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BOOK 1

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Abstract

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THE COLLAPSE OF AN EMPIRE? RATING AGENCY REFORM IN THE WAKE OF THE 2007 FINANCIAL CRISIS

*Elizabeth Devine**

"There are two superpowers in the world today in my opinion. 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. And believe me, it's not clear sometimes who's more powerful."

—Thomas Friedman[1]

INTRODUCTION

In 1996, Thomas Friedman's remarks echoed the sentiments of many. The rating agency business was booming, and it seemed like the agencies themselves could do no wrong. Because nearly every financial business was limited in some way by credit ratings,[2] a rating agency became the most powerful player in many business transactions. If issuers and investors could keep the rating agencies profitable, and if rating agencies could provide issuers and investors with the ratings they needed, what could possibly go wrong?

In 2007, the fall of the U.S. housing market sparked a "once in a

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1. Interview by Jim Lehrer with Thomas L. Friedman, New York Times Columnist, on The News Hour, PBS Television (Feb. 13, 1996).

2. FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 66 (1st ed. 2003).

century credit tsunami,"[3] resulting in a worldwide financial meltdown. The financial crisis was triggered by the failure of the market for collateralized debt obligations ("CDO"), particularly in the segment based upon subprime mortgages.[4] The crisis began and has been fueled by the fact that the CDOs with the highest ratings were worth far less than their face amounts.[5] In effect, their ratings were worthless.

As analysts begin to investigate who is to blame for the current financial situation, some argue it was the fault of overzealous lenders, others say that homeowners were simply borrowing well beyond their means, but many analysts now point fingers at the rating agencies themselves. By giving mortgage-backed securities the top ratings and underestimating the risk of default and foreclosure, the rating agencies played a key role in inflating the housing bubble and contributing to the financial meltdown.[6] "How on earth could a bond issue be AAA one day and junk the next unless something spectacularly stupid has taken place . . . ? [M]aybe it was something spectacularly dishonest like taking that colossal amount of fees in return for doing what Lehman and the rest wanted."[7]

The key to the rating agencies' involvement in the financial crisis is that the unregulated ratings for asset-backed securities in CDOs became proxies for the full disclosure required by securities law.[8] The SEC detailed in a report that the rating agencies failed to accurately rate the creditworthiness of many structured financial products resulting in the overreliance by both the government and investors on the inaccurate ratings.[9] The consequences of this reliance came to the detriment of

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3. Kristofor W. Nelson, Note, *Rough Waters for the Ratings Companies: Should the Securities Ratings Companies Be Held Liable for Investor Reliance in the Wake of the Real Estate Meltdown of 2007-2008?*, 63 U. MIAMI L. REV. 1177, 1177 (2009).

4. Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U. ILL. L. REV. 1359, 1361 (2009).

5. *Id.*

6. James Surowiecki, *Ratings Downgrade*, NEW YORKER, Sept. 28, 2009, at 25.

7. Kevin G. Hall, *How Moody's Sold Its Ratings—and Sold Out Investors*, MCCLATCHY-TRIB. NEWS SERVICE, Oct. 16, 2009 (citing Lawrence McDonald, former vice president of Lehman Brothers).

8. *See* Mendales, *supra* note 4, at 1361-62.

9. *Approaches to Improving Credit Rating Agency Regulation: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 111th Cong. 6 (2009) [hereinafter *Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee Hearing*]

investors, and later, the markets themselves.

Though analysts, scholars and lawmakers struggle to find the exact cause of the financial meltdown, one thing is clear. If we are going to reform the system, and prevent a similar crisis in the future, fixing the rating agencies should be at the top of the list.[10] Congress must reevaluate how the rating agencies conduct their business. With respect to how to reform the rating agencies, two questions come to mind. First, are the rating agencies simultaneously too protected and too unregulated by the government? Second, were the judgments of the rating agencies tainted?

This paper argues that current securities regulation is not equipped to respond to another financial meltdown of this magnitude. It suggests the best response to prevent another crisis is not to halt or alter the issuance of certain financial structures, but to reform the rating agencies that rate these structures, making the rating process more transparent and legitimate.

