TESTIMONY

Testimony of Steven L. Schwarcz

before the United States Senate Committee on Governmental Affairs,
March 20, 2002

I am Professor of Law at Duke University School of Law, Founding Director of Duke's interdisciplinary Global Capital Markets Center, and Adjunct Professor of Business Administration at Duke's Fuqua School of Business. My testimony will be centered around my law review article, *Private Ordering of Public Markets: The Rating Agency Paradox*, imminently forthcoming in the UNIVERSITY OF ILLINOIS LAW REVIEW (Issue #1, 2002). I have attached a final draft of this article to my testimony.

My testimony focuses on whether rating agencies should remain unregulated and, if not, whether it is feasible for individual nations to regulate multinational entities of this type.[1] My testimony does not address non-regulatory issues, such as whether ratings are superior to credit spreads and other rating alternatives as a means of assessing an investment's safety – although it does later suggest an approach by which such alternative approaches could be tested.

I. Introduction

A. The Problem: Investors in domestic and cross−border financial transactions increasingly rely on rating agencies for substantial comfort regarding the risks associated with the full and timely payment of debt securities. Rating agencies, however, are private companies that are not substantively regulated by the United States or any other major financial-center-nation.[2]

Several major financial-center nations, however, impose a minimal form of governmental control by giving official recognition to rating agencies that meet certain criteria. This is exemplified in the U.S. by the NRSRO designation. As you know, if a rating agency is designated an NRSRO, its ratings can be used to satisfy rating requirements established by government agencies like the SEC in certain federal regulatory schemes.

Today's hearing is being held largely because of the failure of the rating agencies to predict the Enron melt-down. In this context, I should note that rating agencies have always made their rating determinations based primarily on information provided by the issuer of securities; thus a rating is no more reliable than that information. Ratings also do not cover the risk of fraud. To the extent Enron provided the rating agencies with insufficient or fraudulent information, that would explain their failure to predict Enron's demise.

II. Analysis

The normative rationale for regulation, in an economic context where health and safety are not at issue, is fostering improvements judged in efficiency terms. There are two ways that regulation could improve rating agency efficiency: by making rating agencies perform better the tasks they already do well, or by limiting the negative consequences of their actions. I consider each in turn.

In making this inquiry, it must be cautioned that regulation itself poses intrinsic costs that can offset any efficiency gain.

A. Regulation to Improve Performance: Rating agencies improve the efficiency of securities markets by acting as informational intermediaries between issuers and investors in order to increase the transparency of securities and thereby reduce the information asymmetry. This is especially valuable where individual investors face high costs relative to their investment in assessing the creditworthiness of an issuer's securities. A relatively small number of rating agencies can make this assessment on behalf of many individual investors, thereby achieving an economy of scale. Government regulation could increase this efficiency only by reducing overall costs or by improving ratings reliability.

Presently, there is little reason to believe that rating agency costs are excessive. The fee charged by a rating agency typically is market-driven and varies according to the size and complexity of the transaction being rated. Even if rating agency costs were considered excessive, however, government regulation rarely reduces costs and includes costs of its own, such as the public sector need to administer the regulation and the private sector need to retain counsel to advise on compliance with the regulation.

Likewise, there is little reason to believe that increased regulation will improve the reliability of ratings. Rating agencies have had a remarkable track record of success in their ratings, and recent rating experience is even more reliable:

> In 20 years only one company with an investment-grade rating from Moody's has defaulted on long-term debt – Manville, a single-A company that went bankrupt voluntarily to protect itself from asbestosis lawsuits. A New Zealand finance company, DFC, defaulted on its commercial paper in 1989 while still carrying a prime rating by S&P. The agency says it relied on a government commitment to provide liquidity, but the government reneged.[3]

Because most studies only appear to take into account defaults on debt that is highly rated at the time of default, they do not necessarily address ratings stability. However, a recent internal analysis by Standard & Poor's, using information extracted from its proprietary database on 9,169 companies with rated debt, confirms the stability of investment grade ratings, finding for example that "all 'A' rated companies at the beginning of a given year would have an 87.94% chance of maintaining that same rating by year end."[4]

I agree that Enron is a very visible and dramatic exception to these data. But statistically, the failure to predict Enron's demise does not materially change these data. And, to the extent such failure resulted from Enron providing the rating agencies with insufficient or fraudulent information, the failure is truly an anomaly.

The reliability of ratings can be explained by reputational costs: the profitability of rating agencies is directly dependent on their reputations. Inaccurate ratings will impair, if not destroy, a rating agency's reputation. Thus, rating agencies should want to continue to provide accurate ratings, whether or not there is regulation. Regulation, on the other hand, could impair the reliability of ratings by increasing the potential for political manipulation, and by diminishing the importance of reputational costs as would occur, for example, if regulation were based on considerations other than ultimate ratings reliability.

