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# Problems and Reforms in Mortgage-Backed Securities: Handicapping the Credit Rating Agencies

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# **PROBLEMS AND REFORMS IN MORTGAGE- BACKED SECURITIES: HANDICAPPING THE CREDIT RATING AGENCIES**

*F. Phillip Hosp*\*

|  |    |
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| Introduction.....  | 2  |
| I. General Background.....                                 | 4  |
| II. Credit Rating Agencies as Gatekeepers.....             | 6  |
| A. Case Study: Lehman Brothers Inc. ....                   | 7  |
| B. Reputational Gatekeeper .....                           | 9  |
| C. Regulatory Gatekeeper .....                             | 11 |
| D. Credit Ratings in Mortgage Securitization.....          | 13 |
| III. Problems in the Credit Rating Industry .....          | 17 |
| A. SEC Examination of the Credit Rating Agencies.....      | 18 |
| B. Regulatory Licenses.....                                | 20 |
| C. Monopolistic Market.....                                | 24 |
| IV. Recent Regulation .....                                | 26 |
| V. Proposal: Handicapping the Credit Rating Agencies ..... | 28 |
| A. Options to Reform the Regulatory Structure .....        | 29 |
| B. Effects of Handicapping.....                            | 34 |
| Conclusion.....  | 36 |

*“The credit rating agencies occupy a special place in our financial markets. Millions of investors rely on them for independent, objective assessments. The rating agencies broke this bond of trust and federal regulators ignored the warnings signs and did nothing to protect the public.”<sup>1</sup>*

## INTRODUCTION

Here we go again – another financial mess with credit rating agencies (“CRAs”) on the chopping block. This is nothing new. Over the last four decades, CRAs have been associated with several major financial disasters: the bankruptcy of Penn Central Transportation Company in 1970, the bankruptcy of Orange County in 1994, the Asian financial crisis in the late 1990’s, the bankruptcy of Enron in 2001, and the bankruptcy of WorldCom in 2002.<sup>2</sup>

The United States is currently facing a financial disaster of its own, precipitated largely by the deterioration of asset-backed securities, particularly mortgage-backed securities. The process of securitizing mortgages is complex and involves many players within the financial market. The financial system currently counts on these players to perform their own due diligence on the assets that back the investments they buy – i.e., the mortgages. However, the current economic crisis has shown that, instead of conducting their own due diligence, market participants relied on CRAs to assess market risks.<sup>3</sup> This is a primary reason that the economy is suffering from a lack of confidence in the “future prospects of . . . mortgage-backed securities and the methodologies the credit rating agencies

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<sup>1</sup> *Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. on Oversight and Gov’t Reform*, 110th Cong. 1–4 (2008) [hereinafter *Credit Rating Agencies and the Financial Crisis*] (opening statement of Rep. Henry Waxman, Chairman, House Comm. on Oversight and Gov’t Reform).

<sup>2</sup> JOHN C. COFFEE JR., *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* 297 (2006) [hereinafter COFFEE, *GATEKEEPERS*].

<sup>3</sup> On February 8, 2009, Lloyd Blankfein, CEO of Goldman Sachs, wrote an article in the *Financial Times* where he commented on seven lessons that he learned from the current economic crisis. Specifically, he noted that “too many financial institutions and investors simply outsourced their risk management. Rather than undertake their own analysis, they relied on the rating agencies to do the essential work of risk analysis for them.” Lloyd Blankfein, *Do not destroy the essential catalyst of risk*, *FIN. TIMES*, Feb. 8, 2009, at 7.

used to rate these securities.”<sup>4</sup>

Recently, former Treasury Secretary John Snow testified before Congress that the U.S. needs one strong regulator to oversee the financial firms and fix the current “fragmented approach” to regulating the market.<sup>5</sup> Although Mr. Snow’s point addresses the problem with the financial market’s regulatory structure, the question still remains: what entity is best positioned in the market to act as a strong regulator? This article answers that question by advancing the argument that CRAs can be a major part of the solution because they are uniquely positioned as financial gatekeepers to regulate the securitization of mortgages and other asset-backed securities.

Nevertheless, although the government has positioned CRAs in the financial market to provide necessary checks and balances, recent problems have surfaced (e.g., knowingly issuing inaccurate ratings) proving that CRAs are unreliable in this regulatory capacity. However, these problems cannot be addressed by punishing individual CRAs. Instead, policymakers must address the incentives – or lack thereof – within the industry generally. As this article explains, the current regulatory structure lacks appropriate incentives that force CRAs to accurately measure and effectively communicate the risks of mortgage-backed securities. Consequently, by relying on faulty credit ratings, many investors purchased precarious investments that are currently worthless in today’s financial markets.

In light of the CRAs’ important role in the financial markets and the problems that currently plague it, this article proposes to reform the credit rating industry. Specifically, it proposes to assign handicaps to each rating agency that will reduce or enhance the agency’s own rating depending on its past performance in rating similar types of securities. Like the ratings issued by CRAs on securities, these handicaps will be an easily understood symbol issued by the government. But, instead of predicting whether a company will default on its financial obligations, CRA handicaps will predict whether an agency’s ratings will be accurate. Handicaps will also be kept current as the agency’s past performance data is updated.

Consequently, CRAs will have incentives to issue accurate ratings and investors will have access to information that easily communicates the

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<sup>4</sup> *Recent Events in the Credit and Mortgage Markets and Possible Implications for U.S. Consumers and the Global Economy: Hearing Before the H. Comm. on the Fin. Affairs*, 110th Cong. 3 (2007) (testimony of Robert K. Steele, Under Secretary for Domestic Finance, United States Department of the Treasury); KENNETH G. LORE & CAMERON L. COWAN, *MORTGAGE-BACKED SECURITIES* § 2:12 (2008) (discussing toxicity of mortgage-backed securities).

<sup>5</sup> Scott Lanman & Steve Matthews, *Greenspan Concedes to ‘Flaw’ in His Market Ideology* (Update2), Bloomberg.com, Oct. 28, 2008, [www.bloomberg.com/apps/news?pid=20601087&sid=ah5qh9Up4rlg&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=ah5qh9Up4rlg&refer=home).

trustworthiness of a credit rating. This will restore confidence in credit ratings, and will ensure that CRAs evaluate market risks independently, competitively, and honestly. This information will also help investors regain confidence in complex investments like mortgage-backed securities, which will restore their trading value. As a result, our markets will stay innovative and become more transparent. Furthermore, our government will not have to assume excessive regulatory costs that will inhibit the government's ability to properly regulate other areas of the financial markets.

The following sections address the proposal in more detail. In all, this article has five sections. Section I provides a brief history of how CRAs came to be. It also discusses the general role of CRAs in the debt securities market and explains what each credit rating means. Section II discusses the emergence of CRAs as government sanctioned gatekeepers of the financial system. It discusses the two types of gatekeepers – regulatory and reputational – and why both types are essential regulators of the financial system.

That leads to section III which addresses why CRAs currently lack the necessary incentives to be effective regulators. The section starts off by discussing the verifiable consequences caused by the broken credit rating industry, and the two problems – i.e., regulatory licenses and CRA monopolies – that broke the industry.

Section IV discusses the Credit Rating Agency Reform Act of 2006, which Congress passed to improve the transparency and competition within the credit rating industry, and why that regulation – along with the SEC's current proposals – will have no meaningful impact upon the CRAs.

Finally, in section V, this article proposes to handicap the CRAs and discusses how the handicapping process will improve the current regulatory structure guiding the credit rating industry. The section further discusses (1) how handicaps will increase transparency and competition within the industry, which will provide incentives for CRAs to regain their reputational capital within the financial markets; and (2) why restoring their reputational capital will help restore investors' confidence in mortgage-backed securities.

## I. GENERAL BACKGROUND

Discussing the CRAs' role in mortgage-backed securities is a complicated concept. As an introductory matter, it is helpful to start by explaining the general role of CRAs in the debt securities market.

Generally, a company or other entity issues a debt instrument to raise

capital or fund future business transactions. Debt instruments can take many forms – e.g., a note, bond, certificate, mortgage, or lease – and are usually secured by the issuer’s assets.<sup>6</sup> In issuing a debt instrument, the company (referred to as the “issuer”) contractually agrees to pay the instrument holder principal and interest payments in addition to any transaction-specific payments.<sup>7</sup> In turn, the debt holder pays the issuer an amount of money determined by the value of those payments.<sup>8</sup>

Oftentimes, securities law requires that issuers obtain official verification by independent regulatory entities that they can fulfill the payment obligations under an agreement with a debt holder.<sup>9</sup> CRAs perform that task by assessing both the issuer’s financial viability and the risks associated with the debt obligations.<sup>10</sup> After assessing the two, the rating agency issues a rating on the security. In issuing their ratings, CRAs use a set of symbols that represent the likelihood that the borrower will default on its obligation to repay the debt.

The two largest rating agencies are Moody’s and Standard and Poor’s (“S&P”). Both agencies issue ratings using a set of letters to represent the risk associated with the rated debt.<sup>11</sup> As Chart 1.1 illustrates, “Aaa” and “AAA” are the best ratings issued by Moody’s and S&P, respectively. Accordingly, an issuer has the lowest risk of default (i.e., highest probability of repaying debt obligation) if it is rated either Aaa or AAA and vice-versa.

The current regulatory structure has grouped credit ratings into two levels of quality: investment grade and speculative grade (commonly referred to as “junk”).<sup>12</sup> Generally, investment grade bonds are rated BBB or higher and are considered by the rating agency as likely to meet payment

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<sup>6</sup> WILLIAM A. KLEIN & JOHN C. COFFEE, *BUSINESS ORGANIZATION AND LEGAL FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 7-8, 251-60 (10th ed. 2007); see BLACK’S LAW DICTIONARY 433 (8th ed. 2004) (defining a “debt-instrument” as “[a] written promise to repay a debt, such as a promissory note, bill, bond, or commercial paper.”).

<sup>7</sup> KLEIN & COFFEE, *supra* note 6, at 311.

<sup>8</sup> *Id.*

<sup>9</sup> See Richard E. Mendales, *The New Junkyard of Corporate Finance: The Treatment of Junk Bonds In Bankruptcy*, 69 WASH. U. L.Q. 1137, 1143-45 (1991) (discussing credit ratings issued on junk bonds).

<sup>10</sup> *Id.*

<sup>11</sup> See Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 46-50 (2004) [hereinafter Hill, *Regulating the Rating Agencies*] (discussing the history of the rating agencies).