Part I of this paper describes the evolution of the rating agency business and the growth and importance of nationally recognized statistical rating organizations. Part II discusses the growth of mortgage-backed securities and the increasingly important role rating agencies played in the securitization market. Part III focuses on the collapse of the rating agency empire, analyzing the holes in the system that may have contributed to the 2007 financial meltdown. Part IV questions the reality of reforming the rating agency business and discusses why past attempts at reform failed. Finally, Part V argues that reform is necessary in order to recover from the current financial crisis and prevent a future one. It focuses on the importance of transparency, and discusses proposed litigation regarding reform.

I. HISTORY

Rating agencies have been around for about a century,[11] beginning in 1909 when John Moody set about synthesizing all types of credit information into a single rating, publishing a manual called "Moody's Analyses of Railroad Investments."[12] By the mid-1920s, the idea of a unified credit rating had caught on, and three competitors joined

(statement of Spencer Bachus, Member, H. Comm. on Financial Services).

10. *See* Surowiecki, *supra* note 6, at 25.
11. *Id*.
12. Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES, Apr. 27, 2008, at 36.

Moody's: Standard Statistics, Poor's Publishing and Fitch.[13] Rating agencies rate debt obligations based on the ability of an issuer to make timely payments on securities.[14] Ratings are meant to be an estimate of probabilities,[15] and are not a recommendation to buy or sell. Now, as it was nearly one hundred years ago, "a triple-A rating has been regarded as the gold standard for safety and security of these investments."[16]

Though the ratings provided by the rating agencies were useful to investors, it was not until the 1930s, when regulators began incorporating ratings into their regulatory schemes, that the rating agencies gained popularity. For example, the Banking Act of 1935 provided that national banks could only purchase securities that were investment securities.[17] In 1936, the U.S. Treasury Department further classified this restriction on banks, defining "investment securities" to be securities that were not "distinctly and predominately speculative" according to a "designated standard" which must be "supported by not less than two rating manuals."[18] Other regulatory bodies soon followed suit, increasing the demand for ratings.[19] Despite this attempt to restrict what securities certain firms could purchase, one glaring loophole regarding the ratings remained. Without further classification for *which*

13. *Id.*

14. *Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 1 (2008) [hereinafter *Oversight and Government Reform Hearing*] (statement of Henry A. Waxman, Chairman, H. Comm. on Oversight and Government Reform). *See also* Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 8 (2002).

15. *See* Lowenstein, *supra* note 12.

16. *See Oversight and Government Reform Hearing*, *supra* note 14 (statement of Henry A. Waxman, Chairman, H. Comm. on Oversight and Government Reform). Each rating agency has its own nomenclature unique to its rating scale, but each generally follows the same methodology. Moody's, for example, rates bonds on a scale with 21 steps, from AAA to C. Ratings that begin with the letter "A" carry the least amount of risk, those beginning with "B" have moderate risk and those with a "C" rating are in poor standing or default. *See* Lowenstein, *supra* note 12. For the purposes of this paper, references to "Triple-A" or "AAA" will denote bonds with the least amount of risk.

17. Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111, 1117 (2009).

18. Darren J. Kisgen & Philip E. Strahan, *Do Regulations Based on Credit Ratings Affect a Firm's Cost of Capital?* 6 (Nat'l Bureau of Econ. Research, Working Paper No. 14890, 2009), *available at* http://ssrn.com/abstract=1353327.

19. *See* Dennis, *supra* note 17, at 1117; *see also infra* notes 31-39.

rating agency's ratings could be used for these regulations, anyone could establish an arbitrary firm to provide "ratings" that would circumvent the effects of the regulations.[20]

The rating business grew at a slow and steady pace until 1970, when the sudden and unexpected collapse of Penn Central[21] caused investors to think twice about what information the rating agencies were providing.[22] Investors were furious that the rating agencies failed to foresee this bankruptcy. The collapse of Penn Central put the rating agencies in the spotlight, and the idea of credit risk at the forefront of investors' minds.

