Ratings Failure: The Need for A Consumer Protection Agenda in Rating Agency Regulation

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Abstract

As the credit crisis unfolds, rating agencies have been properly identified as playing a central role in causing the crisis and misleading investors. What has been forgotten in this acrimonious environment is that in their quest to increase the market for their services, rating agencies also took positions that were particularly bad for many homeowners.

This article first reviews the explosive growth of the subprime mortgage market. It then discusses the ways in which the leading rating agencies, Standard & Poor’s, Moody’s and Fitch, acted as government-approved gatekeepers to the financial markets and contributed to the rapid expansion of the subprime market. These three entities profited from the growth of that market and suppressed efforts by states to crack down on the predatory lending practices that had become endemic to it.

The article concludes that ongoing efforts to reform the regulation of the rating agencies fail to address their systemic bias against the public interest. As their regulators seek to tighten oversight of these important players in the financial markets, it is important to ensure that future regulation provides additional protection for consumers as well.
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As the credit crisis unfolds, credit rating agencies have been properly identified as playing a central role in causing the crisis and misleading investors. What has been forgotten in this acrimonious environment is that in their quest to increase the market for their services, rating agencies also took positions that were particularly bad for many homeowners. As their regulators seek to tighten oversight of these important players in the financial markets, it is important to ensure that such regulation provide additional protection for consumers as well. Residential mortgage borrowers, in particular, have been negatively impacted by decisions of rating agencies. This has highlighted the need for a consumer protection agenda in rating agency regulation.

Rating agencies have been actively rating securities in the United States since the beginning of the twentieth century. Certain rating agencies are what are known as National Recognized Statistical Rating Organizations (“NRSROs”). The Securities and Exchange Commission (“SEC”) first granted NRSRO status in 1975. NRSRO status initially referred to those rating agencies whose ratings could be used in implementing the net capital requirements for broker-dealers.

Standard & Poor’s, Moody’s Investors Services and Fitch Ratings (collectively, the “Big Three”) are NRSROs and they utterly dominate the credit rating market, particularly that for mortgage-backed securities. The Big Three provide ratings for pools of mortgages that are converted to securities and sold to investors throughout the world, a process known as securitization. For their labors, the Big Three are compensated by fees from issuers of securities that solicit ratings from them.


3 Claire A. Hill, Regulating the Rating Agencies, 82 WASH. U. L.Q. 43, 44 (2004); see Rhodes, supra note 2, at 321-22.

4 Rhodes, supra note 2, at 321.

5 See GLOBAL CREDIT ANALYSIS 52 (David Stimpson ed., 1991). For example, the SEC relies heavily upon the services of NRSROs in Rule 3a-7, relating to the 1940 Investment Company Act. See Rhodes, supra note 2, at 345. Pursuant to Rule 3a-7, “a favorable rating by only one NRSRO of an asset-backed securities issuance exempts the transaction from the regulatory scheme” of that Act. Id. It is in this manner that the NRSRO rating reduces the transaction costs and provides other benefits to issuers of residential mortgage-backed securities while...
As NRSROs, The Big Three are granted a privileged status by numerous financial services regulators. This privileged status results from the incorporation of the Big Three’s ratings throughout a vast web of government regulation of private companies. Since the SEC anointed the chosen NRSROs in 1975, federal and state financial regulators have “found that ratings may serve a variety of uses.”6 The current regulatory environment “requires or encourages various entities—broker-dealers, banks, money-market funds, insurance companies, trust companies, pension funds, and many others—to purchase financial instruments rated investment grade” by an NRSRO.7 While the NRSROs thereby bestow significant regulatory benefits upon issuers of securities, they themselves have not been “subject to substantive monitoring.”8

The Big Three have been described as operating a “regulation-induced oligopoly.”9 This is because the lack of a rating from at least one of the Big Three, which effectively grant regulatory licenses to institutions that wish to issue securities, is the financial equivalent of a death sentence for a residential mortgage-backed securities (“RMBS”) offering. Thus, the Big Three’s NRSRO status effectively makes them gatekeepers to other private financial entities attempting to access the financial markets.10

Also providing a benefit to the NRSRO itself because of the fees that it can charge to the issuer for the rating analysis prescribed by Rule 3a-7.


7 Hill, supra note 3, at 44; see Partnoy, supra note 6, at 692 n.349 (charting history of increasing use of ratings in legislation and regulation); see BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2004) (describing new international standards for risk-based capital requirements that heavily relies on rating agencies).