<sup>12</sup> *Id.*

and performance obligations.<sup>13</sup> On the other hand, junk bonds typically have a rating lower than BBB and a higher risk of default.<sup>14</sup> These bonds usually pay higher yields than investment quality bonds to compensate investors for this increased risk of default.<sup>15</sup>

**CHART 1.1**<sup>16</sup>

| <u><b>Moody's</b></u> | <u><b>S&amp;P</b></u> | <u><b>Grade</b></u> | <u><b>Risk</b></u> |
|-----------------------|-----------------------|---------------------|--------------------|
| Aaa                   | AAA                   | Investment          | Lowest             |
| Aa                    | AA                    | Investment          | Low                |
| A                     | A                     | Investment          | Low                |
| Baa                   | BBB                   | Investment          | Medium             |
| Ba, B                 | BB, B                 | Junk                | High               |
| Caa, Ca, C            | CCC, CC, C            | Junk                | High               |
| C                     | D                     | Junk                | In default         |

## II. CREDIT RATING AGENCIES AS GATEKEEPERS

Generally, the financial market is kept in check by a group of professionals known as “gatekeepers” who ensure the transparency and integrity of financial information.<sup>17</sup> Although each profession provides different services, the gatekeeper concept generally applies to auditors, CRAs, securities analysts, and attorneys.<sup>18</sup> Their services include: verifying a company’s financial statements (auditor), evaluating the creditworthiness of a security or a company (CRA), assessing a company’s potential investments (securities analyst), and assessing the legality of a corporation’s

<sup>13</sup> *Id.*; KENNETH G. LORE & CAMERON L. COWAN, MORTGAGE-BACKED SECURITIES § 9:1 (2008).

<sup>14</sup> Hill, *Regulating the Rating Agencies*, *supra* note 11, at 46-50.

<sup>15</sup> *Id.*

<sup>16</sup> Amy K. Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?* 20 SETON HALL LEGIS. J. 293, n.41 (1996).

<sup>17</sup> See COFFEE, GATEKEEPERS, *supra* note 2 (discussing the role of gatekeepers in financial markets); Frank Partnoy, *How and Why Credit Rating Agencies are Not Like Other Gatekeepers*, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59 (Yasuyuki Fuchita & Robert E. Litan eds., 2006) [hereinafter Partnoy, *Not Like Other Gatekeepers*].

<sup>18</sup> Partnoy, *Not Like Other Gatekeepers*, *supra* note 17.

business decisions (attorney).<sup>19</sup>

Gatekeepers perform this function by providing services in which they verify or certify the accuracy of information that is communicated to investors and government regulators.<sup>20</sup> This is critical for U.S. financial system to function properly. By ensuring that accurate information is disclosed to investors and the government, gatekeepers maintain an efficient market, which incorporates information into the price or demand of a traded security.<sup>21</sup> This theoretically blocks bad actors and bad deals from profiting in the financial markets.

#### *A. Case Study: Lehman Brothers Inc.*

Dale George, a former Washington Mutual senior risk manager, correctly described the gatekeepers' role by comparing them to "brakes that prevent the car from going over a cliff."<sup>22</sup> Lehman Brothers is an example of a company that went "over a cliff" after its executives ignored warnings communicated to them by the company's own analysts.

Lehman Brothers was the fourth-largest U.S. investment bank, and considered by some to be the most prestigious and well-respected financial institutions on Wall Street. On September 15, 2008, the company filed for Chapter 11 bankruptcy protection – the largest filing of its kind in U.S. history – shocking many in the financial industry.<sup>23</sup> The effects of Lehman's failure were felt far beyond the company and its shareholders as panic spread throughout the entire U.S. economy. Because of Lehman's failure, many started to question the financial viability of other financial institutions like Morgan Stanley and Merrill Lynch. The New York Times dubbed September 15, 2008 as one of the most "dramatic days in Wall

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<sup>19</sup> *Id.*; see also Christopher Cox, Chairman, SEC, Address to the 2007 Corporate Counsel Institute (March 8, 2007) (discussing the lawyer in the role of a gatekeeper), available at <http://sec.gov/news/speech/2007/spch030807cc.htm>.

<sup>20</sup> COFFEE, GATEKEEPERS, *supra* note 2, at 24-70.

<sup>21</sup> STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 33 (2d ed. 2008).

<sup>22</sup> Pierre Thomas & Lauren Pearle, *Exclusive: WaMu Insiders Claim Execs Ignored Warnings, Encouraged Reckless Lending*, ABC NEWS ONLINE, Oct. 13, 2008, <http://www.abcnews.go.com/TheLaw/Story?id=6021608&page=3> ("We are the brakes that prevent the company from going over the cliff").

<sup>23</sup> Steve Fishman, *Burning Down His House*, N.Y. MAGAZINE, Dec. 8, 2008, at 28; Susanne Craig, *AIG, Lehman Shock Hits the World Markets*, Wall St. J., Sept. 16, 2008, at A1 (discussing the size of Lehman's bankruptcy).



Street's history."<sup>24</sup> The anxiety quickly caused sources of commercial paper to disappear and costs of borrowing to skyrocket.<sup>25</sup> This ripple effect eventually paralyzed the entire financial system after banks stopped lending money due to concerns about their capital reserves.<sup>26</sup>

After the collateral damage of the Lehman bankruptcy became apparent, the Congressional House Committee on Oversight and Government Reform summoned Richard Fuld, Lehman's CEO, to testify in what was the first of many hearings intended to identify the problems that affected the financial system.<sup>27</sup> In the hearing, the Committee ultimately determined that, in Lehman's case, executives pursued a business strategy that took on too much leverage despite internal memos at Lehman warning against it.<sup>28</sup>

In his own defense, Mr. Fuld claimed that the company was brought down by events outside his control.<sup>29</sup> He cited various factors like short selling and mark-to-market accounting rules.<sup>30</sup> However, the Committee dismissed his excuses citing Lehman's internal documents from employees acting in gatekeeper capacities warning management about the company's over-leveraged position.<sup>31</sup> The Committee also cited Lehman documents revealing that company executives "saw warning signs" but "did not move early/fast enough," and that the company lacked "discipline about capital allocation."<sup>32</sup>

In the end, these documents and Lehman's demise demonstrate why gatekeepers are an important check and balance on a corporation's business decisions. If their warnings are ignored, significant consequences are likely to result that can affect the financial strength of the company or, in

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<sup>24</sup> Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall Street*, N.Y. TIMES, Sept. 15, 2008, at A1.

<sup>25</sup> Chairman Waxman noted that Lehman's bankruptcy caused a snowball effect throughout the financial markets. After its filing, investors worried about the stability of the financial markets causing them to invest in Treasury Bills. In turn, banks became worried about liquidity and started to hoard cash. In all, these events caused the credit markets to freeze. See *The Causes and Effects of the Lehman Brothers Bankruptcy: Hearing Before the Comm. on Oversight and Gov't Reform*, 110th Cong. 1 (2008) (opening statement of Rep. Henry Waxman, Chairman, House Comm. on Oversight and Gov't Reform).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

Lehman's case, the entire American financial system.

So, besides the example of Lehman Brothers, why should executives head warnings from its own gatekeepers? Moreover, why should policymakers and participants in the financial market trust gatekeepers to regulate the market? Generally, gatekeepers are reliable for two reasons. First, gatekeepers often have reputational incentives to act as a neutral party in reporting or certifying investment information.<sup>33</sup> Second, some have an obligation, via governmental regulations or corporate governance procedures, to verify the validity of corporate disclosures and investments, and the legality of a corporation's business decisions.<sup>34</sup>

In the following subsections, this article demonstrates why CRAs are uniquely positioned – compared to other gatekeepers – to regulate financial instruments such as mortgage-backed securities. In sections II(A) and II(B), this article discusses the evolution of the credit rating industry and its current role in our financial system. Section II(C) focuses specifically on mortgage-backed securities by discussing the CRAs' role in the securitization process.

### *B. Reputational Gatekeeper*

A reputational gatekeeper is “a repeat player who has over time developed ‘reputational capital’<sup>35</sup> by verifying only [information] that it believes [to be] accurate.”<sup>36</sup> After a reputational gatekeeper establishes credibility within the financial community, its opinion on a financial representation, whether it regards the value of an investment or the stability of a company, makes the information in that financial representation more believable.<sup>37</sup> In other words, because the gatekeeper pledged its reputation in verifying the information, people are more willing to rely on that information in making important business decisions.

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<sup>33</sup> *Id.*

<sup>34</sup> See Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 622 (1999) [hereinafter Partnoy, *The Siskel and Ebert of Financial Markets*] (discussing regulations that require credit ratings).

<sup>35</sup> Reputation capital is the quantitative measure of an entity's reputation for integrity and fairness within a particular financial community. KEVIN T. JACKSON, BUILDING REPUTATIONAL CAPITAL: STRATEGIES FOR INTEGRITY AND FAIR PLAY THAT IMPROVE THE BOTTOM LINE 63-76 (2004).

<sup>36</sup> Merritt B. Fox, *Gatekeeper Failures: Why Important, What To Do*, 106 MICH. L. REV. 1089, 1091 (2008) (summarizing Professor Coffee's reputational gatekeeper argument).

<sup>37</sup> *Id.*

As shown below, because current regulations require that market participants use CRAs, reputational capital has become almost irrelevant for CRAs to make a profit. However, in the late nineteenth century – before these regulations existed – this was not the case. In those days, CRAs relied on their reputations as credible purveyors of business information to sell their rating publications to business people. These publications consisted of the agencies' opinions on the creditworthiness of different businesses or types of debt.<sup>38</sup> Because CRAs initially relied on subscription fees paid by investors, their profitability and success relied on their reputation as non-biased conveyers of accurate information.<sup>39</sup>

The demand for this information started after the collapse of the financial sector in 1837 when many banks stopped lending money to businesses.<sup>40</sup> Although there are a variety of explanations for this lending freeze, the primary reason behind this is that banks lacked information to determine whether a particular business could repay a debt during those tough financial times.<sup>41</sup> In recognizing a need for this information, a silk merchant named Lewis Tappan decided to sell his detailed business records to other business people. These records contained information detailing the creditworthiness of his clients.<sup>42</sup> In 1841, Tappan expanded this idea by creating the Mercantile Agency, which became the first companies to provide a venue for merchants to exchange reports on the standing of their clients.<sup>43</sup>

Starting in 1890, Henry Poor and John Moody followed Tappan's lead by establishing Poor's Publishing Company and Moody's Rating Agency, respectively.<sup>44</sup> By 1916, both of these companies developed simple rating methodologies (shown in Chart 1.1) used to rate stocks and corporate debt.<sup>45</sup> Businesses and investors relied heavily on this information to decide which company deserved their money. In fact, these entities relied so much on credit ratings that some commentators describe the 1920s as a time when

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<sup>38</sup> Richard Cantor & Frank Packer, *The Credit Rating Industry*, 19 FED. RESERVE BANK OF N.Y. Q. 1 (1994).

<sup>39</sup> Partnoy, *The Siskel and Ebert of Financial Markets*, *supra* note 34, at 640 (“During this time, ratings were financed entirely by subscription fees paid by investors, and the rating agencies competed to acquire their respective reputations for independence, integrity, and reliability.”).