The government responded. In 1975, the Securities and Exchange Commission ("SEC") decided to penalize brokers for holding bonds that were less than investment grade and created a category of officially designated rating agencies, "nationally recognized statistical rating organizations" ("NRSROs") to determine what exactly "investment grade" meant and finally answering the question of which rating agency's ratings could be used.[23] The SEC immediately grandfathered the three existing agencies – Moody's Investors Service ("Moody's"), Standard & Poor's ("S&P") and Fitch – into the NRSRO category.[24] This designation made Moody's, S&P and Fitch the "official arbiters of financial soundness,"[25] and gave a tremendous amount of power to a small number of rating agencies.[26] Dubbing the "big three" rating agencies NRSROs was supposed to make it easier for investors to know their investments were safe,[27] and the new SEC regulations and NRSRO designation quickly turned rating agencies from mere opinion givers into indispensable gatekeepers.[28]

The rise of the rating agencies, and particularly the development of NRSROs, had a huge regulatory impact in the United States. Originally used as a basis for judging the quality of securities that broker-dealers

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20. *See* Kisgen & Strahan, *supra* note 18, at 8.

21. *In re* Penn Central Transp. Co., 484 F.2d 1300 (3d Cir. 1973).

22. *See* Lowenstein, *supra* note 12.

23. *Id.*

24. *See* Kisgen & Strahan, *supra* note 18, at 8.

25. *See* Surowiecki, *supra* note 6, at 25.

26. BARRY RITHOLTZ & AARON TASK, BAILOUT NATION: HOW GREED AND EASY MONEY CORRUPTED WALL STREET AND SHOOK THE WORLD ECONOMY 158 (2009).

27. *See* Surowiecki, *supra* note 6, at 25.

28. *Id*.

could use to satisfy their capital requirements,[29] today, many investment rules and regulations are based on a bond's credit rating as provided by the rating agencies, and particularly by NRSROs.[30] For example, under the 1940 Act, taxable money market funds may not hold more than five percent of their assets in securities rated below the top tier ratings of at least two rating agencies.[31] In 1951, the National Association of Insurance Commissioners established a "Securities Valuation Office" to assign risk ratings to bonds held in the investment portfolios of insurance companies.[32] The Securities Valuation Office used ratings corresponding to those of the major rating agencies.[33] Under the Secondary Mortgage Market Enhancement Act of 1984, "mortgage related securities" ranked in one of the two highest rating categories by at least one NRSRO were deemed acceptable investments for federal savings and loan associations and credit unions.[34] In 1988, the Department of Labor instituted a regulation permitting pension fund investment in asset-backed securities only if they were rated A or better.[35] By 1994, Savings and Loans, who had already gone through significant reorganization following the Banking Act of 1935, were prohibited from investing in "junk bonds," as designated by the rating agencies.[36] The Eurobond and Asset-Backed Securities markets now often require a certain rating for a firm in order for that firm to participate in the market.[37] Even state regulations now require certain ratings as provided by NRSROs.[38]

Clearly, the scope and use of credit ratings, and particularly a rating provided by an NRSRO is vast, and well beyond its original intentions. The SEC acknowledges, "Although we originated the use of the term NRSRO for a narrow purpose in our own regulations, ratings by NRSROs today are used widely as benchmarks in federal and state legislation, rules issued by other financial regulators, in the U.S. and

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29. *See* Mendales, *supra* note 4, at 1374.
30. *See* Kisgen & Strahan, *supra* note 18, at 6.
31. *Id*. at 7.
32. *Id.* at 6.
33. *Id.*
34. *See* Mendales, *supra* note 4, at 1369.
35. *See* Kisgen & Strahan, *supra* note 18, at 7.
36. *Id.* at 6.
37. *Id.* at 7.
38. *Id.* at 7-8 (stating that "California state regulations prohibit California-incorporated insurance companies from investing in bonds rated below single-A.").

abroad, and private financial constructs."[39]