8 Hill, supra note 3, at 44.


10 Richard Cantor, Moody’s Investors Service Response to the Consultative Paper Issued by the Basel Committee on Bank Supervision “A New Capital Adequacy Framework,” 25 J. BANKING & FIN. 171, 179 (2001) (“By using ratings as a tool of regulation, regulators fundamentally change the nature of the rating agency product. Issuers pay rating fees, not to facilitate access to the capital market, but to purchase a privileged status for their securities from the regulator. As a result, licensed rating agencies will have a product to sell regardless of the analytic quality of their ratings and their credibility with the investor community.”); Steven L. Schwartz, Private Ordering of Public Markets: The Rating Agency Paradox, 2002 U. ILL. L. REV. 1, 2 (“To a large extent, the almost universal demand by investors for ratings makes rating agencies gatekeepers of the types of securities that investors will buy. . . . This unprecedented power, combined with their de facto control over international debt markets, makes the issue of whether rating agencies should remain unregulated more urgent.” (footnotes omitted)); see Paul Robbe & Ronald Mahieu, Are the Standards Too Poor?: An Empirical Analysis of the Timeliness and Predictability of Credit Rating Changes 1 (Jan. 31, 2005) (unpublished manuscript), available at http://ssrn.com/abstract=648561 (“In the United States, banks and other financial institutions have only been allowed to hold bonds of investment grade quality (i.e., bonds that are rated BBB- or better) ever since 1936. As a consequence, having a credit rating has become a necessity in order to acquire external debt capital.”).
The most vehement criticism of the Big Three is that they do not provide accurate and valuable information to the markets. One leading rating agency scholar argues that the Big Three have survived not because they produce credible and accurate information. They have not maintained good reputations based on the informational content of their credit ratings. Instead, the credit rating agencies have thrived, profited, and become exceedingly powerful because they have begun selling regulatory licenses, [that is], the right to be in compliance with regulation.11

The Big Three also faced popular criticism for failing to warn of dramatic failures such as that of Enron.12 These academic and popular critiques led to Congress’ enactment of the Credit Rating Agency Reform Act of 2006, well before the extent of the credit crisis had become clear.13

Lost within the ongoing debate over the flaws of the Big Three is the fact that they have also taken anti-consumer positions that were aligned with the interests of their industry and the securitization industry as a whole. In particular, this article argues that the Big Three took positions against a variety of consumer protection statutes that were intended to assist subprime borrowers because such statutes might slow the growth of the RMBS market, thereby slowing the growth of the Big Three themselves.

This article proceeds as follows. First, it describes the development of the subprime mortgage market. Second, it describes the process of securitization and the role of rating agencies in that process. Third, it describes the nature of the privilege that the three main rating agencies enjoy and how they abused this privilege. Fourth, it reviews efforts to regulate them and identifies the limitations of these efforts. It concludes by calling for consumer protection to be placed on the reform agenda for this industry.

THE EXPLOSIVE GROWTH OF THE SUBPRIME MORTGAGE MARKET

The way that Americans borrow money to buy homes has changed radically since the 1980s.14 Before that time, Americans who wanted to buy a home would typically walk into their local savings and loan and speak to a loan officer who would evaluate their application.15 Depending on income, wealth, and ties to the community, the loan officer might have approved a

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11 Partnoy, supra note 6, at 711.
loan. And typically, only those with a healthy, or “prime,” profile were approved. That is, they had a steady work history, a large down payment, and no problems with their credit.

Thrifts were not only the dominant type of lender, but they also vertically dominated the residential mortgage market. They originated and serviced the mortgage typically holding it until it was paid off by the borrower. Now, technological, financial and legal innovations allow global finance companies to offer a range of mortgage products to a broad array of potential residential borrowers. As a result of these innovations, there has been an unbundling of the submarkets of the mortgage industry.

A mortgage now can be:

(1) originated by a mortgage broker who makes money only from origination;

(2) serviced by a mortgage banker who did not originate the loan and may have bought the right to service the loan from another mortgage banker;

(3) originated with the credit risk taken by one of the secondary market institutions, perhaps along with a mortgage insurance company; and

(4) funded by a mortgage-backed security (MBS) sold into the capital markets, and the MBS can be packaged as a bundle of derivative securities that separate interest rate and prepayment risk among different investors.

“Subprime” lending had been a significant and growing portion of this activity, reaching a peak of 20% of all originations in 2006 before the subprime market crashed. Subprime lending is the extension of credit to those with lower incomes, less wealth and riskier credit profiles than traditional, “prime” borrowers. A negative consequence of the change in the mortgage industry away from dominance by thrifts and toward relatively unregulated specialty firms has resulted in a variety of abuses in the subprime portion of the secondary market.