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

CRAs reached their pinnacle as reputational gatekeepers.<sup>46</sup>

### C. Regulatory Gatekeeper

CRAs are also considered “regulatory gatekeepers.” A regulatory gatekeeper is an entity whose verification services are mandated by government rules and regulations.<sup>47</sup> In 1931, the Comptroller of the Currency issued the first rule incorporating CRAs into the U.S. financial system. The purpose of this rule was to strengthen the viability of national banks after the 1929 stock market crash. The rule required that banks holding bonds rated lower than BBB (or its equivalent) write-off a fractional portion of those investments’ values.<sup>48</sup> This encouraged the banking industry to make safer investments because fractional write-offs affected their profit margins. Consequently, credit ratings became a significant consideration for banks investing in corporate debt.<sup>49</sup>

The next significant change to the regulatory structure came in 1975 when the SEC adopted the Net Capital Rule.<sup>50</sup> Through this rule, the SEC required that broker-dealers maintain a requisite amount of capital in reserve to cover the risks associated with their investment portfolios.<sup>51</sup> The Net Capital Rule used credit ratings to determine the risk of these investments.<sup>52</sup> Accordingly, if a broker-dealer has investments that the rating agency considers more likely to default, the SEC requires the broker-dealer to maintain more cash on hand to cover the risks associated with those investments.<sup>53</sup>

As Professor Frank Partnoy of The University of San Diego notes, CRAs have been incorporated into over 100 regulatory decisions, releases, and rules since 1973.<sup>54</sup> Some of these regulations directly affect buyers of

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<sup>46</sup> See *Id.* at 646 (describing the 1920s and 1930s as the CRAs’ “heyday”).

<sup>47</sup> See *Id.* at 681-83 (describing regulations that incorporating CRAs into the U.S. financial system).

<sup>48</sup> NEIL HERMAN JACOBY & RAYMOND JOSEPH SAULNIER, *BUSINESS FINANCE AND BANKING* 212 (1947).

<sup>49</sup> See Partnoy, *The Siskel and Ebert of Financial Markets*, *supra* note 34, at 686-90 (providing a more detailed historical account of the 1930’s regulations).

<sup>50</sup> 17 CFR § 240.15c3-1 (2008); COFFEE, *GATEKEEPERS*, *supra* note 2, at 289.

<sup>51</sup> COFFEE, *GATEKEEPERS*, *supra* note 2, at 289; The term “broker-dealer” means “[a] brokerage firm that engages in the business of trading securities for its own account (i.e., as a principal) before selling them to customers.” BLACK’S LAW DICTIONARY 205 (8th ed. 2004).

<sup>52</sup> Rhodes, *supra* note 16, at 334-36.

<sup>53</sup> JACOBY & SAULNIER, *supra* note 48.

<sup>54</sup> Partnoy, *The Siskel and Ebert of Financial Markets*, *supra* note 34, at 691.

mortgage-backed securities by restricting the kinds of investments they can buy. For example, the government mandates that institutional investors like pension funds, money market funds, insurance companies, and banks hold only securities that are rated non-investment grade.<sup>55</sup> Because institutional investors constitute the majority of the investors who buy mortgage-backed securities, CRAs are essential in “monitor[ing] and evaluat[ing] the performance and value of these securities.”<sup>56</sup>

The government also regulates the sale of mortgage-backed securities. For example, in some instances, the Securities Act of 1933 requires an issuer to register a mortgage-backed security with the SEC before it can sell the security in the U.S.<sup>57</sup> The purpose of this registration is to give investors important information concerning the securities being offered.<sup>58</sup> This protects them from misrepresentations and other fraudulent conduct in the sale of a security.

Normally, the registration process requires a significant amount of time and effort on behalf of the issuer. First, the issuer registers its security by filing a registration statement with the SEC.<sup>59</sup> Following its registration, the issuer waits for the SEC’s staff to review the statement and respond with their comments. However, SEC regulations provide a timesaving shelf registration exception for investment grade securities.<sup>60</sup> Under this exception, an issuer can offer a mortgage-backed security “off the shelf,” which means that the regulations permit the issuer to register the security prior to planning any specific offering.<sup>61</sup> Subsequently, the issuer can offer

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<sup>55</sup> See *Id.* at n.230 (discussing limits imposed on an institutional investor in buying or holding non-investment grade securities).

<sup>56</sup> Aaron Unterman, *Exporting Risk: Global Implication of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 90-91 (2008) (discussing the large amount of capital that institutional investors have invested in securitization markets). See COFFEE, GATEKEEPERS, *supra* note 2, at 290 (discussing the different industries that utilize CRAs); Partnoy, *The Siskel and Ebert of Financial Markets*, *supra* note 34, at 691; Edward F. Green & Linda C. Quinn, *Building on International Convergence of the Global Markets: A Model for Securities Law Reform*, 1281 PLI/Corp 11 at 7 (2001).

<sup>57</sup> Securities Act of 1933, ch. 38, title I, §1, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §77e (1994)); Unterman, *supra* note 56, at 92 (stating that disclosure requirements do not apply to securities being bought by institutional investors because they have the capability to protect themselves by employing analysts).

<sup>58</sup> Douglas J. Dorsch, *The National Securities Market Improvement Act: How Improved is the Securities Market?*, 36 DUQ. L. REV. 365, 367 (1998).

<sup>59</sup> See Adoption of Integrated Disclosure System, Exchange Act Release No. 33,6383, 47 Fed. Reg. 11,380 (Mar. 3, 1982).

<sup>60</sup> See 17 CFR 229.1101 (2005).

<sup>61</sup> See Security Ratings, 73 Fed. Reg. 40,106 (proposed July 11, 2008). See generally CHOI & PRITCHARD, *supra* note 21, at 459-460 (discussing the SEC review process of initial public offerings).

the security without waiting for further action by the SEC and save substantial time and effort in selling the security.<sup>62</sup> As such, regulations that incorporate CRAs not only affect the institutional investor who buys the security, but they also affect the issuer who sells them.

#### *D. Credit Ratings in Mortgage Securitization*

CRAs also play an important role in the mortgage securitization process. This role makes them ideally positioned to assess the risks of mortgage-backed securities. First, CRAs are the last party to scrutinize the investment before the issuer sells it to investors. At this stage, CRAs have the power to unilaterally prevent the issuer from selling the security on the market. This gives CRAs the power to demand necessary information concerning the viability of the assets underlying the security. Second, CRAs receive their fees regardless of whether a security is profitable. This makes CRAs a disinterested evaluator of the security's risk.

Commentators rightfully argue that the "issuer pays" fee structure creates perverse incentives for CRAs to overstate their ratings.<sup>63</sup> However, as section VI will discuss, unlike current regulations, a handicapping system will penalize CRAs for such fraudulent conduct.<sup>64</sup> This – along with a more competitive market – will counter-balance current incentives for CRAs to overstate their ratings. In any case, before addressing the CRAs' role in securitization, it is helpful to explain the mortgage securitization process generally.

Securitization starts when an originator provides thousands of loans to

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<sup>62</sup> Security Ratings, 73 Fed. Reg. 40,106 (proposed July 11, 2008).

<sup>63</sup> In 2007, New York Attorney General, Andrew Cuomo, addressed this problem when he signed an agreement with the big-three CRAs that requires up-front fees ratings are published. See Press Release, N.Y. State Attorney Gen. Andrew Cuomo, Attorney General Cuomo Announces Agreement with Three Lenders (June 5, 2007), [http://www.oag.state.ny.us/media\\_center/2008/jun/june5a\\_08.html](http://www.oag.state.ny.us/media_center/2008/jun/june5a_08.html). See Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 43 (R.M. Levich, G. Majnoni, & C.M. Reinhart, eds. 2002) [hereinafter White, *The Credit Rating Industry*]; Hill, *Regulating the Rating Agencies*, *supra* note 11, at 50; Rhodes, *supra* note 16, at 308-309.

<sup>64</sup> See SEC. EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 6 (2008) [hereinafter SEC SUMMARY REPORT] (never recommending punitive action in the "Remedial Action" sections of the report), <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

homebuyers in which their homes act as collateral.<sup>65</sup> The originator transfers these loans to an arranger who groups the loans into pools. The arranger transfers the loans to a trust, which issues the securities collateralized, by the pool.<sup>66</sup> In transferring the loans, the trust buys the rights associated with the loan pool and thus controls the collateral, collects the cash, and passes the interest and principal to the investors.<sup>67</sup> The trust finances the purchase of the loan pool by issuing shares of the pool to investors.<sup>68</sup> Before selling shares of the loan pool to investors, however, the arranger segregates the loans based on their risk by dividing the loan pool into tranches.<sup>69</sup> Each tranche represents a category of risk and usually contains similar loans, debt instruments, or other assets having a similar risk of default.<sup>70</sup>

Tranches with the least risk are referred to as “senior tranches.”<sup>71</sup> Generally, senior tranches include some credit protection, which usually comes in the form of a credit derivative. The most common credit derivative is the credit default swap. A credit default swap is essentially an insurance policy requiring the seller to reimburse the buyer if any specific credit event occurs.<sup>72</sup> Typically, credit events are determined by a percentage of the pool defaulting on their payments.<sup>73</sup> Moreover, senior tranches are almost always comprised of first liens, which shield investors from the loss of interest and principal due to defaults in the loan pool. It also provides investors with superior claims to the revenues generated by the trust’s assets. Accordingly, because senior tranches have a lower risk of default, they are usually sold at a premium with an AAA, AA, or A credit

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<sup>65</sup> *Id.* at 6; INT’L ORG. OF SEC. COMM’N, THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS 7 (2008) [hereinafter IOSC], <http://www.cmvm.pt/NR/rdonlyres/85312A11-A927-4F63-810A-082C1A2CF5F8/9759/RelIOSCOsobrePapelCRAMercProdEstrut.pdf>.

<sup>66</sup> SEC SUMMARY REPORT, *supra* note 64, at 6.

<sup>67</sup> IOSC, *supra* note 65, at 9.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> SEC, Proposed Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-57967, File No. S7-13-08, at 5 (June 16, 2008) [hereinafter SEC’s Proposed Rules for NRSROs], available at <http://www.sec.gov/rules/proposed/2008/34-57967.pdf>.

<sup>71</sup> Wong, *Emerging and Nonstandard Products: A Rating Agency’s Perspective*, 759 PLI/COMM 347, 350 (1997).

<sup>72</sup> Unterman, *supra* note 56, at 89 (discussing general concepts of derivatives).

<sup>73</sup> *Id.*

rating.<sup>74</sup>

On the other hand, tranches containing riskier types of loans – e.g., subprime loans – are referred to as “junior tranches.”<sup>75</sup> These tranches are riskier because they have secondary claims to the security’s revenues as their payment is usually contingent on senior tranches being paid first.<sup>76</sup> Some junior tranches also have either a second lien or no lien on the home and will likely have less credit protection.<sup>77</sup> Accordingly, CRAs usually assign these tranches lower credit ratings, which range from BB or lower. Since these tranches normally carry low credit ratings, institutional investors usually decline to or are prevented from investing in them.<sup>78</sup>

After the issuer segregates the loan pool into tranches, the issuer pays a CRA to rate each tranche.<sup>79</sup> In rating each tranche, the CRA is essentially forecasting the likelihood that the issuer will default on its obligations to make interest and principal payments on the debt instrument to the investors.<sup>80</sup> In other words, the CRA is predicting how profitable the investment will be.