With so many institutions and regulatory bodies relying on the ratings granted by NRSROs, these entities became indispensible tools for institutional investors. In the rating agency business, the "big three" (NRSROs Moody's, S&P and Fitch) control 95% of the market.[40] A rating from one of these agencies was like a key that could unlock the regulatory system, giving institutional investors a wide range of investment possibilities. In essence, a better rating by an NRSRO meant better regulatory treatment for these investors.[41]

The importance of an NRSRO's rating on a firm is demonstrated in a study conducted by Darren J. Kisgen and Philip E. Strahan.[42] Since designating the "big three" NRSROs, the SEC has infrequently designated any additional agencies,[43] leaving Moody's, S&P and Fitch the only NRSROs. However, in 2003, the SEC designated Dominion Bond Rating Service ("DBRS") as the fourth NRSRO.[44] Studying the effects of DBRS's status as an NRSRO, Kisgen and Strahan found that the change in status from non-NRSRO to NRSRO changed the impact of DBRS' ratings on a firm's yield bonds.[45]

With respect to asset-backed securities, the rating from an NRSRO became an essential component in the sale of a corporate bond or package of mortgages. Obtaining the highest, triple-A rating became a necessity[46] and issuers' lawyers began spending a considerable amount of time negotiating with the rating agencies in order to achieve such ratings.[47] The fact that the rating agencies were able to dictate what financial institutions could and could not do simply by way of what rating they attached to a particular securities gave the rating agencies, and particularly NRSROs the force of law.[48] This was a significant step for the rating agencies, considering they were private companies.[49]

Rating agencies and NRSROs gained even more power when they

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39. *Id*. at 8.
40. *See* Dennis, *supra* note 17, at 1114 (Moody's and S&P alone control 80% of the market.).
41. *See* PARTNOY, *supra* note 2, at 66.
42. *See* Kisgen & Strahan, *supra* note 18.
43. *Id*. at 1.
44. *Id*.
45. *See id*.
46. Surowiecki, *supra* note 6, at 25.
47. Mendales, *supra* note 4, at 1375.
48. Surowiecki, *supra* note 6, at 25.
49. *Id*.

were allowed to switch from having investors pay for their services to charging the issuers of debt for their services.[50] Now, realizing they had an invaluable product, rating agencies were able to leverage their power. Since so many regulations required issuers to seek ratings from the rating agencies and NRSROs, the rating agencies started charging these issuers a pretty penny for favorable ratings,[51] and the issuers were willing to pay. Suddenly, the rating agency business had grown from advisory, to necessary, to big-money-makers. The rating agencies latched on to their profit potential.

With the new payment structure, nearly every company that publicly traded bonds began paying the rating agencies directly for their services.[52] The average cost of these services ranged between $30,000 and $100,000.[53] In some instances, Wall Street paid as much as $1 million for ratings.[54]

With the new millennium, both Moody's and S&P went public and a push for an even greater revenue growth resulted.[55] In 2000, when Moody's went public, mid-level executives at the company were given stock options.[56] These executives therefore had incentive to consider not just the accuracy of their ratings but also the effect those ratings would have on Moody's as a business.[57] An investment bank might be willing to pay a higher fee for an AAA rating than a BB rating. Not surprisingly, when Moody's went public, its profits increased by 900%.[58] By 2002, Moody's was worth more than Bear Stearns, which, at the time was a prominent investment bank.[59] Revenues that were $800.7 million in 2001 soon topped $1.73 billion in 2005 and reached $2.03 billion in 2006.[60]

Although "[t]he public may think of [the rating agencies] as detached arbiters of security quality, like a financial Supreme Court . . .

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50. Hall, *supra* note 7.
51. Lowenstein, *supra* note 12.
52. PARTNOY, *supra* note 2, at 66.
53. *Id*.
54. *See* Hall, *supra* note 7.
55. *60 Minutes: House of Cards: The Mortgage Meltdown* (CBS television broadcast Jan. 23, 2008) (interview between Steve Kroft and Jim Grant) [hereinafter *60 Minutes*].
56. *See* Hall, *supra* note 7.
57. *Id*.
58. Lowenstein, *supra* note 12.
59. *Id*.
60. *See* Hall, *supra* note 7.