16 “Prime” mortgages share certain characteristics relating to their “type, duration, age, performance, and other specific criteria.” SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES § 9.04, at 9-21 (Ronald S. Borod ed., 2003) [hereinafter SECURITIZATION]. In order to determine the “necessary level of credit enhancements for financing,” rating agencies have developed a “list of the characteristics [that] a ‘prime pool’ of residential mortgages” would include. Id. at 9-21 to 9-22.


19 Van Order, supra note 15, at 233.

20 Id. at 233-34.


Subprime loans have higher interest rates than prime loans. Most subprime loans are originated by mortgage and consumer finance companies. Most subprime mortgages are used to refinance existing mortgages. The secondary market provides much of the liquidity and capacity for growth for the subprime market, with 75% of the subprime market being securitized in 2006.

Although mortgage default and delinquency rates began to rise in 2006, subprime lenders kept lending. Lenders made loans on very easy terms, at least for initial teaser periods, to borrowers with poor credit, low income and low assets. By 2007, the subprime market began to look disastrous as a wave of foreclosures quickly built and swept across the nation. The subprime boom had gone bust, taking the rest of the credit markets with it.

The subprime market is far less regulated and standardized than the prime market. As such, it presents an opportunity for those seeking to separate financially unsophisticated borrowers from the equity that they have in their homes. That is, it presents an opportunity to engage in predatory lending. Most predatory behavior takes place between a mortgage broker or mortgage banker and the borrower. But such thinly funded entities could not exist without funding from secondary market investors.

Predatory lending was also far more common in the “refinance” or “home equity” market than in the home purchase market because home equity borrowers have much more equity in their home than purchasers: the existing home equity gives predatory lenders a greater

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26 See Demanyyk & Van Hemert, supra note 21, at 32.
30 Id.
31 See Kurt Eggert, Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine, 35 CREIGHTON L. REV. 503, 511-13 (2002) (surveying a variety of definitions of predatory lending proposed by scholars and regulators).
33 Charles Schorin et al., Home Equity Loans, in THE HANDBOOK OF NONAGENCY MORTGAGE-BACKED SECURITIES 79, 83 (Frank J. Fabozzi et al. eds., 2d ed. 1999) [hereinafter HANDBOOK]. The term “home equity loan” covers many different products; it includes the traditional second lien mortgage, but “it more commonly today refers to first liens to borrowers with impaired credit histories’ and/or high debt-to-income ratios. Id. at 79. Home equity loans are typically used to “consolidate consumer debt in a lower, tax deductible form; reduce a homeowner’s monthly mortgage payment by extending the loan’s term; finance home improvements; monetize equity in the home; finance temporary liquidity needs, such as for education or medical expenses.” Id. at 84-85.
opportunity to pack a loan with excessive fees that might not be readily identifiable by the borrower who need not pay such increased out-of-pocket costs as a new homeowner would.\textsuperscript{34}

While there is no generally accepted comprehensive definition of predatory lending,\textsuperscript{35} the U.S. General Accounting Office (GAO) has cobbled together a good working description: it is “an umbrella term that is generally used to describe cases in which a broker or originating lender takes unfair advantage of a borrower, often through deception, fraud, or manipulation, to make a loan that contains terms that are disadvantageous to the borrower.”\textsuperscript{36} Accordingly, the GAO has defined predatory lending so as to include the following abusive practices and loan terms: (1) excessive fees; (2) excessive interest rates; (3) single-premium credit insurance; (4) lending without regard to ability to repay; (5) loan flipping; (6) fraud and deception; (7) prepayment penalties; and (8) balloon payments.\textsuperscript{37}

Predatory practices were present in much of the subprime market,\textsuperscript{38} where low- and moderate-income borrowers are concentrated.\textsuperscript{39} They are used to prey on unsophisticated homeowners, often those who are not integrated into the sphere of mainstream financial institutions such as banks and credit unions.\textsuperscript{40}

\begin{footnotes}
\item[34] See GAO, CONSUMER PROTECTION, supra note 24, at 20.
\item[35] See Azmy & Reiss, supra note 22, at 649 & nn.8-10 (discussing difficulties of comprehensively defining predatory lending).
\item[36] GAO, CONSUMER PROTECTION, supra note 24, at 18. Independent mortgage brokers typically sell loans that they originate to lenders for premiums ranging from 2-5%. FITCH IBCA, SUBPRIME HOME EQUITY: WHAT NEXT? 8 (Apr. 27, 1999).
\item[37] GAO, CONSUMER PROTECTION, supra note 23, at 18-19.
\item[38] See Azmy & Reiss, supra note 22, at 655-56 (discussing tactics of predatory lenders).
\item[40] See James H. Carr & Jenny Schuetz., Financial Services in Distressed Communities: Framing the Issue, Finding Solutions, in FINANCIAL SERVICES IN DISTRESSED COMMUNITIES: ISSUES AND ANSWERS 5, 6 (Fannie Mae Found. 2001).
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THE ROLE OF RATING AGENCIES IN RMBS SECURITIZATIONS

