It is time to open the bond rating industry to new entrants.

The SEC's Other Problem

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The U.S. Securities and Exchange Commission currently has its hands full with corporate governance issues and oversight of the accounting industry. Lurking in the background, however, is a different and less well-known problem of SEC regulation—one that seriously undercuts the SEC's frequent claim that it promotes open and efficient capital markets.

The problem concerns the SEC's regulation of the bond rating industry. Until recently, few people—even among knowledgeable Washington insiders—were aware that the SEC regulates the industry. But it has done so since 1975, by limiting entry in an indirect but powerful way. And that is the problem; incumbent bond rating firms are protected, potential entrants are excluded, and new ideas and technologies for assessing the riskiness of debt (and therefore the allocation of capital) may well be stifled.

This entry regulation is a perfect example of good intentions gone awry in accordance with the "law" of unintended consequences. The good intentions were to improve the safety-and-soundness regulation of financial institutions, and even to use "market" information to do so. But the unfortunate result has been a distortionary entry restriction regime with respect to bond rating firms.

Fortunately, there are better ways to achieve the desired goals.

BACKGROUND

Bond rating firms primarily provide judgments about the credit quality of debt instruments—bonds and similar debt obligations issued by companies and governments. The information provided by the bond raters can be seen as part of the process by which lenders (bond buyers) try to pierce the "fog" of asymmetric information and determine to whom to lend (whose bonds to buy) and on what terms, and also part of the effort by borrowers (bond issuers) to "tell their story" as to why they are worthy recipients of lent funds.

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In the United States today, there are only three debt-rating firms of any significant size: Moody's, Standard & Poor's (S&P), and Fitch. Moody's is the largest. It is currently a free-standing corporation, having been spun off by Dunn & Bradstreet in 2000 (which acquired Moody's in 1962). Moody's had revenues of $797 million in 2001, of which 87 percent was derived from its bond rating activities; 70 percent of its revenues arise from its U.S. activities. S&P's bond rating activities are embedded in its wider financial information activities (e.g., the compilation of stock market indexes), and S&P itself is part of McGraw-Hill. Consequently, far less is known about the specifics of S&P's bond rating activities. Fitch is distinctly the third-place bond rater. It is part of a French conglomerate and has a larger relative presence in Europe than in the United States.

There are a few smaller bond rating firms, and at least one specialized firm (A.M. Best) that focuses on the obligations of the insurance industry. But the major players number only three, and historically their numbers have fluctuated only within a narrow range of three to five since the 1920s. Why so few? Part of the reason is due to fundamental economic forces. Economies of scale and scope are surely important in allowing a rating firm to gain a reputation as a reliable rater across a variety of industries, time periods, and economic situations. Reputation is important for market participants who are trying to deal with asymmetric information. Also, investors may prefer to keep track of just a few rating scales in assessing bonds, just as college admissions offices surely prefer dealing with only one or two standardized entrance examinations in assessing applicants.

But something more has been at work, at least since 1975. That something is the SEC's restrictive regulation.

HISTORY

John Moody published the first public bond ratings, for railroad bonds, in 1909. Poor's Publishing Co. followed in 1916; the

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Standard Statistics Co. began issuing ratings in 1922. (The two merged to form S&P in 1941; McGraw-Hill absorbed S&P in 1966.) The Fitch Publishing Co. began its ratings in 1924. The standard business model was that the companies sold their ratings to investors.

The financial markets' ready embrace of the information provided by the ratings firms in that era is understandable because financial disclosure was quite limited, at least by modern standards. Recall that the SEC and its requirements for corporate financial disclosure (which would provide further information for lenders) came into existence only after 1933. Through the 1920s, then, it is clear that the bond rating companies were meeting a market test as to the value of their services.

A major change occurred in the 1930s. In 1930 the Federal Reserve began using ratings in its informal judgments about the suitability of the bond portfolios of its member banks. In 1931, the Office of the Comptroller of the Currency (OCC) — the federal regulator of nationally chartered banks — formally required banks to use current market prices ("mark to market") for any bonds in their portfolios that were below "investment grade" (i.e., below a "BBB" rating, which was and still is S&P's designation of investment grade). But the OCC allowed the banks to continue valuing bonds that were rated at BBB (or its equivalent) or higher at original purchase cost. The OCC followed in 1936 with a far more draconian measure that persists to the present day: Banks could not hold bonds in their portfolios that were below investment grade.

Notice the impact of those regulatory measures: For the first time, government regulators were requiring major participants in the bond markets to pay attention to the ratings of the bond rating firms.