Consequently, government regulation would neither reduce costs nor improve reliability. I therefore turn to the question of whether regulation would limit the negative consequences of rating agency actions.

B. Regulation to Limit Negative Consequences: There are various negatives associated with rating agency actions. First is the perception that rating agencies are not accountable because they are not officially subject to public scrutiny. This would be problematic if, as a result, rating agencies misbehaved or generally issued inaccurate ratings. As the foregoing discussion has shown, however, the lack of official public scrutiny does not appear to affect ratings accuracy because of the de facto accountability of rating agencies through reputation. The failure to predict Enron does not appear to represent a generalized failure of the rating process.

A second potential negative is the conflict of interest inherent in the way that rating agencies are paid. Rating agencies are virtually always paid their fee by the issuer of securities applying for the rating. This raises the possibility that the issuer will use, or the rating agency will perceive, monetary pressure to improve the rating. There nonetheless appears to be little alternative to this arrangement because one rarely can know in advance which investors will purchase a given issuance of securities, and even if one did it would be difficult to persuade those investors to pay their pro rata portion of the rating agency fee directly. The issuer therefore may be the only party realistically capable of paying the rating agency's fee in all situations.

This does not, however, eliminate the potential conflict of interest. Markets are not perfect, and the fact of the issuer's control over paying the fee might tempt it to strategically bargain for a higher rating in any event. In theory, a regulation could require investors to pay this fee, or could require an issuer to pay the fee irrespective of the rating ultimately assigned. Regulation, however, is costly, and the custom already exists that issuers are required to pay rating agency fees irrespective of the rating ultimately assigned. The amount of the fee is also independent of the rating. Coupling this with the fact that reputational costs help to ensure the objectivity and independence of the ratings decision, the aforesaid conflict of interest does not appear to cause any negative consequences.[5]

In summary, then, regulation would neither limit the negative consequences of rating agency action nor improve rating agency performance. There therefore appears to be little theoretical justification for such regulation generally.

As discussed, however, States that make the applicability of their laws turn on a rating often utilize NRSRO designation as a minimal form of regulation. *Whether the applicability of law should turn on a rating is beyond the scope of my testimony.[6]* Nonetheless, so long as the applicability of law *does* turn on ratings, some form of regulatory approval of rating agencies would appear appropriate. In this context, I next examine the appropriateness of NRSRO designation as a regulatory methodology.

C. NRSRO Approach to Regulation: As shown above, regulation is not generally needed to improve rating agency efficiency. And, indeed, the purpose of NRSRO designation does not appear to be to improve efficiency *per se*. Such designation in fact has another purpose: to ensure that where the applicability of specific laws turns on a rating, the issuer of the rating – and thus the rating itself – is a reliable indicator of whether or not to apply those laws.

This suggests that NRSRO designation must be analyzed in the context of those specific laws. The analysis is simplified, however, by the fact that there appears to be only one category of laws whose applicability turns, or should turn, on a rating: securities laws. This intuitively follows because the purpose of ratings is to assess the risks associated with the payment of *securities*. Conceptually this follows because rating agencies perform the same function as securities law – reducing the information asymmetry between issuers of and investors in securities. NRSRO designation is therefore a component of securities law and should be analyzed in that context.

NRSRO designation at first appears to be a theoretically unusual approach to securities law. In the U.S., for example, the historical debate regarding enactment of securities laws focused on whether those laws should provide for full disclosure or, instead, governmental merit analysis. The consensus was that federal securities laws should not establish a system of merit regulation because investors' ability to make their own evaluations of available investments through the federal regulatory framework of full disclosure obviates any need that some observers may perceive for the more costly and time-consuming governmental merit analysis of the securities being offered.

NRSRO designation, however, constitutes an indirect form of merit regulation of securities. This is because the designation itself, which controls whether or not securities law exemptions become available, is based on governmental merit analysis of the rating agencies. Nonetheless, this form of merit analysis may be superior to full disclosure. The historical rationale for full disclosure – that investors' ability to make their own evaluations of available investments obviates the need for costly and time-consuming merit analysis – is not always applicable. In the case of evolving and complex debt structures, for example, the cost of each investor individually evaluating his or her investment would be excessive. Rating agency evaluation, in contrast, provides an economy of scale.[7] Furthermore, at least as presently performed, the minimal merit analysis needed for NRSRO designation is neither costly nor time-consuming. Thus NRSRO designation, even though a form of merit regulation, may well be appropriate.[8]