The ratings process can be divided into four steps.<sup>81</sup> In the first step, the issuer sends data on both itself and the security to the rating agency.<sup>82</sup> The issuer data includes information on its background, strategy, operations systems, historical performance data, etc.<sup>83</sup> The security data includes information on the loans held by the trust including the principal amount,

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<sup>74</sup> PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 8 (Mar. 2008) [hereinafter PRESIDENT’S WORKING GROUP] (“The subprime RMBS and the ABS CDOs were structured in tranches and a very large share of the total value of the securities issued was rated AA or AAA by the credit rating agencies.”), [http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil\\_03122008.pdf](http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf); Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1070 (1996) [hereinafter Hill, *Securitization: A Low-Cost Sweetener*].

<sup>75</sup> Wong, *A Rating Agency’s Perspective*, *supra* note 71, at 350.

<sup>76</sup> Unterman, *supra* note 56, at n.49 (citing Joseph R. Mason and Joshua Rosner, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions 3, Hudson Institute, [www.hudson.org/files/publications/Hudson\\_Mortgage\\_Paper5\\_3\\_07.pdf](http://www.hudson.org/files/publications/Hudson_Mortgage_Paper5_3_07.pdf) (May 2007)).

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*; Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2047 (2007).

<sup>79</sup> CRAs charge issuers a fee based on a determined percentage of the total value of the rated security. SEC SUMMARY REPORT, *supra* note 64, at 7; IOSC, *supra* note 65, at 9.

<sup>80</sup> SEC SUMMARY REPORT, *supra* note 64, at 7; IOSC, *supra* note 65, at 9.

<sup>81</sup> Hill, *Securitization: A Low-Cost Sweetener*, *supra* note 74, at 1071.

<sup>82</sup> SEC SUMMARY REPORT, *supra* note 64, at 7; IOSC, *supra* note 65, at 9.

<sup>83</sup> SEC SUMMARY REPORT, *supra* note 64, at 7; IOSC, *supra* note 65, at 9.



geographic location of the property, credit history of the borrower, ratio of the loan amount to the value of the property and the type of loan – i.e., first lien, second lien, primary residence, or secondary residence, the proposed capital structure of the trust, and the proposed level of credit protection for each tranche.<sup>84</sup>

In the second step, the CRA analyst assesses the potential future performance of the loan pool. These predictions are based on a stress test which uses both the issuer and security data.<sup>85</sup> With this information, the analyst simulates the loans' performance under various possible scenarios which differ in their degrees of stress.<sup>86</sup> The purpose of this initial stress test is to determine the amount of risk at each tranche level.<sup>87</sup> The rating agency determines these risks based on the number of loans in each tranche that default in this test scenario.<sup>88</sup> For example, if the loan pool in a senior tranche defaults more than is acceptable for a certain credit rating, then the analyst will go back to the issuer and require that it provide more credit protection so that the senior tranche can be rated accordingly.<sup>89</sup>

In the third step, the analyst evaluates a particular tranche's risk by evaluating four different aspects of the security: (1) qualitative; (2) quantitative; (3) servicing; and (4) legal.<sup>90</sup> In the *qualitative analysis*, the CRA analyst checks the security's proposed capital structure to determine whether it satisfies the CRA's rating requirements.<sup>91</sup> In the *quantitative analysis*, the CRA analyst reviews the security's cash flow.<sup>92</sup> In other words, the CRA analyst tests the amount of revenue generated by the principal and interest payments under various stress scenarios. In analyzing the *servicing aspect* of the security, the CRA analyst considers the "underwriting criteria as well as the capabilities of the services of the loans

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<sup>84</sup> IOSC, *supra* note 65, at 9-10.

<sup>85</sup> IOSC, *supra* note 65, at 9 ("This analysis also includes assumptions as to how much principal would be recovered after a defaulted loan is foreclosed."); Wong, *supra* note 71, at 351.

<sup>86</sup> IOSC, *supra* note 65, at 9.

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*; Wong, *supra* note 71, at 351.

<sup>89</sup> IOSC, *supra* note 65, at 9. Many commentators have noted that the CRAs provide too much guidance in recommending remedial actions for the issuers to take. *Id.*

<sup>90</sup> David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 1014 (2006) (describing four steps in the analyses); compare with SEC SUMMARY REPORT, *supra* note 64, at 7-8 (only describing three types of analyses).

<sup>91</sup> SEC SUMMARY REPORT, *supra* note 64, at 7-8.

<sup>92</sup> As Professor Reiss notes, "[the] primary concern here is the risk profile of the originator." Reiss, *supra* note 90, at 1014 (citing SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES § 9.04, at 9-21 (Ronald S. Borod ed., 2003)).

that are placed within the pool.”<sup>93</sup> Finally, in the *legal analysis*, the CRA analyst will consider the legal risks associated with the security. These risks include the effects of bankruptcy, the regulatory issues of the issuer/industry, the legal structure of the sale, the requirements necessary for a perfection of security interests, and the tax implications.<sup>94</sup>

In the fourth step, the analyst develops a rating recommendation for each tranche and presents it to a rating committee.<sup>95</sup> The rating committee is usually comprised of junior and senior level analysts.<sup>96</sup> After the analyst’s presentation, the committee votes on each tranche and notifies the issuer of its decision to assign each tranche a particular rating.<sup>97</sup> If the issuer disagrees with the rating, then the issuer can contest it.<sup>98</sup> The rating committee will then reconsider their decision and issue its final rating.<sup>99</sup>

In sum, CRAs are deeply engrained in our regulatory structure and the mortgage securitization process. Therefore, they are ideally positioned to act as effective gatekeepers. However, as section IV will show, current problems in the credit rating industry have made them ineffective at best and dangerous at worst.

### III. PROBLEMS IN THE CREDIT RATING INDUSTRY

Although the credit rating process appears to be a legitimate way to assess the risks of the mortgage-backed securities market, commentators and market participants have criticized the thoroughness of the CRAs’ due diligence efforts.<sup>100</sup> These critics claim that problems within the credit rating industry have negatively affected the reliability of the credit

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<sup>93</sup> *Id.*

<sup>94</sup> In Professor Reiss’s article, he discusses the effect that anti-predatory lending laws in Georgia, New Jersey, and North Carolina have on the legal risks associated with mortgage-backed securities. Specifically, he argues that because these states passed laws making investors liable for lending law violations, mortgages from those states were not sold on the secondary market because CRAs would not assign them a favorable rating. *Id.*

<sup>95</sup> SEC SUMMARY REPORT, *supra* note 64, at 9; IOSC, *supra* note 65, at 7-10.

<sup>96</sup> SEC SUMMARY REPORT, *supra* note 64, at 9; IOSC, *supra* note 65, at 7-10.

<sup>97</sup> SEC SUMMARY REPORT, *supra* note 64, at 9; IOSC, *supra* note 65, at 7-10.

<sup>98</sup> SEC SUMMARY REPORT, *supra* note 64, at 9; IOSC, *supra* note 65, at 7-10.

<sup>99</sup> SEC SUMMARY REPORT, *supra* note 64, at 9; IOSC, *supra* note 65, at 7-10.

<sup>100</sup> See James J. Cramer, *The Great Shakeout*, N.Y. MAG., Sept. 29, 2008, at 26. (“[R]ating agencies, like Standard & Poors and Moody’s blew the call. Failing to take the new risky lending practices into account, the just assumed that as long as employment held up. . . the mortgages backed by bonds were good.”).

ratings.<sup>101</sup> This article agrees with that assessment. As such, this section argues that credit ratings lack adequate incentives to protect their reputational capital and credibility within the financial system. This problem has occurred for two reasons. First, CRAs have a guaranteed source of income – regardless of their accuracy – as governmental regulations require that market participants use them. Second, Moody's, S&P, and Fitch, commonly referred to as the "Big Three," have a market share monopoly on the business of issuing ratings.<sup>102</sup> Nevertheless, before addressing these problems, this article starts by discussing the verifiable effects – uncovered in a recent SEC examination of the CRAs – these flaws have had on the ratings business.

#### A. SEC Examination of the Credit Rating Agencies

In 2007, foreclosure and delinquency rates in the U.S. began to skyrocket and the Big Three began to precipitously downgrade their ratings on mortgage-backed securities and collateralized debt obligations. This caused market participants and the government to question the "accuracy of [the Big Three's] credit ratings generally as well as the integrity of the ratings process as a whole." Consequently, the SEC launched an examination of the Big Three in which the SEC reviewed their ratings policies, procedures and practices. The purpose of the examination was to "develop an understanding of the practices of the rating agencies surrounding the rating of [residential mortgage-backed securities] and [collateralized debt obligations]."

On July 8, 2008, the SEC issued a report detailing its findings. These findings showed, that despite record profits, CRAs knowingly used faulty models to rate mortgage-backed securities.<sup>103</sup> As a result, credit ratings failed to communicate the actual risk of a mortgage-backed security at the time it was issued. In addition, the CRAs did not update ratings to reflect subsequent changes in a security's risk caused by new economic conditions

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<sup>101</sup> Michael Lewis and David Einhorn, *The End of the Financial World as We Know It*, N.Y. TIMES, Jan. 4, 2009, at WK9.

<sup>102</sup> See Hill, *Regulating the Rating Agencies*, *supra* note 11, at 60-65 (discussing the Big Three and their strangle hold on the credit rating industry).

<sup>103</sup> Congressman Waxman noted that, "The total revenues for the three firms doubled from \$3 billion in 2002 to over \$6 billion in 2007. At Moody's, profits quadrupled between 2000 and 2007. In fact, Moody's had the highest profit margin of any company in the S&P 500 for five years in row." *Credit Rating Agencies and the Financial Crisis*, *supra* note 1, at 5; SEC SUMMARY REPORT, *supra* note 64.

in the securities market.<sup>104</sup>

In reaching these findings, the SEC reviewed “internal records, including written policies, procedures and other such documents related to initial ratings, the ongoing surveillance of ratings. . . .”<sup>105</sup> From this, the SEC discovered several emails sent by CRA analysts working for the Big Three who knew that their agency’s ratings were inaccurate. For example, in one email, a CRA analyst observed that her firm’s model did not “capture half of [the deal’s] risk,” but that “it could be structured by cows and we would rate it.”<sup>106</sup> In another email, a staffer stated, “Let’s hope we are all wealthy and retired by the time this house of cards falters.”<sup>107</sup> When combined with other evidence uncovered during the investigation, these emails show that the Big Three continued to rate mortgage-backed securities even though they knew that their models were inadequate or downright wrong.