[i]n fact, they were building booming, diversified, high-margin businesses."[61] Now that the rating agencies were money-hungry, profit-driven companies, the business became more like selling "licenses" than issuing opinions.[62] The rating agencies did their part to feed the enthusiasm and began targeting areas that would provide them with the fastest, greatest revenue growth.[63] In the rating agency business, the more complex a financial structure, the higher the fee can be, and in the 2000s, rating agencies jumped at the opportunity to rate the very CDOs based upon subprime mortgages that led to the eventual collapse of our economy.[64]

II. THE ROLE OF THE RATING AGENCIES IN THE SECURITIZATION MARKET

The origins of CDOs being based upon subprime mortgages, or mortgage-backed securities, which led to the current financial crisis, go back to the creation of the Federal Housing Administration ("FHA") in 1934.[65] Before the FHA was established, mortgage lending was dominated by Savings & Loans ("S&L").[66] S&Ls used the deposits from their customers to make loans, and were therefore limited in the number and amount of mortgage financing each S&L could provide.[67] The FHA insured mortgagors and their successors in interest against mortgage defaults on loans, and between 1938 and 1970, three government-sponsored entities were created in order to facilitate the creation of a secondary market for these mortgages: the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association.[68] These government-sponsored entities ("GSEs") began issuing mortgage-backed securities.[69] The GSEs established strict underwriting and documentation standards and lenders who wished to sell their loans to

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61. CHARLES R. MORRIS, THE TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH 77 (2008).

62. *Id*.

63. *60 Minutes*, *supra* note 55.

64. Mendales, *supra* note 4, at 1361.

65. Dennis, *supra* note 17, at 1119.

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

the GSEs had to comply with these standards.[70] By becoming de facto regulators of the quality of the mortgages they packaged, the GSEs played a substantial role in ensuring the quality of the loans behind the mortgage-backed securities they issued.[71]

Investors were drawn to the mortgage-backed securities issued by the GSEs because of the implicit government guarantee behind them that the GSEs were "simply too big to fail."[72] Soon, realizing the potential of mortgage-backed securities, private institutions were created that issued mortgage-backed securities. However, the private institutions lacked the "government guarantee" of the GSEs, and the biggest purchasers of the non-GSE mortgage-backed securities were big investment banks that did not uphold the same stringent underwriting standards of the GSEs.[73]

Mortgage lenders now had incentive to loan money to riskier borrowers, and sell those riskier loans to investment banks that would then issue the mortgage-backed securities to investors.[74] Investors purchasing the non-GSE mortgage-backed securities had no implicit government guarantee, and had no documentation regarding the underlying loans in the security.[75] Therefore, the *only* indication of the quality of the loans rested upon the rating given to the security by the rating agencies. "In a practical sense, it was Moody's and Standard & Poor's that set the credit standards that determined which loans Wall Street could repackage and, ultimately, which borrowers would qualify. Effectively, they did the job that was expected of banks and government regulators."[76]

Though the rating agencies became the de facto watchdogs over the mortgage industry,[77] they were not loan officers.[78] Rating agencies were often given one day to process, analyze and rate the credit data received from an investment bank.[79] Despite the quick turnaround, the securitized products created by the mortgage-backed security scheme

70. *Id.* at 1120.
71. *Id.*
72. *Id.*
73. *Id.*
74. *Id.* at 1121.
75. *Id.*
76. Lowenstein, *supra* note 12.
77. *Id.*
78. *Id.*
79. *Id.*

quickly became the most powerful (and profitable) tool for the rating agencies.[80] Because the rating given by a rating agency was essentially the only indicator of a package's "worth,"[81] the rating agencies took advantage of investment banks that were willing to pay high fees for high-rated securities. "[T]he rating agencies charged fees on crappy AAA-rated paper that were twice as big on subprime paper versus prime-based loans. And Bloomberg estimated that from 2002 to 2007, the agencies garnered fees on $3.2 trillion in subprime-based mortgages."[82]

The "watchdog" role created a conflict of interest for the rating agencies. The mortgage-backed securities sold and rated by the rating agencies did not have any fixed standards with respect to the quality of the underlying debt instruments.[83] With so much emphasis placed on the rating provided by a rating agency, "a system largely outside the bounds of securities regulation – the ratings issued by private rating agencies – largely displaced the structured disclosure requirements of securities law as the primary basis for investors' purchase of the securities either as direct investments or as components of derivative securities."[84] With no direct regulation, and no fixed standards with respect to the underlying debt instruments, could a rating agency essentially give a security any rating it wanted?