The bank regulatory requirements were followed in the 1930s and 1940s by state insurance regulators who began to link insurance companies' capital requirements to the ratings of the bonds in their portfolios. Again, regulators were requiring major bond transactors to heed the ratings of the bond rating firms.

There was, however, a curious blind spot in the bank and insurance regulators' requirements: The issue of which rating firms' ratings should be heeded was not addressed specifically. Instead, there were vague references to "recognized rating manuals," which were probably understood to mean Moody's, S&P, and Fitch.

One other historical fact is worth noting: In the early 1970s, the rating firms' business model changed from one in which rating manuals were published and sold to investors to one in which the bond issuers paid for the privilege of providing information to the raters, who would subsequently openly publish and distribute the ratings. It seems likely that the technological phenomenon of low-cost photocopying was the major source of the change. Financial historians also point to the trauma of the Penn-Central bankruptcy in 1970 and its effect in heightening the bond market's sensitivity to credit-quality issues and especially in making issuers willing to pay to have the quality of their bond obligations certified by the rating firms.

THE SEC'S ACTIONS

In 1975, the SEC proposed (in Rule 15c3-1) the establishment of minimum net worth (capital) requirements for securities broker-dealers. It wanted to link those requirements to the quality of the bonds of the broker-dealers' portfolios. Following the lead of the other financial regulators, it wanted to employ the bond rating firms' ratings. But the SEC apparently noticed the "whose ratings?" problem: What was to prevent the bogus XYZ rating firm from issuing AAA ratings to any company that paid a suitable sum to XYZ? And what was to prevent a broker-dealer from claiming that XYZ's ratings were "reputable" and should be used in judging that broker-dealer's bond portfolio and its capital requirements?

Consequently, as part of the broker-dealer capital regulation, the SEC established an entirely new regulatory category for bond rating firms — "nationally recognized statistical rating organizations" (NRSROs). The SEC designated the NRSROs' ratings as the only ratings that could be used for determining the broker-dealers' capital requirements. The SEC also immediately "grandfathered" the three incumbents (Moody's, S&P, and Fitch) into the NRSRO category.

Over the next few years, other financial regulators adopted the SEC's NRSRO category designation so that the regulators' requirements as to the use of bond ratings would mean the required use of only the NRSROs' ratings. Further, the use of bond ratings for financial regulatory purposes greatly expanded during the 1980s and 1990s. The SEC, for example, again invoked the NRSRO category in 1991 when it declared (in Rule 2a-7) that no more than five percent of the assets of money market mutual funds could be invested in low-rated commercial paper. And, most recently, in 2001 the regulator of Fannie Mae and Freddie Mac (the Office of Federal Housing Enterprise Oversight) linked its minimum capital requirements for Fannie and Freddie to the NRSROs' bond ratings of the insurers that often provide mortgage insurance on the mortgages that the two enterprises buy and hold or securitize.

Newcomers The SEC was not wholly dormant with respect to the new category that it had created. In 1982 and 1983, it designated Duff & Phelps and McCarthy, Crisanti and Maffei, respectively, as NRSROs. And in 1991 and 1992, it designated IBCA (a British rating firm) and Thomson BankWatch, respectively, as specialized NRSROs for the obligations of banks and financial institutions only. However, mergers subsequently removed all of the entrants from the field by the end of 2000, leaving only the original three grandfathered incumbents as the current NRSROs.

A point of further interest: The SEC did not state any explicit criteria for admission into the NRSRO category at the time of the original grandfathering, nor at the time of its subsequent approval of the four entrants.

GOOD INTENTIONS... AND THEIR CONSEQUENCES

Consider the sequence of regulatory events. Initially, bank regulators, entrusted with the safety and soundness of banks, decided to make use of outside parties — the bond rating firms — to help in evaluations of the appropriateness of bonds in banks' portfolios. Regulators today are often urged to make more use of market information. The bank regulators of the 1930s would appear to have been ahead of their time.

However, it is one thing to rely on market information where the market is a well-defined but impersonal mechanism. The bank regulators of the 1930s appear to have hoped for such reliance with their reference to "recognized rating manuals." But bond ratings were never going to have the impersonality of, say, market prices of Treasury bills. Thus, the reliance could be considered more as a regulatory delegation of safety judgments to specific parties. And so, there was no way to avoid the "whose ratings?" issue, which the SEC addressed in 1975.