In addition, the SEC discovered internal emails showing that the Big Three continued to issue new ratings even though they lacked the time or the manpower to properly rate and monitor rated securities.<sup>108</sup> For example, in one internal memo a Big Three staffer noted that “[t]ensions are high. Just too much work, not enough people, pressure from company, quite a bit of turnover and no coordination of the non-deal ‘stuff’ they want us and our staff to do.”<sup>109</sup> In another memo, Mabel Yu, an executive with Vanguard Investments, felt that the downgrades in the summer of 2007 from S&P “came about 1 1/2 years too late” and demonstrated “frustration” with the ratings agencies’ willingness to “allow issuers to get away with murder.”<sup>110</sup> Finally, S&P employees summed up this point when they noted that “staffing issues . . . make it difficult to deliver the value that justifies our fees.”<sup>111</sup>

As if these emails are not discouraging enough, the SEC knew of the problems in early 2007 and decided not to investigate the CRAs until later that year. In March 2007, Christopher Cox, Chairman of the SEC, gave a

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<sup>104</sup> SEC SUMMARY REPORT, *supra* note 64, at 10-12; Unterman, *supra* note 56, at 94-95 (noting that sub-prime loans infiltrated the mortgage-backed securities market in 2004 & 2005 as lenders reduced their standards to issue more loans).

<sup>105</sup> SEC SUMMARY REPORT, *supra* note 64, at 3-4.

<sup>106</sup> *Id.* at 12.

<sup>107</sup> *Id.* at n.8.

<sup>108</sup> *Id.* at 12.

<sup>109</sup> *Id.*

<sup>110</sup> *Credit Rating Agencies and the Financial Crisis*, *supra* note 1 (E-mail from Mary Elizabeth Brennan to Moody’s Subprime Working Group, July 11, 2007).

<sup>111</sup> SEC SUMMARY REPORT, *supra* note 64, at 12.

speech to the Corporate Counsel Institute where he said, “[b]ecause CRAs relied on others to verify the quality of the assets underlying the structured products they rated, it is very likely those ratings were often based on incorrect information.”<sup>112</sup> However, despite this statement, the SEC did not start examining the Big Three until about October 2007.<sup>113</sup> This shows that, in addition to the Big Three, the SEC was also complicit in the lack of oversight on the mortgage-backed securities market.

If regulators knew about such abuse within the credit rating industry, why didn’t they address it sooner? Although we may never know the answer to this question, it is helpful to discuss why the Big Three acted so egregiously in conducting their regulatory duties. Sections 3B and 3C will address this issue by discussing the problems of regulatory licenses and the Big Three’s monopoly on credit ratings.

### B. Regulatory Licenses

The Big Three failed to act as effective gatekeepers because they lacked adequate incentives to protect their reputational capital and the credibility of their ratings. The first reason that CRAs lack adequate incentives is because financial regulations require that market participants continue to buy their ratings – a professional safety net of sorts – regardless of whether the ratings are accurate or not.<sup>114</sup> Moreover, current governmental regulations create financial incentives for market participants to pay for a good rating, even if the rating is based on inaccurate data.

For example, the Net Capital Rule requires a broker-dealer to keep extra capital on hand to cover his portfolio’s risks. If the broker-dealer receives a good credit rating, that rating effectively reduces the amount of cash that the broker-dealer must hold back to comply with the Net Capital Rule. This then allows the broker-dealer to invest more money into higher yielding investments rather than to store it in a low-interest yielding bank account.<sup>115</sup> As a result, good credit ratings provide financial regulatory benefits even if they communicate inaccurate information.

Because of these regulatory benefits, the government has created additional value in credit ratings for which market participants will pay. By

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<sup>112</sup> Cox, *supra* note 19.

<sup>113</sup> SEC SUMMARY REPORT, *supra* note 64, at 2 (noting that the final report was the product of a 10 month investigation).

<sup>114</sup> Partnoy, *The Siskel and Ebert of Financial Markets?*, *supra* note 34, at 681-90 (discussing the “regulatory license” view of CRAs).

<sup>115</sup> *Id.*

being incorporated into the government's regulatory structure, credit ratings are valuable for their regulatory benefits and their informational benefits in certifying the risks of an investment. Consequently, issuers will pay for an unsupported investment grade rating as it is cheaper for the issuer to pay the rating fee rather than incur substantial regulatory burdens – e.g., keeping large amounts of capital in reserve.

Professor Partnoy has written extensively on this topic. In his writings, he uses the term “regulatory license” when referring to the non-informational benefits provided by financial regulations.<sup>116</sup> In fact, Professor Partnoy has argued that a credit rating fails to provide any informational value at all.<sup>117</sup> Studies lend credibility to his argument.

In 2004, the Association for Financial Professionals conducted a study that polled financial professionals who regularly rely on credit ratings in their day-to-day business.<sup>118</sup> Generally, the survey concluded that these financial professionals believe that the SEC – or another regulatory body – should be more proactive in overseeing the CRAs. More specifically, only 53% of them found credit ratings to be accurate in conveying useful information for the purposes of risk management.<sup>119</sup> Additionally, only 38% believe that the ratings are timely.<sup>120</sup>

In advancing his “regulatory license” theory, Professor Partnoy contended in 1999 that market participants buy credit ratings for alternative reasons – (1) investments with a good rating attract more potential buyers than non-rated securities; (2) receiving a good rating saves issuers costs associated with regulatory burdens or prohibitions associated with non-rated investment grade securities; and (3) good credit ratings often provide corporate leaders such as portfolio managers with legal protection in case their investors claim that they breached their fiduciary duty in buying or holding the security.<sup>121</sup>

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<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> ASS'N FIN. PROF'LS, 2004 CREDIT RATING AGENCY SURVEY 7 (2004), [www.afponline.org/pub/pdf/2004\\_10\\_research\\_cra\\_report.pdf](http://www.afponline.org/pub/pdf/2004_10_research_cra_report.pdf).

<sup>119</sup> *Id.* at 3.

<sup>120</sup> *Id.*; Journalists have also written about the credibility to which professionals in the financial industry view credit ratings. For example, Michael Lewis and David Einhorn wrote an article for the New York Times in which they detailed the validity of credit ratings on MBIA, Inc., a company that provides financial guarantee insurance and fixed income management. In their article, Lewis and Einhorn illustrate how the credit ratings assigned to MBIA failed to address the hazardous debt that the company incurred. Their article also noted that private companies like Gotham Partners – a hedge fund – recognized hazardous nature of MBIA's portfolio and that the CRAs failed to downgrade MBIA. See Lewis and Einhorn, *supra* note 101.

<sup>121</sup> Partnoy, *The Siskel and Ebert of Financial Markets?*, *supra* note 34, at 681-90.

This article adds one more reason to that list. As current events have shown, corporate executives use CRAs to excuse risky business decisions. As this article discusses above, the U.S. economy has suffered over the past year causing many banks to fail.<sup>122</sup> The federal government, however, saved some of these failing banks because they were “too large to fail.”<sup>123</sup> After the government’s rescue, investors lost confidence in these companies and started to question the business strategies of the corporate officers running them. These events also caused the general public to scrutinize the economic inequities of life on Main Street (i.e., unemployment, foreclosures, budgetary constraints, etc.) versus life on Wall Street (i.e. executive compensation, luxury retreats, private jets, etc.).<sup>124</sup> This populist outcry seemed justified because the government used public funds to keep these failing corporations afloat.

In realizing that such scrutiny could jeopardize any future help from the government, or encourage the government to intervene in their business, corporate executives blamed CRAs for their bad business decisions. For example, in November 2008, Charlie Rose interviewed Vikram Pandit, CEO of Citigroup, after the government announced that it would invest \$20 billion into Citigroup and guarantee \$306 billion against Citigroup’s troubled assets.<sup>125</sup> During the interview, Charlie Rose asked Mr. Pandit whether he considers the job of CEO to be the company’s “ultimate risk manager.” In response, Mr. Pandit agreed to some extent, but he attempted to deflect criticism about decisions made at Citigroup by pointing to the CRAs and the AAA ratings assigned to the “troubled assets” that Citigroup bought.<sup>126</sup> Lloyd Blankfein, CEO of Goldman Sachs, has criticized market

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<sup>122</sup> As of February 19, 2009, the FDIC listed sixty-seven banks on their “Failed Bank List.” See FDIC, Failed Bank List, <http://www.fdic.gov/bank/individual/failed/banklist.html> (last visited Feb. 19, 2008) (on file with author).

<sup>123</sup> Neil Irwin and David Cho, *U.S. Offers Citigroup Expansive Safety Net; Aim Is to Restore Confidence in Critical Bank*, WASH. POST, Nov. 24, 2008, at A1; Peter S. Goodman, *Too Big to Fail?*, N.Y. TIMES, July 20, 2008, at A1.

<sup>124</sup> See Tim Rutton, *Mean Street Replaces Main Street*, L.A. TIMES, at A21 (discussing comparison between life on Main Street and life on Wall Street in the 2008 Presidential Election); Joe Nocera, *It's Not the Bonus Money. It's the Principle*, N.Y. TIMES, Jan. 31, 2009, at B1; Tim Sheehan, *Brother, can you spare a dime?*, FRESNO BEE, Jan. 4, 2009, at D1 (discussing a company’s public perception and receiving federal aid).

<sup>125</sup> *The Charlie Rose Show: Interview with Vikram Pandit*, (KCET television broadcast Nov. 25, 2008), <http://www.charlierose.com/view/interview/9653>.

<sup>126</sup> Mr. Pandit’s actual statement reads as follows: “Let’s think about risk management for a minute. How many times have you seen AAA bonds go to zero?” *Id.*

participants for engaging in this type of conduct.<sup>127</sup> Instead, Mr. Blankfein appropriately contends that investors should conduct their own due diligence and “heed other indicators of financial deterioration.”<sup>128</sup>

For their part, CRAs have vigorously defended the accuracy of their ratings by claiming that they accurately capture risk over time when compared to public information.<sup>129</sup> However, this argument is unpersuasive. CRAs have a bad track record when it comes to honest historical analysis because CRAs have manipulated their ratings in the past to account for faulty risk assessments.<sup>130</sup> To explain, commentators note that CRAs primarily distort their track record by impulsively downgrading the debt of a company days before the company files for Chapter 11 protection.<sup>131</sup> For example, in the case of Enron, Moody’s and S&P rated Enron’s debt “investment grade” until four days before Enron declared bankruptcy even though the company’s financial situation was clear for many months.<sup>132</sup> As commentators note, this made it possible for the rating agencies to claim that their ratings accurately reflected Enron’s risk at the time the company filed for bankruptcy.<sup>133</sup>

Moreover, in today’s markets, CRAs have better access to more information than regular investors.<sup>134</sup> Years ago this was not the case. CRAs rated securities by reviewing corporate disclosures an average investor could find in regulatory databases. Today, however, the market includes complex and confusing investment vehicles like mortgage-backed securities and credit derivatives. Many investors do not comprehend the structure and risks of these types of securities.<sup>135</sup> Regardless, even if an investor understands these investments, mortgage-backed securities do not provide sufficient data about the risk associated with the underlying investments.<sup>136</sup> The only market participants that receive this information

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<sup>127</sup> Blankfein, *supra* note 3.