With the failure of CDOs beginning in 2006 and reaching dimensions beyond anyone's imagination by 2007,[85] many began to wonder whether the rating agencies did issue arbitrary ratings to these mortgage-backed securities. In April 2007, Moody's announced that the model it introduced in 2002 was no longer a good indicator for sub-prime mortgages,[86] and although the rating agencies tightened methodology for rating mortgage-backed securities beginning in the Summer of 2007, their efforts were too little, too late, and billions of dollars of securities were downgraded.[87]

80. *Id.*
81. *Id.*
82. *See* RITHOLTZ & TASK, *supra* note 26, at 112.
83. Mendales, *supra* note 4, at 1368.
84. *Id.* at 1363.
85. *Id.* at 1362.
86. Lowenstein, *supra* note 12.
87. *Id.*

III. THE COLLAPSE OF AN EMPIRE?

With so much weight placed on ratings as indicators of a mortgage-backed security's worth, many financial analysts are pointing blame for the 2007 financial crisis on the rating agencies themselves. In fact, many now argue that the rating agencies knew what they were doing. Rating agencies were deliberately overstating ratings, with little thought to the underlying debt instruments, in order to win over investment banks and increase their revenues.

> This was a systematic and aggressive strategy to replace a culture that was very conservative, an accuracy-and-quality oriented [culture], a getting-the-rating-right kind of culture . . . that was supposed to be 'business friendly,' but was consistently less likely to assign a rating that was tougher than our competitors.[88]

Rating agencies were established to give opinions, and were therefore under no legal obligation to the investment banks for whom they issued their opinions.[89] However, many now argue that the rating agencies may have been too "business" driven. Some rating agency employees admit they did not realize there was a compliance aspect to the issuance of a rating.[90]

"The credit-rating agencies suffer from a conflict of interest – perceived and apparent – that may have distorted their judgment, especially when it came to complex structured financial products."[91] It is this conflict of interest that may have made the rating agencies too money-hungry, resulting in illegitimate and worthless ratings and significantly contributing to the 2007 worldwide financial meltdown.

Several factors account for the conflict of interest that may have altered the judgment of the rating agencies. First, the issuer-pays model, where rating agencies receive payment for their ratings from the issuers of the securities rather than the investors, shifts the focus of a rating from protecting the investors to marketing the ratings.[92]

Second, the rating agencies themselves were active participants in

88. *See* Hall, *supra* note 7 (quote by Mark Froeba, a senior vice president who joined Moody's structured finance group in 1997).

89. *Id*.

90. *Id*.

91. Lowenstein, *supra* note 12.

92. *See Oversight and Government Reform Hearing*, *supra* note 14, at 25.

the creation of the faulty-structured products, not objective third-party arbiters. When sending a security to a rating agency:

> [u]nderwriters don't just assemble a security out of home loans and ship it off to the credit raters to see what grade it gets . . . . Instead, they work with rating companies while designing a mortgage bond or other security, making sure it gets high-enough ratings to be marketable.[93]

For example, during the most recent real estate boom, S&P rated most senior tranches of sub-prime mortgage-backed securities AAA, and issued upgrades to its junior tranches that were initially given lower ratings.[94]

Third, the banks themselves were gaming the system. Investment banks were designing securities to "just meet" the rating agencies' tests,[95] and in return, the three major rating agencies, Moody's, S&P and Fitch were "engaged in a form of payola. They were willing to play along with the investment banks, putting triple-A ratings on paper that turned out to be junk – if the price was right. Call it 'pay for play.'"[96] It should be no real coincidence, then, that the big investment banks would return again and again to the same rating agency despite astronomical fees.[97]

Finally, the weight placed on the ratings of mortgage-backed securities is itself, its own worst enemy.

