or, at the extreme by being cut off from capital).

However, in today's regulatory environment, ratings downgrades are at least partially self-fulfilling prophecies. Securities issued by firms that have been down-graded are worth less than identical securities that have not been downgraded due solely to regulatory factors. Similarly, firms with high ratings may enjoy lower capital costs due to regulations that make it attractive for institutional investors to keep such higher-rated securities in their portfolios, rather than because they are actually better managed or more strongly capitalized than lower-rated rivals.

It is easy to identify the problems of rating agencies. It is more difficult to craft a workable solution. One of the reasons that the problem is so intractable is that ratings are so convenient to use. They may not provide much information, but they provide it in a convenient format. Clearly, getting rid of the regulatory dependence on rating agencies would make the job of the regulators much more difficult. The regulators would have to craft substitute rules if they could no longer avail themselves of the NRSROs. For example, if money market mutual funds were not allowed to use rating agencies to inform them about what short-term debt instruments they could put in their portfolios, what sort of guide would they use instead?

Several commentators, most notably, Professor Partnoy, have proposed using credit spreads as a substitute for credit ratings (a credit spread is the difference between the yield to maturity on the security being evaluated and the yield to maturity on a risk-free (U.S. government) security of comparable structure and maturity).[13] Credit spreads have the advantage of being more accurate and more objectively determined than credit ratings. However, there are several practical shortcomings associated with the use of credit spreads.

One shortcoming is that, at present, nobody really knows what the credit spread equivalent of the NRSRO ratings is. For example, how close to the yield on riskless securities such as U.S. Treasury bills must the yield on a particular security be before it qualifies as having a AAA rating? Somebody is going to have to make this call, and there does not appear to be a particularly principled way to do it.

Another shortcoming with the use of credit spreads is that credit spreads exist only for seasoned issues. When a security has never traded before because it has just been issued, it is not obvious how one would ascertain its credit spread. Similarly, it is not obvious how one would determine the credit spread for thinly traded securities, particularly given the danger that market manipulation might occur if credit spreads substituted for credit ratings for thinly traded securities.

An additional problem with the use of credit spreads as a substitute for the ratings issued by NRSROs is that credit spreads reflect the difference between the yield on the security being evaluated and the yield on a risk-free bond of similar structure and maturity. But for many securities it may be quite difficult to find a risk-free bond of similar structure. The risk-free bonds that comprise the base-line measure for determining credit spreads are very simple in structure. In practice, it would be quite difficult to "normalize" the structure of a highly complex derivative security so that it is comparable with a risk-free security for purposes of determining the credit spread.

However, from a public policy perspective, the issue is not whether credit spreads are perfect. The issue is whether they are better than the alternative, which is the continuation of the NRSRO approach. I think it is incontrovertible that the use of credit spreads offers a superior alternative to the use of NRSROs in certain situations, such as in the case of seasoned issues that trade in thick, liquid markets. Their use should be studied further.

My own view is that Congress should commission the relevant regulatory agencies, such as the SEC and the Department of the Treasury, to study those regulations that require the use of NRSROs. The use of such NRSROs to fulfill regulatory functions should be abandoned where possible. Moreover, in many situations, regulations requiring the use of NRSROs can be abandoned. The need for NRSROs has declined over the past thirty years due to developments in information technology that have reduced the size of the informational asymmetries that exist between investors and issuers.

Where it is appropriate to continue the use of NRSROs, issuers and financial intermediaries should be allowed to use credit spreads as a substitute for the ratings currently generated by NRSROs. The precise formula for determining the credit rating equivalent of a credit spread would have to be determined.

Where firms choose to use credit ratings instead of credit spreads to satisfy regulatory requirements, the rating agencies should, at a minimum, be held accountable for their actions. In particular, the rating agencies should be subject to investigation and enforcement action by the SEC where they issue ratings for which there is no valid economic justification. In addition, the SEC should consider whether the rating agencies should be obliged by regulation: (a) to disclose the public documents on which they relied as the basis for their ratings determinations where the ratings are based on public documents; (b) to disclose whether the information contained in their credit ratings is based on anything other than publicly available documents; (c) to disclose whether the ratings are based on non-public interactions with the issuer; and (d) to disclose whether a ratings is being issued despite the fact that the rating agency lacks the information that a reasonable investor would consider relevant to the formulation of the rating; and (d) the extent to which the ratings they are issuing were actually based on credit spreads.

The market is, by-and-large, unharmed by the poor quality of ratings, because market participants are sophisticated enough to ignore the ratings. The real problem with the declining quality of credit ratings is that regulators are using credit ratings in a wide range of situations as a substitute for regulation. To the extent that ratings are of poor quality, the quality of these myriad regulatory schemes are compromised. The quality of U.S. financial regulation is being compromised by its pervasive reliance on credit ratings.

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[1] Frank Partnoy, The Siskel and Ebert of Financial Markets?: Two Thumbs Down for The Credit Rating Agencies, vol. 77, issue no. 3, Washington University Law Quarterly pp. 619-712, at 687 (1999).

[2] United States Comptroller of the Currency, Purchase of Investment Securities, and Further Defining the Term "Investment Securities" as Used in Section 5136 of the Revised Statutes as Amended by the "Banking Act of 1935," Section II (February 15, 1936).

[3] Partnoy, at 689

[4] Notice of Revision: Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934, release No. 34-10,525, 1973 SEC LEXIS 2309 (Nov. 29, 1973).

[5] 17 C.F.R. Section 240.15c3-1 (1998).

[6] Investment Company Act of 1940, Rule 2a-7, SEC Release No. 33-6,882, Fed. Reg. 8113 (1991).

[7] See letter regarding Selective Disclosure and Insider Trading, dated April 17, 2000 from Vickie A. Tillman, Executive Vice-President and Chief Rating Officer, Standard & Poor's Rating Services, to Jonathan Katz, Secretary, Securities and Exchange Commission (asking for an exception to Regulation FD for nationally recognized statistical rating organizations (NRSROs).

[8] See SEC Release Nos 33-7787, 34-42259, IC-24209 (2000).

[9] Securities and Exchange Commission Form S-3.

[10] Release No. 34-19,565, 48 Fed. Reg. 10,628 (1983).

[11] Partnoy, at 692.

[12] George E. Pinches & J. Clay Singleton, The Adjustment of Stock Prices to Bond Rating Changes, vol. 33 Journal of Finance pp, 29-55 at 39 (1978); see also, George E. Piches & Kent A. Mingo, A Multivariate Analysis of Industrial Bond Ratings, vol. 28 Journal of Finance 1 (1973) and Frank K. Reilly & Michael D. Joehnk, The Association Between Market-Dominated Risk Measures for Bonds and Bond Ratings, 31 J. Fin. 1387 (1976), Richard Cantor & Frank Packer, Determinants and Impacts of Sovereign Credit Ratings, Federal Reserve Board N.Y. Economy Policy Review, October 1996, at 45-46; David Zigas, Why the Rating Agencies Get Low Marks on the Street, Business Week, March 12 1990, at 4.

[13] Partnoy at 705.