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Having addressed it, the SEC opted for a restricted "who": the three grandfathered incumbents and only four entrants permitted during the subsequent 27 years. Potential entrants — smaller domestic firms and foreign rating firms — have been ignored. Indeed, a major reason for IBCA's purchase of Fitch in 1997 (with the Fitch name persisting) was IBCA's impatience in being restricted to a narrow NRSRO category and not being granted broad NRSRO powers.

Notice the power that the NRSRO bestows on incumbents. Because almost all bond issuers hope that their bonds can be bought by regulated financial institutions, they must seek a rating by at least one, and often two, of the NRSROs. Thus, the NRSROs have a guaranteed market for their ratings. Even if the participants in the bond markets were capable of devising better methods, technologies, or institutions for helping determine credit risks, those new and improved ways could well falter if the incumbent NRSROs fail to embrace them, because of the incumbent NRSROs' sinecure.

The additional difficulties that the NRSRO designation creates for non-NRSRO entrants are worth emphasizing. Entrants, of course, always face difficulties in overcoming the advantages of incumbents. But for a bond rating entrant, the absence of a NRSRO designation could well be fatal. Why should the senior management of any bond issuer spend time "telling its story" to a non-NRSRO if the latter's ratings cannot help the issuer get its bonds into the portfolios of regulated financial institutions?

MEETING A MARKET TEST?

The fabric of financial regulation is now so tightly woven around the incumbent bond rating firms — with regulation-driven demand for ratings, combined with regulation-driven restrictions on supply — that it is impossible to know if the incumbent bond raters currently meet a market test as to the value of their services to the debt markets.

The previous sentence may seem quite strong, especially in light of well-documented evidence that the changing of a bond rating by Moody's or S&P can cause the price of that bond to change. Does the market reaction not indicate that the bond rating firms are providing useful information about the likelihoods of bond defaults to the markets?

Not necessarily. The regulatory "cliff" for banks' holdings of bonds — "investment grade" — provides a good illustration of why the responsiveness of bond prices to rating changes may not reflect changes in market beliefs about default probabilities. Suppose that S&P downgrades a bond from AA to A. The market's likely (negative) reaction would be a decrease in the equilibrium price for the bond (and thus an increase in its interest yield). That reaction could be an indication that the market has learned something new from S&P about the increased default probability of the bond. Or the market's reaction could simply be a recognition that the bond has gotten closer to falling off the cliff, with the consequent decrease in price that would surely follow when banks could no longer hold the bond. Even if market participants believed that the change was erroneous and there had been no change in the underlying probability of default on the bond, the decrease in the bond's price would still be a sensible reaction to the bond's closer proximity to the cliff.

Thus, unlike the 1920s, it is not possible to say whether the incumbents' ratings today (and since 1975, and arguably since 1930) meet a market test.

CRITERIA FOR NEW NRSROS

In 1997, the SEC proposed regulations that would specify criteria for admitting any new firms into the NRSRO category (if the SEC were to permit any new entry). The proposed criteria for admission (in the SEC's own regulatory language) were as follows:

National recognition, which means that the rating organization is recognized as an issuer of credible and reliable ratings by the predominant users of securities ratings in the United States.

Adequate staffing, financial resources, and organizational structure to ensure that it can issue credible and reliable ratings of the debt of issuers. That includes the ability to operate independently of economic pressures or control by companies it rates and that it has a sufficient number of staff members qualified in terms of education and expertise to thoroughly and competently evaluate an issuer's credit.

Use of systematic rating procedures that are designed to ensure credible and accurate ratings.

Extensive contact with the management of issuers, including access to senior level management of the issuers.

Internal procedures to prevent misuse of non-public information and compliance with those procedures.

The shortcomings of the SEC's proposed criteria are readily apparent. The first criterion would constitute an obvious "Catch 22" barrier to entry. The fourth criterion also has that quality because non-NRSROs would have difficulties in establishing managerial contacts. Further, the second through fifth criteria essentially focus on inputs into the rating process, rather than on outputs (say, accuracy in predicting bond defaults); firms with innovative technologies that did not meet the input criteria would flunk the SEC's admissions test.

Mercifully, the SEC has not acted on its regulatory proposal over the past five years.

GLOBAL CONSEQUENCES

The consequences of the safety-and-soundness good intentions gone awry are not confined just to the United States. They extend beyond our borders in at least two ways. First, Moody's, S&P, and Fitch are important participants in providing ratings in debt markets around the world. Their protected position in the United States surely gives them extra leverage in their activities elsewhere.