<sup>128</sup> *Id.*

<sup>129</sup> See COFFEE, GATEKEEPERS, *supra* note 2, at 297 (detailing the credit rating industry’s response to accusations that ratings are inaccurate); see also Gregory Husisian, *What Standard of Care Should Govern the World’s Shortest Editorials?: An Analysis of Bond Rating Agency Liability?* 75 CORNELL L. REV. 411, 440-42 (1990) (discussing the accuracy of bond ratings).

<sup>130</sup> COFFEE, GATEKEEPERS, *supra* note 2, at 60-70.

<sup>131</sup> *Id.*

<sup>132</sup> See John Coffee, *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1409-16 (2002).

<sup>133</sup> COFFEE, GATEKEEPERS, *supra* note 2, at 285-86.

<sup>134</sup> PRESIDENT’S WORKING GROUP, *supra* note 74, at 8.

<sup>135</sup> SEC SUMMARY REPORT, *supra* note 64, at 1; Unterman, *supra* note 56, at 92.

<sup>136</sup> Unterman, *supra* note 56, at 92.



are the CRAs, which receive it during the ratings process. Therefore, investors are forced to rely on an investment's rating to determine its risk.<sup>137</sup>

### C. Monopolistic Market

Returning to the bigger picture, in addition to regulatory licenses, the second reason that the credit rating industry lacks adequate incentives is the absence of competition within it.<sup>138</sup> According to the SEC, the Big Three issued 98% of the credit ratings on asset-backed securities and are arguably the most powerful regulators in the financial system. Columnist Thomas Friedman noted the power of these agencies when he stated, "There are two superpowers in the world today. . . There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds."<sup>139</sup>

Professor John C. Coffee suggests that one explanation for the industry's concentration is that credit ratings require reputational capital, which takes time to establish. While this argument might have some merit, concentration is mostly likely due to artificial barriers to entry imposed by the government. One of these barriers is the National Statistical Ratings Organization ("NRSRO") designation, which the SEC required for ratings to be used for any regulatory purpose.<sup>140</sup> The SEC created this designation

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<sup>137</sup> PRESIDENT'S WORKING GROUP, *supra* note 74, at 8 ("Many global investors. . . relied heavily on the ratings in making investment decisions or in communicating risk appetites to their investment managers, rather than undertaking their own independent credit analysis on instruments that often were quite complex."); *Id.*

<sup>138</sup> Partnoy, *The Siskel and Ebert of Financial Markets?*, *supra* note 34, at 681-90; *see also* Lawrence J. White, Comments on References to Ratings of Nationally Recognized Statistical Rating Organizations (Sept. 5, 2008), SEC File No. S7-17-08 ("loosening the deadlock grip that a specific, handful of ratings firms (the firms that the SEC has designated as NRSROs) have had on the quality assessments of securities that the SECs regulated financial institutions have been required to make. In making those quality assessments (usually with respect to the safety and/or liquidity of the debt securities that were in their portfolios), the regulated financial institutions have been required to use exclusively the NRSROs ratings of those securities.").

<sup>139</sup> *The MacNeil/Lehrer Newshour: Interview with Thomas Friedman*, (PBS television broadcast, Feb. 13, 1996).

<sup>140</sup> Professor Coffee suggests that "[t]he most telling evidence that the extremely concentrated character of the credit-rating market in the United States is not the product of a natural market is the existence, outside the United States, of as many as 130 to 150 rating agencies. . . ." COFFEE, *GATEKEEPERS*, *supra* note 2, at 292.

in 1975 to prevent a “race to the bottom” mentality<sup>141</sup> and to prevent any “fly-by-night” agencies attempting to take advantage of the regulatory structure’s reliance on credit ratings.<sup>142</sup> Ultimately, the NRSRO designation accomplished this goal in preventing such non-NRSRO designated CRAs from entering the market. However, the designation also disproportionately blocked legitimate new entrants from issuing regulatory ratings.

In addition to the CRA designation, the SEC also raised the barriers to entry by adopting absurd qualification standards. To qualify as an NRSRO, a rating agency had to be “nationally recognized” and “widely accepted in the United States.”<sup>143</sup> While this standard presented no problem to the already established players, it prevented any new CRA without institutional history similar to the Big Three’s from entering the ratings business.<sup>144</sup> Some argue that non-NRSRO designated CRAs could become “nationally recognized” by rating securities for non-regulatory purposes.

However, as the previous section demonstrates, this argument is impractical because these non-designated CRAs lack the requisite information to properly rate the securities. Furthermore, in practice, non-designated CRAs cannot make money by forecasting the potential of an investment to default because market participants have no reason to pay them. Consequently, the majority of non-designated CRAs make money by informing market participants of the valuation process instead of predicting default.<sup>145</sup>

Furthermore, not only were the qualifications vague, but the SEC refused to provide guidance on how to become “nationally recognized” and “widely accepted.”<sup>146</sup> This made it difficult for CRAs to plan a strategy for obtaining SEC approval. An example lies in Egan-Jones Rating Agency which waited ten years (1998-2008) before the SEC approved its NRSRO application. In addition, the SEC’s lack of guidance allowed it to subjectively deny a CRA’s application without recourse. On one occasion, an Egan Jones employee requested that the SEC clarify its standards.<sup>147</sup> The SEC responded by stating, “[w]e won’t tell you the criteria [for obtaining

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<sup>141</sup> By referring to the “race to the bottom” mentality, Professor Coffee means competitive forces causing rating agencies to dilute their standards to get business. *Id.* at 289.

<sup>142</sup> *Id.* at 289.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Id.* at 292.

<sup>146</sup> Hill, *Regulating the Rating Agencies*, *supra* note 11, at 55 (discussing the SEC’s failure to define criteria in the NRSRO application).

<sup>147</sup> *Id.*; Egan-Jones waited for ten years (1998-2008) before the SEC approved its NRSRO application.

NRSRO designation], otherwise you might qualify.”<sup>148</sup>

In sum, governmental barriers to entry have created an industry that lacks competitive pressures. Over the course of nearly three decades (1975-2002) the SEC granted NRSRO status to only four CRAs other than S&P, Moody’s, and Fitch.<sup>149</sup> These newly designated agencies had a minimal effect on industry competition because the Big Three subsequently bought them all out. Since 2002, the SEC conferred the NRSRO designation to a total of ten agencies.<sup>150</sup>

However, the Big Three still maintain a firm grip on the ratings business, especially with respect to asset-backed securities. In 2008, the SEC stated that the Big Three rated 98% of the residential mortgage-backed securities on the market.<sup>151</sup> This dominance has destroyed competitive incentives for CRAs to develop accurate rating models. In theory, those incentives would motivate the CRAs to develop a rating system superior to its competitors.

Finally, the monopolistic culture of the credit rating industry prevents the SEC from taking punitive against fraudulent NRSROs. Because the Big Three rate the vast majority of mortgage-backed securities, there are few alternative NRSROs that can fill their shoes if the SEC decided to strip any one of the Big Three of their NRSRO status.<sup>152</sup> This explains why the SEC declined to recommend any punitive action against the Big Three after the aforementioned investigation.<sup>153</sup> Congress attempted to address these issues with recent legislation.

#### IV. RECENT REGULATION

In 2006, Congress passed the Credit Rating Agency Reform Act

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<sup>148</sup> Hill, *Regulating the Rating Agencies*, *supra* note 11, at 54. In 2006, as part of the CRARA, the SEC finally adopted qualification standards. See sources cited *infra* note 149.

<sup>149</sup> Hill, *Regulating the Rating Agencies*, *supra* note 11, at 54.

<sup>150</sup> As of February 19, 2009, the SEC designated a total of ten rating agencies as NRSROs. Those agencies are: A.M. Best Company, Inc., DBRS Ltd., Egan-Jones Rating Company, Fitch, Inc., Japan Credit Rating Agency, Ltd., LACE Financial Corp., Moody’s Investors Service, Inc., Rating and Investment Information, Inc., Realpoint LLC, and S&P Ratings Services. See SEC, Credit Rating Agencies – NRSROs, <http://www.sec.gov/answers/nrsro.htm> (last visited Feb. 18, 2009) (on file with author).

<sup>151</sup> “According to their most recent Annual Certifications on Form NRSRO, S&P rates 197,700 issuers of asset-backed securities, the category that includes RMBS, Moody’s rates 110,000 such issuers, and Fitch rates 75,278 such issuers. No other registered NRSRO reports rating more than 1,000 issuers of asset-backed securities.” SEC’s Proposed Rules for NRSROs, *supra* note 70, at n.8.

<sup>152</sup> See SEC SUMMARY REPORT, *supra* note 64.

<sup>153</sup> *Id.*

(“CRARA”) to increase both competition and transparency in the ratings industry.<sup>154</sup> Specifically, Congress sought to increase competition by establishing clear registration procedures for NRSROs and by defining crucial terms such as “credit rating agency,” “credit rating,” and “NRSRO.”<sup>155</sup> Congress attempted to increase transparency by imposing substantive requirements on NRSROs concerning the use and misuse of nonpublic information and conflicts of interest.<sup>156</sup> In addition to its recommended reforms, the CRARA mandated that the SEC propose new rules and recommendations to curb abusive practices by the CRAs.<sup>157</sup>

In 2008, according to Congress’ mandate in the CRARA, the SEC proposed new rules and rule amendments.<sup>158</sup> In its recommendations, the SEC attempted to increase competition within the ratings industry by reducing undue reliance on NRSROs.<sup>159</sup> Specifically, the SEC recommended removing all references to “NRSRO” in the Investment Company Act of 1940 and the Investment Advisors Act of 1940.<sup>160</sup> In addition, the SEC recommended removing some of the references to NRSRO ratings in the Exchange Act.<sup>161</sup>

Although the SEC declined to remove all references to NRSROs, it proposed measures to increase the competition among them. Specifically, the SEC recommended new transparency and recordkeeping requirements so that investors could compare the performance of the CRAs.<sup>162</sup> These recommendations required CRAs to (1) publicly disclose the information that they used to rate each security, and (2) publicly disclose the agency’s performance statistics for one, three, and ten years, within each credit rating category.<sup>163</sup> The SEC also proposed disclosure rules mandating that CRAs

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<sup>154</sup> Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat 1327-1339 (2006). The SEC has known about the problems of the credit rating industry since at least the early 1990’s when it solicited and subsequently received comments for reforming the CRAs. However, to this date, the SEC has not taken any major steps to reforming the credit rating industry until the CRARA. *See* Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Release No. 8236, 8 Fed. Reg. 35,258 (June 12, 2003) (discussing previous actions taken by the SEC).

<sup>155</sup> Credit Rating Agency Reform Act § 3.