Real estate has always been considered good collateral because it needs little monitoring compared to other types of collateral, such as inventory, equipment, and other personal property.\(^{41}\) Yet, Wall Street investors had historically viewed mortgages as riskier investments than those assets because they were regulated by a patchwork of local and state laws.\(^{42}\) It is in large part because of this aversion that, prior to the 1970s, all real estate lending was local.\(^{43}\) Wall Street had ceded these local mortgage markets to local lenders for these reasons and because of the common belief that local lenders had more insight into local conditions.\(^{44}\) This state of affairs was to change with the birth of securitization and the growth of the secondary market.

The basic market requirements for securitization to thrive are standardized contracts; grading of risk via underwriting; historical statistics of performance of similar assets; standardization of servicer quality; reliable supply of credit enhancers; computers to handle the complexity of the necessary analyses; and, most relevant here, standardization of applicable laws.\(^{45}\)

The securitization of residential mortgages, in particular, is attractive to loan originators because these mortgages themselves are not easily traded in a secondary market.\(^{46}\) To be attractive to investors, each mortgage would require its own extensive and expensive evaluation and monitoring, as each typically has its own unique terms and risks. These characteristics would make residential mortgages, which are typically much smaller than commercial mortgages, of limited interest on secondary markets that rely on standardization to reduce the transaction costs associated with conveying assets from one party to another.\(^{47}\) Since the 1970s, investors have become quite comfortable investing in RMBS because the standardization of mortgage terms overcame many of these problems.\(^{48}\) The securitization of subprime mortgages, in particular, took off when RMBS were designed with characteristics that insulate them from

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\(^{42}\) See Kenneth G. Lore & Cameron L. Cowan, *Mortgage-Backed Securities* § 1.11 (2005). They were also viewed as riskier because mortgages were necessarily tied to local economies and a local recession or natural disaster could increase defaults and decrease the value of a pool of geographically concentrated mortgages. *Id.*


\(^{44}\) See *id.* at 4-6.


\(^{47}\) See Hill, *supra* note 46, at 1074.

\(^{48}\) Lore & Cowan, *supra* note 42, § 1.11. RMBS standardization in the 1970s was driven by secondary market purchasing standards set by government-sponsored enterprises. Carrozzo, *supra* note 46, at 797 (noting that Fannie Mae and Freddie Mac agreed that first order of business was development of standard mortgage).
the increased level of credit risk from the underlying subprime mortgage collateral pool.\textsuperscript{49} Nonstandardized state law relating to lending practices and foreclosures remained, however, a problem from the perspective of the financial services industry, including the rating agencies.

Nearly every securitization of mortgage-backed securities is rated by one, and often two, of the Big Three.\textsuperscript{50} The rating that the agency provides “is an assessment of the likelihood of timely payment on securities.”\textsuperscript{51} The function of the rating agencies is to reduce “the information asymmetry between issuers of securities and investors.”\textsuperscript{52}

The rating process is typically initiated by or on behalf of a securities issuer.\textsuperscript{53} The issuer then provides the rating agency with information regarding the issuer’s background, strategy, operations systems, historical performance data, and any other information that may be relevant.\textsuperscript{54} The issuer then typically meets with the rating agency to explain the proposed structure of the deal, the nature of the underlying assets, and the operations of the originator of the assets.\textsuperscript{55}

In order to evaluate the “loss potential” of nonagency mortgage pools (nonagency RMBS are those that are not issued by government sponsored entities (like Fannie Mae) nor by government agencies (like Ginnie Mae), and are also referred to as “private-label” RMBS),\textsuperscript{56} rating agencies need to evaluate four key aspects of a securitization transaction: (1) frequency of default; (2) severity of loss, given default; (3) pool characteristics; and (4) credit enhancement and the structure of the security.\textsuperscript{57}

In order to understand these four key aspects of the transaction, rating agencies conduct four types of analyses: (1) qualitative,\textsuperscript{58} (2) quantitative,\textsuperscript{59} (3) servicing,\textsuperscript{60} and (4) legal risk. The