Second, the Basel Committee on Banking Supervision, under the auspices of the Bank of International Settlements, has proposed a revision (often described as "Basel II") to its 1988 capital standards for banks. The revision, which is far more complicated than the 1988 rules, has three alternative schemes for determining appropriate capital levels for banks. one of the schemes would bring bond ratings directly into the determination of the minimum capital requirements that would be required for a bank's loans to any borrower that had rated debt.

Thus, the Basel II proposals would explicitly expand the role of bond rating firms in the safety-and-soundness regulation of banks in the United States and simultaneously expand that infiltration to bank regulation around the world. Perforce, the Basel II proposals would also expand globally the role of governments in limiting entry into bond rating. As the Basel Committee explicitly recognizes, other countries' financial regulators would have to establish criteria to answer the "whose ratings?" question for their bank regulation as well. The Basel Committee's suggested criteria for answering that question are slightly better than the SEC's 1997 proposals, but they are nevertheless heavily oriented toward input measures rather than output measures.

WHAT IS TO BE DONE?

There are two ways that public policy could proceed so as to avoid the distortionary entry limitations of the SEC's NRSRO approach.

First, and by far the best route, would be for financial regulators to cease delegating their safety-and-soundness judgments to the bond rating firms. That may seem to be a step backwards in the efforts to bring more market-oriented information to bear on regulatory decisions. But when the safety delegation is to specific parties, and entry into that category is then restricted and a sinecure is created, the effort to bring more market-oriented information into the regulatory process has been perverted.

How would the cessation of safety delegations work? It is easiest seen for bank regulation. Bonds should be treated by bank regulators on a par with how banks' loans are treated. When a bank examiner evaluates a bank's bond portfolio, she ought to ask the same types of questions about the bonds that she asks about the bank's loan portfolio: Are the bonds suitable for holding by the bank? Why? What research has the bank done on the companies that issued the bonds? If the bank has relied on the ratings of a rating firm, what research has the bank done about the reliability of that firm's ratings?

Those questions would place the responsibility for determining the safety and soundness of a bank's bond portfolio initially on the bank and then on the regulator for review, which is where it ought to be. Similar methods could be developed to replace the other financial regulators' safety delegations to the bond rating firms, including the safety delegations of the SEC itself.

With the safety delegations withdrawn, there would no longer be a need for the NRSRO category, and the SEC could eliminate it. The participants in the financial markets would then be free to make their own determinations as to whose ratings and which methods provide the most useful information in predicting defaults. The current incumbents might continue to thrive if the markets judge their information to be worthwhile; or upstarts might unseat them. The important thing, of course, would be that these would be the judgments of the capital markets and not of bureaucrats in Washington.

The SEC might lead the way by simply withdrawing its own safety delegations and eliminating the NRSRO category, thereby exposing the other regulators' safety delegations as the specific sinecures that they are. If the wholesale withdrawal of safety delegations is considered too radical or utopian, then any "plan B" would have to keep the NRSRO designation, so as to deal with the bogus rating firm problem. But then the SEC must cease being an artificial barrier to entry for any firm that wants and is qualified to become a NRSRO. The SEC must actively consider applicants and have a transparent process for reviewing incumbents as well as potential entrants. Its criteria must be centered on outputs — the efficacy of firms in predicting bond defaults — rather than on the inputs that were the focus of its 1997 proposals.

If such judgments are considered beyond the capabilities of the SEC, then there is always "plan A": End the safety delegations to the bond rating firms, and eliminate the NRSRO category.

Finally, the Basel II proposals should be similarly revised, so as to eliminate the global delegation of bank regulators' safety judgments to bond rating firms and the concomitant necessity for restrictive entry regulation.

IS CHANGE POSSIBLE?

The bond raters and their special position received a brief flurry of attention last February and March. After Enron declared bankruptcy in December 2001, it was noticed that Moody's and S&P had persisted in giving "investment grade" ratings to Enron's debt until a few days before the company's bankruptcy filing. Newspaper stories were written and congressional hearings were held. The SEC promised to look into the matter. To make sure that the agency did so, the Sarbanes-Oxley legislation that was passed in July contained a specific provision (Sec. 702) that instructed the SEC to compile a report within 180 days that studied "the role and function of credit rating agencies in the operation of the securities market," including "any barriers to entry into the business of acting as a credit rating agency, and any measures needed to remove such barriers."

The soon-to-be-issued report could provide the SEC, Bush administration, and Congress with the opportunity to rethink the entire issue of safety judgment delegations and the consequent distortionary NRSRO approach. It may well be a once-in-a-lifetime opportunity. R

READINGS

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