The remaining question is how to balance the protection provided by the NRSRO-designation with the goal of ensuring that a sufficient number of rating agencies receive such designation to assure competition. In this context, it has been proposed that NRSRO-designation be awarded to some foreign recognized rating agencies, as well as to arms' length subsidiaries of domestic firms active in evaluating the business and securities of companies.[9] There should be relatively little risk if these entities are well-capitalized, have reputations for "quality financial analysis in the investment community," and have acceptable business plans to rate securities.[10] Consideration might even be given, for example, to firms that utilize alternative rating approaches, such as credit spreads and stock-price volatility.[11] The risk could be further minimized by making any *de novo* applicant's NRSRO-status provisional for some trial period.[12] In this way, the potential anti-competitive effect of NRSRO designation can, consistent with the integrity of such designation, be reduced. Reducing the anti-competitive effect also would mitigate any theoretical concern that rating agencies will engage in cartel behavior (although the prevalence of split ratings is evidence against present cartel behavior), such as by giving unnecessarily negative ratings or extracting oligopoly profits.

D. Multinational Considerations: My analysis has so far indicated that additional regulation of rating agencies is unnecessary and probably inefficient. This view is reinforced by the fact that rating agencies are multinational entities whose assets are human capital. As such, a rating agency subject to excessive regulation would be more likely than an ordinary multinational company to relocate to a foreign country that does not impose such regulation, assuming the country has the educational infrastructure to supply the ongoing need for analysts.[13] This in turn might lead to a race to the bottom, in which countries compete to reduce their level of regulation in order to attract rating agencies that wish to relocate. Reputational considerations might mitigate relocation to the extent that a rating agency prefers to comply with the regulation as an additional means of signalling to the market its reliability; but ultimately a rating agency would have to balance the cost of such compliance with the costs of relocating, including any perceived loss of reputation.

A possible solution to this dilemma is to impose regulation on a global scale. However international regulation of rating agencies, like any other form of global regulation, would be inherently costly if not impractical in our primitive system of international law.

Even minimal international regulation, by analogy to the NRSRO-designation, appears unnecessary. A limitation of such a designation is that it is national, not international. Inconsistent designation criteria among countries therefore might create confusion for cross-border financings, which have become increasingly common, and also could create the potential for inconsistent application of bank capital adequacy standards. One therefore may ask whether there should be a *globally* recognized statistical rating organization (perhaps called GRSRO) designation.

I do not believe that global designation is necessary, or that inconsistent NRSRO designations are likely to give rise to confusion. In a given transaction, the only relevant

NRSRO designation would be that of the country where the applicable securities are issued. Thus, in a cross-border securitization transaction where, for example, a company in State X sells receivables to an SPV in State Y which in turn obtains financing by issuing securities through an SPV in State Z, only State Z's NRSRO designation would be relevant. There is little room for confusion.

On the other hand, GRSRO designation procedures, even if practical, would be costly because of the political maneuvering needed to achieve international consensus as well as the need to conform national securities laws that presently rely on NRSRO designation to the new designation procedure. Furthermore, a single GRSRO designation might exacerbate the anti-competitive effect of national designation by diminishing the ability of local rating agencies to germinate and grow.

---

[1] I further focus on regulation via the administrative system of direct public control. For an analysis of enforcing private tort rights against rating agencies, *see* Gregory Husisian, Note, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411 (1990). Although Mr. Husisian concludes that the private tort system should not be expanded beyond its limited existing state, his rationale – that such expansion would induce rating agencies to create costly "paper trails" that would not produce a better product – does not necessarily apply with the same force to direct public control.

[2] Several non-financial center nations in Latin America (Argentina, Bolivia, Uruguay, Mexico, Paraguay, Chile and Peru) and East Asia (Malaysia, Korea, Taiwan) do, however, regulate the ratings industry through structural requirements, such as capitalization thresholds, employee experience and integrity requirements, and through rating methodology directives. For example, in Argentina and Chile, regulators require rating agencies to submit rating methodology and criteria to a regulatory body for approval, and have established official bodies that oversee and approve ratings. Korea regulates entrance procedures for new rating agencies by imposing capitalization and employee qualification requirements. Taiwan requires rating agencies to partner with an internationally recognized rating agency, and also imposes standards similar to those in Latin America as well as overseeing agency structure by approving its corporate documents (such as the articles of incorporation and corporate bylaws) and any changes thereto. India requires that rating agency applications be endorsed by reputable parties in the financial community, and that agencies must renew their applications every three years. It also imposes a net capital worth threshold, limits the agency's business to credit ratings, and requires that no employee be convicted of any transgression involving moral turpitude or any economic offense.

[3] *Credit-Rating Agencies: Beyond the Second Opinion*, ECONOMIST, Mar. 30, 1991, at 80.