<sup>156</sup> Credit Rating Agency Reform Act § 4.

<sup>157</sup> Credit Rating Agency Reform Act §§ 6-7.

<sup>158</sup> Proposed Rules for NRSROs, *supra* note 70, at § II.

<sup>159</sup> *Id.*

<sup>160</sup> *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,124 (proposed July 11, 2008).

<sup>161</sup> *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,088 (proposed July 11, 2008).

<sup>162</sup> SEC’s Proposed Rules for NRSROs, *supra* note 70, at 19.

<sup>163</sup> *Id.* at 40-41.

submit annual reports on the number of ratings in each class, in addition to maintaining a database of all rating actions.<sup>164</sup>

The SEC believed that disclosure and reporting requirements would allow “[m]arket participants and observers [to] be able to compare the ratings of the NRSROs hired by the arrangers against the ratings of NRSROs and others not hired by the arrangers.”<sup>165</sup> Commentators and lawmakers agree that these are steps in the right direction.<sup>166</sup> However, this article argues that more is needed to create a regulatory structure that rewards the CRA with the most accurate ratings. After all, the regulatory structure depends on the accuracy of these ratings because transparency in information allows market participants to make the best business decisions.<sup>167</sup> Without such transparency, Adam Smith’s invisible hand becomes misguided.

## V. PROPOSAL: HANDICAPPING THE CREDIT RATING AGENCIES

Currently, the CRARA fails to implement the necessary reforms. As an initial matter, the SEC’s current disclosure proposals do not require that CRAs submit timely information.<sup>168</sup> In fact, Professor Coffee noted that, with CRARA data, “the public will still not receive current information but only year-old data, which will only go back one year to 2007.”<sup>169</sup> As a secondary matter, the current proposals do nothing to ensure that CRAs disclose accurate information to investors.<sup>170</sup> Instead, the disclosures create a hodgepodge of information that is complex and hard to understand.

The first problem is not hard to fix because regulators can simply

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<sup>164</sup> *Id.*

<sup>165</sup> *Id.*; see also White, *supra* note 138, at 2 (“With greater choice as to where they seek information, the financial markets can impose market discipline, based on which rating firms (or other types of information-provision firms) have been the most reliable, which have had the best “track records” in predicting defaults, which have had the least conflict-of-interest problems, which have revealed the most information (e.g., about their methodologies and procedures) that the markets consider important, etc. Competition will work, if given a chance. New ratings forms, procedures, and participants may well emerge. Innovation will have an open field.”).

<sup>166</sup> See White, *supra* note 138 (commenting on the SEC’s recommendations).

<sup>167</sup> Comm. on Bankr. and Corp. Reorg. of the Ass’n of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW 527, 535 (1995).

<sup>168</sup> John C. Coffee Jr., *SEC’s New Rules Fail to Address Key Rating Issues*, 241 N.Y.L.J. 5 (Jan. 15, 2009).

<sup>169</sup> *Id.*

<sup>170</sup> Professor Coffee also has argued that default statistics disclosed by the CRAs are useless because the numbers are “as cooked as Enron’s books.” COFFEE, *GATEKEEPERS*, *supra* note 2, at 285-86.

require that CRAs submit more current data. The second problem however can be solved in three different ways: (1) by relying on the free market to sort good information from bad information, (2) adopting a draconian regulatory system where the government analyzes all CRA disclosures on every security rated, or (3) finding common ground between the two where government has a regulatory role, but does not need to scrutinize the vast quantities of CRA disclosures.

Logically, the third option makes the most sense. However, this article discusses all three below.

#### *A. Options to Reform the Regulatory Structure*

First, as shown in the CRARA, policymakers can opt to rely on investors to process complicated CRA disclosure data when scrutinizing the accuracy of the CRAs. This free market approach benefits the government because it would minimize the government's burden of processing all the information disclosed by the credit rating industry. This includes statistical data on past ratings, modified ratings, rating procedures, and information detailing an agency's rating methodologies.<sup>171</sup>

Processing this information will require a considerable amount of investment in models and personnel to determine if the credit ratings legitimately capture risks in the financial market.<sup>172</sup> To create and maintain these models, the government must hire qualified financial professionals and pay them large salaries to lure them away from more lucrative offers at private financial firms.<sup>173</sup> However, by relying on investors to scrutinize disclosure information, the government does not have to assume these costs.

Nonetheless, some experts argue that despite the reduced regulatory costs of the free market, the financial system requires government's heavy hand to control risky business decisions on Wall Street.<sup>174</sup> The current financial crisis has given credibility to this argument as investment bankers admit that free market forces failed to control bad decisions on Wall Street.

For example, Mr. Blankfein acknowledged that despite financial institutions' dependence "on a healthy, well-functioning system," they "failed to raise enough questions about whether some of the trends and practices that had become commonplace really served the public's long-

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<sup>171</sup> See White, *The Credit Rating Industry*, *supra* note 63, at 14.

<sup>172</sup> See *infra* II(C); SEC, SUMMARY REPORT, *supra* note 64, at 10-12.

<sup>173</sup> See Hill, *Regulating the Rating Agencies*, *supra* note 11, at 81 (detailing the personnel investment required to rate emerging financial instruments of "staggering complexity.").

<sup>174</sup> Blankfein, *supra* note 3.

term interests.” Mr. Blankfein also admitted that “self-regulation has its limits” because “[financial institutions’] self-interest in preserving and expanding our market share, as competitors, sometimes blinds us – especially when exuberance is at its peak.”<sup>175</sup>

This lack of discipline is typical in a market bubble environment where the popularity of an investment compromises risk management procedures. As Professor Coffee noted, “in an atmosphere of market euphoria, investors rely less on gatekeepers, and managements in turn regard them as more a formality than a necessity.”<sup>176</sup> This “euphoria” has two consequences. First, market participants will not scrutinize the integrity of the ratings issued by a CRA. Second, as Mr. Blankfein noted, CRAs will “dilute” the integrity of the ratings to increase their fees.<sup>177</sup>

Second, policymakers could rely solely on a governmental regulatory body like the SEC to ensure that CRA performance data is accurate and CRA models properly measure market risks. After all, governmental regulatory agencies like the SEC are neutral parties that are theoretically well suited to protect the integrity of the broader financial market. Moreover, government agencies are duty bound to balance the interests of Wall Street with the interests of Main Street.

However, a regulatory policy relying solely on the government is detrimental because it is impractical and would consume a substantial amount of government resources that would compromise the government’s ability to regulate other areas of the market.<sup>178</sup> For example, if policymakers assign this task to the SEC, the SEC would have to dedicate resources that would otherwise be used to investigate other fraudulent behavior within the financial system. Currently, the SEC already faces a challenging regulatory duty to oversee thousands of hedge funds, mutual funds, stockbrokers, and billions of dollars worth of trading activities on several exchanges. The Bernard Madoff case provides an example of how

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<sup>175</sup> *Id.*

<sup>176</sup> COFFEE, GATEKEEPERS, *supra* note 2, at 67-69.

<sup>177</sup> Blankfein, *supra* note 3.

<sup>178</sup> Some might argue that increased responsibility would be good for an agency’s morale, however, commentators have noted that increased enforcement duties negatively affect the SEC’s personnel turnover rate. For example, after Congress passed Sarbanes-Oxley, the SEC’s turnover rate increased to 9.1%. See Gregory W. Smith, *The Deterioration of Investor Tools and the Resulting Fiduciary Challenges*, J. GOV’T FIN. MGMT, Oct. 1, 2008, at 26.

the SEC is already challenged in its current regulatory role.<sup>179</sup>

Recently, former SEC chairman Harvey Pitt joined prominent short seller Jim Chanos and Nobel Laureate Elie Wiesel on a panel discussing the Bernard Madoff scandal and ways to prevent future fraud in the financial markets.<sup>180</sup> In his comments, Mr. Pitt said the SEC does not have enough resources to uncover fraud in the financial markets. “You can't take young people, two, three, four years out of college, pay them \$50,000, \$60,000, \$70,000, and expect them to have the sophistication to assess a \$20 billion hedge fund.”<sup>181</sup> As such, there is “a lack of real sophistication” at the SEC.<sup>182</sup> “I can say this as a lapsed lawyer . . . the SEC is overlawyered in the sense that it's heavily dependent on lawyers. There aren't enough economists, there aren't enough MBA, there aren't enough market specialists in the agency providing the kind of additional sophistication” that the SEC needs.<sup>183</sup> Therefore, redirecting resources would further reduce the SEC's ability to regulate the markets.

Moreover, by directly regulating CRAs, the government would have to increase the agency's funding to oversee new investment vehicles – in addition to mortgage-backed securities – as they enter the marketplace. Currently, mortgage-backed securities are only the latest investment vehicle to enter the financial system. As the market continues to introduce more complex investment vehicles, increased regulatory costs associated with those investments would overwhelm the SEC's budget and place additional constraints on its ability to be an effective regulator.

To cope with these constraints, the government would have to increase the budget of the SEC, consequently making taxpayers indirectly subsidize the due diligence costs of these investment vehicles. This is not an equitable result. Taxpayers with no interest in an investment should not bear its due diligence costs. Instead, the market should incorporate due diligence costs into a security's price. This would effectively make the investor, who is trying to profit from the investment, pay for the due diligence of that

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<sup>179</sup> *Assessing the Madoff Ponzi Scheme and Regulatory Failures: Hearing Before the H. Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, H. Comm. Financial Services*, 111th Cong. 13-15 (2009) (testimony of Mr. Harry Markopolos) (discussing the SEC's failure to investigate Bernard Madoff after whistleblower warnings).

<sup>180</sup> See Portfolio Staff, Wiesel Lost “Everything” to Madoff, Portfolio.com, Feb. 27, 2009, <http://www.portfolio.com/executives/2009/02/26/Elie-Wiesel-and-Bernard-Madoff> (on file with author).

<sup>181</sup> *Id.*

<sup>182</sup> *Id.*

<sup>183</sup> *Id.*



investment. If these costs exceed the potential profit of an investment, the investment should not be sold in the market.

Third, policymakers and regulators can ensure that CRAs accurately rate securities by using a handicapping system to essentially rate the raters. Adopting a handicapping system of CRAs would incentivize them to accurately measure risks of particular investments. The proposal will also encourage the free market to choose the most accurate rating. Finally, the proposal will limit regulatory burdens on the government of monitoring the accuracy and legitimacy of credit ratings.