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\item See Randall D. Luke & Louis F. Burke, United States, in SECURITIZATION 205, 221 (David G. Glennie et al. eds., 1998); G. Rodney Thompson & Peter Vaz, Dual Bond Ratings: A Test of the Certification Function of Rating Agencies, 25 Fin. Rev. 457, 457 (1990) (suggesting that typically two ratings significantly decrease the yield of a security, thereby increasing issuer’s return); Richard Cantor & Frank Packer, Multiple Ratings and Credit Standards: Differences of Opinion in the Credit Rating Industry 13 (Fed. Reserve Bank of N.Y., Research Paper No. 9527, 1995), available at http://www.newyork.org/research/staff_reports/research_papers/9527.pdf (arguing that additional ratings “are likely to be most desirable when the degree of uncertainty about a firm’s prospects is large and when the amount of funds to be Raised . . . is substantial”).
\item Schwarcz, supra note 10, at 15.
\item \textit{Id.} at 10.
\item \textit{Securitization, supra} note 16, § 9.01, at 9-3.
\item \textit{Id.} at 9-4.
\item \textit{Id.} at 9-3. While RMBS issuers typically solicit a rating, it is also standard practice for Moody’s and S&P to rate a security even where an issuer has not solicited (and paid for) a rating. Such ratings are based solely on public information. Butler & Rodgers, supra note 9, at 1 (reviewing Moody’s unsolicited ratings practices).
\item Lea, Sources of Funds, supra note 14, at 143.
\item Douglas L. Bendt et al., The Rating Agencies’ Approach, in HANDBOOK, supra note 33, at 191, 192.
\item “Qualitative analysis involves a review of those items that could result in a delay or failure of payment to the investors.”\textsuperscript{5} SECURITIZATION, supra at note 16, § 9.01, at 9-5. A primary concern here is the risk profile of the originator. The rating agency will also review the assets to be contributed into the collateral pool supporting the securities to be issued to determine, among other things, the predictability of their cash flow.\textit{Id.} at 9-6.
\item Quantitative analysis involves a review of the cash flow aspects of the transaction. This quantitative analysis is a key part of evaluating the collateral and determining the credit enhancement levels; it also is key to determining
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last type of analysis involves a review of the legal risks associated with the proposed transaction.\textsuperscript{61} These legal risks, also called “litigation risks,” include the risk that RMBS investors will be liable for violations of consumer protection laws by the originators of the mortgages in any given RMBS pool.\textsuperscript{62} One important type of litigation risk is whether a particular mortgage might be the subject of a lawsuit by the borrower and whether the ultimate holder of that mortgage, a securitized pool, might face liability as a result. As states began to enact predatory lending statutes in 1999,\textsuperscript{63} the rating agencies began to warn that such statutes may impose liability on owners of RMBS because they abrogated the holder in due course doctrine in certain cases, allowing for assignee liability for violations of such statutes.\textsuperscript{64}

Standard & Poor’s, Moody’s and Fitch each had its own approach to rating RMBS pools, but they all pay particular attention to the impact of consumer protection statutes on such pools. All of the Big Three review such statutes in order to determine whether they are (1) ambiguous; (2) allow for assignee liability; and (3) allow for unquantifiable damages.

The Big Three rate RMBS transactions by categorizing each state statute based upon the nature and degree of the assignee liability and damages provisions of its consumer protection law.\textsuperscript{65} Based on those evaluations, the Big Three decide whether the transaction can be rated and, if it can be rated, how much credit enhancement is necessary to achieve the desired rating.\textsuperscript{66} In states where there is both assignee liability and unquantifiable damages, various members of the Big Three have refused to rate various transactions containing mortgage loans from such jurisdictions.\textsuperscript{67} Thus the Big Three can effectively shut down the entire mortgage market of a state that passes strong predatory lending legislation.

\textsuperscript{61} See Kathleen C. Engel & Patricia A. McCoy, \textit{Predatory Lending: What Does Wall Street Have to Do with It?}, 15 \textit{Housing Pol’y Debate} 715, 723 (2004) (“Litigation risk is the possibility that borrowers will bring predatory lending claims or, when charged with nonpayment, raise predatory lending defenses against the trusts that own their loans.”).

\textsuperscript{62} North Carolina passed the first such law. N.C. GEN. STAT. § 24-1.1E (West 2006).

\textsuperscript{63} That is, the law allows for liability for a wrong perpetrated by the originator of a note to attach to an assignee of the note.


\textsuperscript{66} See generally Reiss, \textit{Subprime Standardization}, supra note \textit{Error! Bookmark not defined.Error! Bookmark not defined.}.
In 2004, New Jersey felt compelled to amend one of its premier consumer protection laws, the Home Ownership Security Act, even though it was enacted with broad partisan support only one year prior. The New Jersey law was designed to control a small number of unscrupulous brokers and lenders that originate extremely predatory loans. That same year, Georgia found itself doing the same thing—amending its own antipredatory lending law, the Fair Lending Act, that it had enacted mere months before.