[4] Leo Brand & Reza Bahar, *Corporate Defaults: Will Things Get Worse Before They Get Better*, S&P CREDITWEEK, Jan. 31, 2001, at 15, 27 (also available at http://www.standardandpoors.com/Forum/RatingsCommentaries/CorporateFinance/index.html) (setting forth, *id*. at 23, a table of average one-year transition rates, showing for each initial rating from AAA down to CCC the likelihood that the rating will change during a year).

[5] A possible exception is Moody's allegedly issuing artificially low unsolicited ratings in private transactions. It is unclear, however, that unsolicited rating actually constitutes an abuse because whether such ratings are in fact artificially low is just suspicion. Furthermore, Moody's recently voluntarily instituted disclosure for certain unsolicited ratings, in recognition that market participants have shown an interest in knowing which ratings lack the issuer's participation and to help to dispel misconceptions, and increase the credibility and utility of its ratings in the capital markets. Reputational costs alone therefore have been sufficient, even in this context, to help correct rating agency misbehavior.

[6] In this context, however, I note that external credit ratings are increasingly being adopted in regulations worldwide. Although ratings have been employed most extensively by regulatory agencies in the United States, and to a lesser extent in Japan, there has been expanded use of ratings in Latin American and Asian emerging markets, and the Task Force on the Future of Capital Regulation of the Basel Committee on Banking Supervision has proposed using ratings to help determine sovereign and private sector risk weights in a revision of Basel capital requirements. British regulators use ratings to help decide how much capital securities firms should set aside against their bond holdings. Japan's finance ministry allows only highly rated borrowers to sell bonds to Japanese investors. *See* ADAMS, MATHIESON & SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS 145 (International Monetary Fund survey, Sept. 1999).

[7]Ratings thus would be viewed as a de facto substitute for full disclosure to the extent that investors rely on ratings in lieu of disclosed information. Whether this shift in reliance is justified, however, is beyond the scope of my testimony. *Cf*. Revisions to Rules Regulating Money Market Funds, Investment Company Act of 1940 Release Nos. 33-6882; IC-18005, 56 Fed. Reg. 8113 (Feb. 27, 1991) (indicating that investors should not use ratings as a substitute for making informed judgments based on disclosure). Opponents of the shift may argue, for example, that ratings do not cover fraud risks, that rating agencies rely only on information provided by the issuer, and that the integrity and reliability provided by independent professionals such as investment banks and attorneys are discounted where investors read the offering papers less carefully or completely.

[8] This view is supported by commercial law theory. In contrast to the traditional approach of the past two centuries (referred to as transactional regulation) in which public agencies have assumed responsibility for the oversight and

direct regulation of the conduct of private parties, a system of commercial law only should require the State to establish the minimal structure necessary to create private institutions that will then operate under market incentives to allocate public resources (an approach known as organizational regulation). The rationale for favoring organizational over transactional regulation derives from actual experience. Organizational regulation produces rules that are optimal in light of the costs of the rules because it relies on simple commitment mechanisms, such as reputation. Transactional regulation, however, does a particularly poor job of achieving optimal legal complexity because protecting the legitimacy of the State, not efficiency, is its primary goal. Thus, it treats as absolute the value of the rights at stake while largely ignoring costs. In the commercial context of rating securities, the State's legitimacy is not at issue and the rights at stake need not be treated as absolute. Accordingly, the NRSRO-designation derives its normative authority from being a form of organizational regulation.

[9] Letter from Antitrust Division of the U.S. Department of Justice to the SEC 3 (Mar. 6, 1998) (commenting on the SEC's proposed amendments to Rule 15c3-1 regarding NRSRO designation; and listing investment and commercial banks, insurance companies, and accounting and consulting firms as examples of the types of firms active in evaluating companies' business and securities).

[10] *Id*.

[11] *Compare* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 658 (1999) (arguing that credit spreads are superior to traditional ratings) *with* ADAMS, MATHIESON & SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, at 141-43 (arguing that "[r]atings are clearly more stable than market spreads," while both provide the same degree of imperfect foresight). *See also* Jia He, Wenwei Hu, & Larry H.P. Lang, *Credit Spread Curves and Credit Ratings* (forthcoming 2000) (available at http://papers.ssrn.com/paper.taf?abstract_id=224393).

[12] Letter from Antitrust Division to the SEC, *supra* at 3 (proposing a 12-18 month trial period).

[13]Of course, the flexibility to relocate would be less in such dominant markets as the United States, especially to the extent the rating agency desires to continue to have its ratings qualify for the NRSRO securities law exemptions. Furthermore, a State could attempt to indirectly regulate foreign rating agencies that assign ratings to securities issued in its jurisdiction by directing enforcement at the issuer located in the State, much like a State can tax interest income paid to a foreign lender by requiring a domestic borrower to withhold a portion of the interest payable and turn it over to the State as a withholding tax.