> The real problem is not that the market . . . under weighs ratings quality but rather that in some sectors, it actually penalizes quality . . . it turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want ratings downgrades; short-sighted bankers labor short-sightedly to game the ratings agencies.[98]

Where the system itself is not looking for quality ratings, why should a rating agency put forth extra effort to supply "quality" when a

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93. *See* RITHOLTZ & TASK, *supra* note 26 (quoting Aaron Lucchetti, *How Rating Firms' Calls Fueled Subprime Mess*, WALL ST. J., Aug. 15, 2007, at A1).

94. Nelson, *supra* note 3, at 1186.

95. Lowenstein, *supra* note 12.

96. *See* RITHOLTZ & TASK, *supra* note 26.

97. Lowenstein, *supra* note 12.

98. Raymond McDaniel, Confidential Presentation to Moody's Board of Directors (Oct. 21, 2007), *available at* http://content.lawyerlinks.com/library/sec/briefs/2007/moodys/moodys_declaration_111708_F.pdf.

client does not look for it?

The inherent and apparent conflict of interests drove some rating agencies to take drastic measures to ensure a profitable, booming business. Moody's is said to have fired analysts and executives who warned of trouble before the housing market collapsed in 2007.[99] Moreover, it pushed out employees in its compliance department, replacing them with "business people" who had given the highest ratings to pools of mortgages that were later downgraded to junk.[100]

The creation of privately sponsored mortgage-backed securities coupled with the power granted to rating agencies by regulatory bodies and NRSRO designation made it impossible for investors to not rely on the ratings issued by the rating agencies. Moreover, it may have let the rating agencies exert too much influence on the securities they rated.[101] Once a mortgage-backed security was given a rating, and if that rating were AAA, investors no longer cared about the underlying debt instruments.[102] Too much reliance on one ingredient is a risky game to play, and investors and the rating agencies should not have let a security's rating become a rubber-stamp to buy or sell.

Investors were not the only party who failed to recognize the underlying debt instruments in a security. The rating agencies themselves do not perform due diligence to ensure adequate documentation for each mortgage pooled into a mortgage-backed security, nor do the rating agencies adhere to the same strict standards of the GSEs.[103] The rating agencies further failed to account for the effects of the deterioration of underwriting standards as was reported by the Office of the Comptroller of Currency.[104] In each of the years 2004 through 2007, the Office of the Comptroller of the Currency reported that banks had eased their underwriting standards.[105] By failing to account for these changes, rating agencies continued to assign high ratings to mortgage-backed securities likely composed of riskier and riskier loans.

In light of the recent financial collapse, financial analysts and investors point out that the models used by the rating agencies were

99. *See* Hall, *supra* note 7.
100. *Id*.
101. *See* Surowiecki, *supra* note 6, at 25.
102. *See* Lowenstein, *supra* note 12.
103. *See* Mendales, *supra* note 4, at 1377; *see also supra* notes 71-72.
104. *See* Dennis, *supra* note 17, at 1126-27.
105. *Id*.

based on historical data that did not reflect accurate characteristics of subprime mortgages.[106] Rating agency models rely upon the historical performance of a class of assets in order to predict how it will perform in the future,[107] but with respect to subprime mortgages, had the rating agencies based their models on more recent data, their ratings may have been more accurate. Agencies typically resist changing their models and assigned ratings because when they do, the change tends to be belated, widespread and big.[108] Due to the restrictions imposed by regulatory bodies, institutional investors cannot hold many low-rated securities. Therefore, when rating agencies downgrade their ratings, it leads to forced selling and magnified panic and prevents others from buying the securities.[109]

Rating agencies have no real incentive to update their statistical models to reflect changing market conditions because there is an absence of effective competition.[110] S&P and Moody's have enjoyed a near duopoly in rating asset-backed securities[111] and the SEC has helped promulgate this "big boys club." From 1975 to 2000, the SEC designated only four more firms as NRSROs, but mergers always reverted them back to the "big three," Moody's, S&P and Fitch.[112] Though a rating agency must apply to the SEC in order to obtain NRSRO status, the SEC has never provided qualifications for NRSRO designation, making it infinitely difficult for rating agencies to obtain recognition.[113] The process of obtaining NRSRO status has been criticized for its lack of transparency regarding qualifications and for

106. *Id.* at 1124.