These changes were driven in large part by the Big Three which had decided, in effect, that the laws had to change. And change they did. The Big Three, which promote themselves as no more than information-analyzing handmaidens to the invisible hand of the market, have taken it upon themselves to prevent states from regulating in their traditional spheres of authority: mortgage and consumer protection laws.

A result of the Big Three’ analysis has been that they have pushed states to standardize their consumer protection laws in a manner favorable to the Big Three and the RMBS industry. This standardization is not implemented with the needs of homeowners in mind. The evidence is clear that key players in the more than twenty other states that passed predatory lending legislation watched the interplay between the Big Three and these two state governments and modified their own bills to comply with the standardization that the Big Three imposed in those two cases.

At the same time, the Big Three claimed to sell only their objective judgment. In the words of a senior Moody’s employee, “it is widely recognized that a rating agency and its analysts should be independent—not subject to influence by interested market forces, such as financial intermediaries, governments, or issuers themselves.” But NRSRO ratings are, indeed, subject to biases that are not consistent with the public interest. This is also borne out by admissions of NRSRO employees, who often describe themselves as “advocate[s]” for investors.

The Big Three, whether driven by bias or merely by their own mandate to protect investors first and foremost, have come to hold a veto over state legislators who have attempted to stop predatory practices in their jurisdictions. This veto by unelected, unaccountable, private corporations is highly disturbing, to say the least.

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69 GA. CODE. ANN. §§ 7-6A-1 to -13 (West 2006).
70 Reiss, Subprime Standardization, supra note Error! Bookmark not defined.
71 See Engel & McCoy, supra note 66, at 1033 (describing battle over New Jersey and Georgia laws).
72 See, e.g., Diane Velasco, Others Have Tried Something Similar, ALBUQUERQUE J., Jan. 26, 2004, at 9 (noting that a spokesman for ACORN, which was instrumental in drafting New Mexico’s predatory lending legislation, stated that “[d]uring the last (legislative) session, we made sure that the [secondary market’s] problems with the Georgia law were not duplicated in the New Mexico law so we wouldn’t have the same difficulties”). For a thorough review of the legislation in those other states, see Baher Azmy, Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation, 57 FLA. L. REV. 295, 361-78 (2005).
73 GLOBAL CREDIT ANALYSIS, supra note 5, at 52.
74 Reiss, Subprime Standardization, supra note Error! Bookmark not defined.
75 See SECURITIZATION, supra note 16, § 9.01, at 9-3.
INCORPORATING CONSUMER PROTECTION IN RATING AGENCY REGULATION

While regulators have incorporated the ratings of the Big Three into their regulations, the Big Three themselves had not been regulated in any meaningful way before 2006. Thus, to the extent that they made systemic mistakes or demonstrated systemic biases, they were not held accountable to anyone. The business model of the Big Three has been found to be rife with problems: conflicts of interest, lack of transparency and lack of leadership being three of the main ones. But commentators have not identified the lack of a consumer protection agenda as a problem in the industry. This should change.

Their business model was based on serious conflicts of interest, conflicts that should and did undermine the trust that others had in them. The Big Three were paid by the issuers who needed their ratings and the profit motive drove the agencies to recklessly expand the market for their services by giving higher ratings than merited to many mortgage-backed securities. But commentators have not identified the lack of a consumer protection agenda as a problem in the industry. This should change.

The Big Three were also deficient when it came to transparency. They helped investment banks to structure the transactions that they were to rate to an extent not known to the rest of the world. They were integrally involved, for instance, in legitimizing subprime debt instruments like the collateralized debt obligation (CDO), securities that make up many of the toxic assets that are dragging down the balance sheets of so many financial firms. The rating agencies also claimed that their very sophisticated rating models were reliable enough to predict with great accuracy the risk of default and delayed payment. It turns out however, that “sophisticated” was just a way of saying complex and confusing.

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79 See Mason & Rosner, supra note 77, at 13-15 (noting that rating agencies were integral to determining “marketability” of CDOs).

80 See generally SECURITIZATION, supra note 16, § 9.01(2) (providing summary of how rating agencies claim to test MBS collateral under Great Depression worst-case scenario).