Before discussing the details of the proposal, the meaning of the term “handicap” should be explained. A “handicap” is an advantage given or disadvantage imposed to account for past performance.<sup>184</sup> In applying this to CRAs, the handicap will be individually assigned to a particular CRA to reflect the likelihood that the rating issued accurately forecasts the risk associated with a particular investment. This concept is similar to a golf handicap where players are assigned individual handicaps commensurate with their playing ability.<sup>185</sup>

In the game of golf, a player’s handicap represents the potential scoring ability of that player compared to a recommended number of strokes per round. For example, a golf handicap of 10 means a golfer will potentially average about 10 strokes over par per round. Usually, par for a regulation course is around 72 strokes. Accordingly, if par for the course is 72, a 10 handicap predicts that the golfer will take 82 strokes to complete the round.<sup>186</sup>

The purpose of a handicap is to level the playing field between players of different skill levels. A golf handicap accomplishes this by giving less skilled golfers a number of strokes to deduct from their score. The number of strokes given to the less skilled golfer is the difference between their handicap and their competitor’s handicap. For example, if a person with a two handicap plays against a person with a ten handicap, the first person cuts two strokes off his final score, while the second person cuts ten strokes off of his final score. This gives the less skilled golfer – the ten handicap – eight more strokes to deduct from their score. The scores are then compared and the golfer with the lowest score wins.

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<sup>184</sup> WEBSTER’S THIRD NEW INT’L DICTIONARY 1027 (1986).

<sup>185</sup> John Paul Newport, *The Genius of Handicapping – The beauty of golf’s scoring system is that it levels the field for all players*, WALL ST. J., Nov. 1, 2008, at W6. See generally United States Golf Association Website, Handicaps, <http://www.usga.org/playing/handicaps/handicaps.html>.

<sup>186</sup> The meaning of the term “stroke” is “the forward movement of the club made with the intention of striking at and moving the ball...” U.S. GOLF ASS’N, THE RULES OF GOLF 16 (2007).

To further explain this concept, consider this hypothetical: Joe has a two handicap and he plays against Tom who has a 10 handicap. If Joe hits the ball 76 times (gross score), his net score is 74 ( $76 - 2 = 74$ ). If Tom hits the ball 83 times (gross score), his net score is 73 ( $83 - 10 = 73$ ). Although Joe hit the ball less times than Tom, Tom's handicap adjusted his net score below Joe's net score. In other words, Tom played better than Joe after considering each golfer's capabilities. Therefore, Tom wins.

In regulating the CRAs, the SEC could apply the concept behind a golf handicap. However, unlike golf, an agency's handicap would not reward the less skilled CRA because the higher the rating is, the better. This is in opposition to the game of golf where the lowest score is best. Therefore, as will be shown, the CRA handicaps will penalize the less skilled (i.e., less accurate) CRAs.<sup>187</sup> This would level the playing field between CRAs by accounting for the increased risk that the less skilled CRA will inaccurately rate a security.

The first step in this process is calculating the handicaps. In golf, the USGA uses historical data on the performance of the individual golfer on a particular course. Like the USGA, the SEC would also use historical inputs to determine a CRA's handicap. The inputs would include: the accuracy of the CRA's past ratings, the CRA's accuracy in rating similar types of debt or securities, and the timeliness of its downgrades.

After calculating the handicap, the SEC would apply the handicap to an individual CRA's ratings to obtain the "net rating." After determining the "net rating," the SEC uses it to determine whether a security's risk comports with regulatory requirements. The SEC would determine this by comparing an agency's net rating to the "par rating." The term "par rating" would be a rating – predetermined by a certain regulation – that restricts a market participant from investing in that security.

For example, in the world of mortgage-backed securities and collateralized debt obligations, financial regulations prohibit some institutional investors from buying non-investment grade securities.<sup>188</sup> Because investment grade securities are defined as securities with a rating

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<sup>187</sup> As used in the game of golf and defined in Webster's Dictionary, a handicap normally provides "an advantage to the weaker contestant or imposes a disadvantage on a stronger candidate." However, Webster's dictionary also describes the term "handicapping" to mean the "the odds of predicting a winner..." As applied to credit ratings, it is logical to predict the most inaccurate credit ratings by imposing disadvantages – i.e., reducing their ratings – on the CRAs that have issued inaccurate ratings in the past. Similarly, it is logical to predict the most accurate credit ratings by providing an advantage to CRAs that have issued accurate ratings in the past.

<sup>188</sup> Unterman, *supra* note 56, at 90-91.

of BBB or higher, this would be called the “par rating.”<sup>189</sup> Therefore, if an agency’s handicap lowered a mortgage-backed security’s rating to a level below BBB, laws would preclude certain investors from buying that investment.

To fully illustrate this concept, consider the following hypothetical: The issuer of a company hires a CRA to rate a mortgage-backed security. The CRA performs the steps described in section III and issues a rating of AA on the security’s senior tranche. This rating would be called the “gross rating” (i.e., unadjusted rating). After the CRA issues the gross rating, the SEC applies the agency’s handicap to determine the “net rating” (i.e., adjusted rating). If the agency has a poor track record in rating similar securities or has been late to downgrade its ratings, the handicap could potentially reduce the gross rating from AA to A. If the CRA’s track record so warrants, the handicap could even reduce the rating of AA to BBB, or lower.

Therefore, if a company repeatedly issues inaccurate ratings, their handicap would reduce the security’s rating to a level that would bar institutional investors such as pension funds from investing in the security that the CRA rated.

### *B. Effects of Handicapping*

Handicapping credit ratings would be beneficial to the financial system for several reasons. First, handicapping credit ratings would allow investors to compare CRAs more efficiently than they could under the SEC’s current proposals. The SEC’s current proposals require market participants to analyze a hodgepodge of information provided by the CRAs. Alternatively, under this model, market participants will be able to translate the handicaps – like the ratings themselves – into universal symbols that easily communicate the competence of a CRAs risk assessment. This promotes a more transparent market. Moreover, investors would feel more comfortable relying on handicaps rather than information disclosed by the CRAs themselves because CRAs have a bad reputation for manipulating the accuracy of their ratings. Thus, investors would be more confident in relying on information about the accuracy of a CRA if it came from a government regulatory agency like the SEC.

Second, handicaps will create financial incentives for CRAs to focus on accuracy. As shown above, one of the problems with credit ratings is that CRAs have focused on quantity, not quality. Incorporating handicaps will lead CRA executives to rethink their current approach because handicaps

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<sup>189</sup> *Id* at n.46.

will increase the potential costs for skimping on due diligence. These costs will occur in the form of lost profits as inaccurate ratings will negatively affect a rating agency's handicap.

Bad handicaps will likely translate into lost profits because issuers will want CRAs with good reputations to rate their securities. A bad handicap would negatively affect a CRA's reputation for two reasons. First, issuers will want the CRA's rating to be predictable. If a CRA has a bad handicap, their rating will not indicate the rating that can ultimately be used for regulatory purposes. In addition, investors will want to purchase securities that have a predictable amount of risk. If a CRA has a bad handicap, issuers will have a harder time attracting investors to that security.<sup>190</sup> Thus, by handicapping CRAs and making past performance a factor in the handicapping system, CRAs that focus only on profits will have to consider the costs of skimping on due diligence. This will also encourage CRAs to hire the personnel necessary to properly monitor securities and to develop models that accurately capture the risks associated with the investments or debt that they rate.

Third, like golf, handicapping the CRAs would level the playing field and allow smaller rating agencies to compete with large CRAs. Ideally, smaller CRAs could outperform the larger CRAs if they develop superior modeling techniques by specializing in a particular field within the financial system. In fact, some CRAs have already adopted this business model. For example, A. M. Best Co. has developed a niche in insurance.<sup>191</sup> According to its website, A.M. Best provides "ratings, news and financial data for the insurance industry worldwide and . . . are recognized as the benchmark for assessing the financial strength of insurance related organizations and the credit quality of their obligations."<sup>192</sup> Consequently, because A.M. Best has focused on the insurance business, many market participants consider their ratings on insurance to be more reputable than ratings by other CRAs.

As with other proposals currently under advisement, policymakers might encounter a few hurdles in implementing a handicapping system.

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<sup>190</sup> If an NRSRO's rating increases a mortgage-backed security's offering price in today's market because NRSROs are considered to be established rating firms, it is logical to conclude that the offering price would also be enhanced if investors knew that the security's rating was issued by a CRA with a handicap – i.e., a good track record for issuing accurate ratings. See Partnoy, *The Siskel and Ebert of Financial Markets?*, *supra* note 34, at 681-90 (discussing the "regulatory license" view of CRAs).

<sup>191</sup> See A.M. Best Website, Best's Ratings and Analysis, <http://www3.ambest.com/ratings/default.asp> (February 10, 2009); COFFEE, GATEKEEPERS, *supra* note 2, at 300-302 (discussing rating agencies that have developed specialized rating services).

<sup>192</sup> A.M. Best Website, Best's Ratings and Analysis (February 10, 2009), <http://www3.ambest.com/ratings/default.asp>.

Currently, three issues arise. First, as in golf, financial regulators will likely have trouble “getting everyone to agree on a uniform method for calculating [the handicap].”<sup>193</sup> Political pressures will undoubtedly create deadlock in determining the exact equation.<sup>194</sup>

Second, handicaps might be ineffective in preventing a crisis similar to the current economic crisis because, like current modeling techniques, handicaps are based on historical performance. When economic events like the housing crisis have no historical precedent, handicaps will be useless in protecting investors from unforeseen market conditions.

Third, creating the handicapping system will take a large capital investment and constant maintenance to be current and relevant to the marketplace. Although this task could seem arduous and complex, it is less invasive and costly than directly overseeing the business operations of the CRAs.

### CONCLUSION

After every financial crisis, regulators and experts revisit regulations governing the CRAs and debate over implementing reforms of the industry. During this crisis, one is hopeful that they act to reform the credit rating industry. As government sanctioned gatekeepers, CRAs are uniquely positioned within the financial market to act as strong regulators. Correctly utilizing them would balance the inefficiencies of government and the unreliability of the free market.

However, as this article shows, current regulations and lack of competition do not encourage CRAs to accurately rate complex investment vehicles like mortgage-backed securities. Instead, these problems cause CRAs to use their government-sanctioned position as a financial gatekeeper to make enormous profits and preclude competitors from entering the market. Ultimately, this causes an unfounded sense of wellbeing amongst investors in the financial market.

This article suggests that the SEC’s current proposals are not sufficient to fix the problems that have plagued the credit rating industry for decades. Therefore, policymakers and regulators should implement a handicapping system to bolster the proposed disclosure requirements. This reform will

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<sup>193</sup> See Newport, *supra* note 185 (discussing the problems that golf experienced when trying to form a handicap).

<sup>194</sup> See FRANK PARTNOY, *FIASCO: THE INSIDE STORY OF A WALL STREET TRADER* 250 (1997) (discussing “health campaign contributions” and the persuasion of our elected representatives) *but see* Jonathan R. Macey, *Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation*, 65 U. CHI. L. REV. 1487, 1506 (1998) (countering Professor Partnoy’s assertions).

create penalties for CRAs that inflate their rating for a given security, causing them to focus on developing the models and hiring the people required to issue an accurate rating. In addition, handicaps will level the playing field by allowing other smaller CRAs to issue ratings for regulatory purposes. In the end, this reform will help make the financial market more transparent, efficient, and reliable.