81 See Mason & Rosner, supra note 77, at 68 (“The ability to repackage [mortgage-backed securities] and call them [CDOs], with no fundamental change to their risk characteristics, in order to achieve an improved bond rating is the fundamental source of ratings arbitrage.”).
assumptions undergirding them—national housing prices will never go down on a year-to-year basis, for one.\textsuperscript{82}

Finally, the leadership at the rating agencies set an ethos that clearly distorted the mission of these firms.\textsuperscript{83} The rating agencies did not properly monitor their employees to ensure that they avoided even the most obvious conflicts of interest.\textsuperscript{84} There was a culture of understating risks in their ratings.\textsuperscript{85} They also failed to alert the public as to changes in rating models that impacted the value of their ratings.\textsuperscript{86} And they allowed “out of model adjustments” (that is, material exceptions) to their ratings of certain securities which again threw the value of the rating into question.\textsuperscript{87}

As a result, at the peak of the boom, they collected fees and did insufficient work to earn them. As with all recent financial crises, there is the obligatory “smoking gun” internal email: one rating agency employee wrote to another that a transaction “could be structured by cows and we would rate it.”\textsuperscript{88} Understaffing appeared rampant at the agencies. Again, an employee emails another a harmful admission: “staffing issues, of course, make it difficult to deliver the value that justify our fees.”\textsuperscript{89}

The Credit Rating Agency Reform Act of 2006 (the “NRSRO Act” or “the Act”) was enacted, in part, to respond to the widespread criticism of the Big Three stemming from earlier crises. In particular, it was intended to “improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.”\textsuperscript{90} While the NRSRO does appear to be a step in the right direction as far as investor protection is concerned, it comes up short with regard to consumer protection.

\textsuperscript{82} See Peter L. Bernstein, Op-Ed., \textit{What Happens If We’re Wrong?}, N.Y. TIMES, June 22, 2008, at BU5; see also \textsc{Congressional Oversight Panel, Special Report on Regulatory Reform: Modernizing the American Financial Regulatory System} 42 (2009) [hereinafter COP: Special Report] (“Many of the models involved excessively rosy assumptions about the quality of the underlying mortgages, ignoring the fact that these mortgages (especially the subprime mortgages) were far riskier than ever before and were in fact becoming steadily riskier year by year.”)

\textsuperscript{83} Aaron Lucchetti, \textit{McGraw Scion Grapples With S&P’s Woes—Chairman Helped Set Tone in Profit Push As Ratings Firms Feasted on New Products}, WALL ST. J., Aug. 2, 2008, at B1 (quoting Harold McGraw III, CEO of Standard & Poor’s parent corporation, McGraw-Hill, “[w]hat we do is provide access to the capital market. . . . If the market wants those kinds of products and the institutional investors want those products, then we move with the market and we’re going to rate whatever.”). \textit{See generally U.S. SEC. & EXCH. COMM’N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES} 23-32 (2008) [hereinafter SEC SUMMARY REPORT] (reviewing conflicts of interest at rating agencies).

\textsuperscript{84} SEC \textsc{Summary Report, supra} note 83, at 23-27.

\textsuperscript{85} One ratings agency manager wrote to another that ratings agencies were continuing to create an “even bigger monster— the CDO market. Let’s hope we are all wealthy and retired by the time this house of cards falters.”\textsuperscript{86} Id. at 12, n.8.

\textsuperscript{86} Id. at 13-14.

\textsuperscript{87} Id. at 14.

\textsuperscript{88} Id. at 12.

\textsuperscript{89} Id.

The NRSRO Act granted the SEC additional “statutory authority to oversee the credit rating industry.” Pursuant to the Act, the SEC issued implementing regulations. The main thrust of the Act and the regulations issued pursuant to it was to set up a process by which a credit rating agency could apply to receive NRSRO status, thereby opening up the industry to competition.

It appears that the NRSRO Act is having some success in this regard as the number of NRSROs has increased from 5 to 10 since the Act was enacted. Some argue that increased competition from other rating agencies will increase the accuracy of the Big Three’s pronouncements. It is unclear, however, whether the new NRSROs will actually present much actual competition to the Big Three. The Act also identified various conflicts of interest that rating agencies might face and banned certain of them. But nothing in the NRSRO Act will address the systemic bias that the Big Three have demonstrated toward state consumer protection initiatives.

As the SEC and Congress indicate the need for further regulation, it is critical that any solution encompass a greater good than just the investor protection embodied by the NRSRO Act and its attendant regulations. One proposal to increase public scrutiny of the NRSROs would use the process for broadcast license renewals as a model for NRSROs. Under this proposal, an NRSRO’s periodic review would include an opportunity for public comment. If NRSROs demonstrated systemic bias, such as system would ensure that that bias was publicly aired. This proposal rests on the assumption that NRSRO status will not be threatened if there are public complaints, but rather that the NRSRO will (like broadcasters) seek to avoid public shaming for

91 Id.
95 Indeed, past experience indicates that the Big Three will gobble up any of the new NRSROs that promise to offer real competition. See Fitzpatrick & Sagers, supra note 77, at n.145.
98 Indeed, because the Act forbids the SEC and the states from regulating “the procedures and methodologies by which any [NRSRO] determines credit ratings,” the Act might need to be amended before a consumer friendly solution could be implemented. 15 U.S.C. § 78o-7(c)(2).
acting inappropriately. Another reform proposal is to empower the SEC to issue a “Writ of Review” to a rating agency to suggest that the agency reconsider a rating. This proposal could be expanded to grant the SEC the power to suggest that a rating agency reconsider an underwriting standard that negatively impacts issues of public concern. While the former proposal is no panacea, and the latter would probably only make sense as part of an overhaul of the entire regulatory scheme for NRSROs, both suggest pathways for giving the public access to air and correct the structural biases of the industry.

CONCLUSION

The bust of the subprime market in the mid-2000s led to the global financial crisis of the late 2000s. This crisis has virtually ended subprime lending for the current credit cycle. Most subprime lenders have gone out of business or merged with other financial institutions. The remaining financial institutions have tightened their underwriting so that they no longer lend to those with subprime credit profiles. It is likely, however, that subprime lending will return in some form once the credit cycle turns.

Rating agencies were historically considered to be mere commentators on the comings and goings of the players in our free market economy while ensuring that objective information

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100 Id.
101 Francis A. Bottini, Jr., Comment, An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies, 30 SAN DIEGO L. REV. 579, 613 (1993). Some rating agencies allow issuers to informally appeal a rating prior to it being released to the public. Rhodes, supra note 2, at 314.
102 The state attorneys general would be appropriate channels for petitioning the SEC on behalf of the public.
103 The current crisis has unleashed many more reform proposals, ranging from dramatically increasing government involvement to increasing private competition to tinkering with the incentives that rating agencies respond to. On the one extreme, some have suggested that the federal government take over the job of providing ratings. Fitzpatrick, supra note 77, at 39 n.191 and accompanying text. This approach is too extreme a remedy, however, for the problem of the Big Three’s biases against the public interest. A slightly less radical proposal is to use public funds to align the NRSROs’ profit motive with the public good. See Lynch, supra note 77 (suggesting the creation of a public credit rating agency to exist in parallel with private NRSROs, using taxpayer dollars to make the public a paying subscriber for rating information or providing tax incentives to reward increased accuracy in ratings). A more modest example of this general approach is that taken by the Congressional Oversight Panel, which has proposed the creation of a Credit Rating Review Board that would “sign off on any rating before it took on regulatory significance.” COP: SPECIAL REPORT, supra note 82, at 44.

As to increasing private competition, former SEC Commissioner Joseph Grundfest has proposed that investors form their own “shadow” rating agencies to issue “shadow” ratings to make NRSROs more accountable for the quality of their ratings. Panelists Call for More Competition, Accountability, Transparency in Ratings, 41 Sec. Reg. & L. Rep. (BNA) 693 (Apr. 20, 2009).

And as to tinkering with the incentives that rating agencies respond to, F. Philip, Hosp V has proposed implementing a “handicapping system” to “create penalties for [rating agencies] that inflate their ratings for a given security….” Problems and Reforms in Mortgage-Backed Securities: Handicapping the Credit Rating Agencies, 79 MISS. L.J. (forthcoming 2010) (manuscript at 37, available at http://ssrn.com/abstract=1362336). And John Patrick Hunt has proposed that rating agencies “be required to disgorge profits derived from issuing ratings on” certain novel financial products under particular circumstances when the ratings are inaccurate. Credit Rating Agencies and the “Worldwide Credit Crisis:” The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement. 2009 COLUM. BUS. L. REV. 109, at 181.

Whatever their merits, such approaches on their own are unlikely to exert sufficient influence over the rating agency industry to curb its systemic biases against the public interest.
This view, however, fails to take into account the privileged regulatory status that the SEC and other government regulators have granted to the Big Three. It also fails to take into account the role that the Big Three have in structuring RMBS transactions. They now have a gatekeeper function in the secondary market, and they can allow their bias in favor of a growing secondary market to influence decisions that also affect matters of great concern to the public. The SEC should remedy this state of affairs by formally reviewing rating agency policies to determine whether they are improperly vetoing state consumer protection initiatives.

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104 Many commentators see this rating agency role as the dominant one. See Partnoy, supra note 6, at 633 n.62 (cataloging articles arguing that ratings have informational content). Such articles ignore or discount the obvious privileged regulatory status of the NRSROs as well as the consistent finance literature that argues that “credit ratings are of scant informational value.” Frank Partnoy, *The Paradox of Credit Ratings*, in *RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM* 65 (Richard M. Levich et al. eds., 2002)