107. *Id*.

108. Surowiecki, *supra* note 6, at 25.

109. *Id.* For example, despite market consensus, throughout the summer and fall of 2001, the rating agencies kept Enron at investment grade, despite the fact that its credit was deteriorating. On November 28, 2001, S&P finally changed Enron's bond to sub-investment grade, causing the stock to collapse. Four days later, Enron filed for bankruptcy. *See* Lowenstein, *supra* note 12. In another example, when the S&P downgraded General Motors to speculative grade, its bonds fell 8%. One reason for the 8% drop was that the downgrade prohibited many institutions from owning the debt. *See* Kisgen & Strahan, *supra* note 18, at 3.

110. *See* Mendales, *supra* note 4, at 1375.

111. *Id*. at 1377.

112. *See* Kisgen & Strahan, *supra* note 18, at 9.

113. *Id.* ("The primary guidance for whether a firm would qualify [as an NRSRO], was that the firm should be 'nationally recognized' in the United States and be an issuer of 'credible and reliable ratings.'").

effectively limiting the number of certified rating agencies.[114]

IV. THE REALITY OF REFORM?

"You have legitimized these things, leading people into dangerous risk."[115]

With rating agencies (and particularly NRSROs) blessed by the government to have the official word with respect to the ratings assigned to securities, very few people ever questioned the veracity of the rating agency business.[116] The rating agency process ran like a well-oiled machine (that is, until the collapse of the housing market and the resulting financial windfall). With so many aspects of business transactions affected by the rating agency business, is it possible to reform rating agencies in a way that will prevent another financial meltdown in the future?

Even with the inclusion of ratings in so many facets of financial regulatory schemes, NRSROs owe no clear legal responsibility to the public to rate securities with care.[117] In fact, previous courts have held that the opinions of rating agencies are the equivalent to editorial commentary that is constitutionally protected under the First Amendment.[118] Some argue, however, that it is unfair for rating agencies to be protected when accounting firms also give opinions and can be sued.[119] Until future courts find that rating agencies are no longer afforded their First Amendment protection, it will be difficult to find an NRSRO liable for damages with respect to its ratings.

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114. *Id.* at 8-9.

115. *See* RITHOLTZ & BARRY, *supra* note 26, at 158 (a July 2007 e-mail from an executive of Fortis Investments, a money management firm, to Moody's).

116. *Id*.

117. *See* Dennis, *supra* note 17, at 1144.

118. *See* Nelson, *supra* note 3, at 1189. *See also* Dennis, *supra* note 17, at 1121 (stating that rating agencies have asserted that they are financial publishers and that as financial publishers, they are entitled to the heightened protections of the "actual malice" standard. Under the "actual malice" standard, a publisher will not be liable for false statements unless the statement is made with knowledge that it was false or with reckless disregard for its truth or falsity.).

119. The Latest in the Financial Services Crisis: Government Control v. The Free Market, Speech at the 2008 National Lawyers Convention (Nov. 21, 2008), *in* 5 J.L. ECON. & POL'Y 259, 263 (2009).

Rating agency reform may not be possible simply because previous attempts at reform have failed. After the collapse of Enron, Congress ordered the SEC to investigate the rating agency business and reform the rating process, but the SEC failed to do so.[120] In 2006, Congress passed the Credit Rating Agency Reform Act ("CRARA").[121] CRARA sought to bring the rating agencies within the jurisdiction of securities laws,[122] but prohibited the SEC from "regulating the substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings."[123] CRARA also required that the SEC establish clearer guidelines for which firms could qualify for NRSRO status[124] and required that rating agencies applying for NRSRO status discuss its methods and general procedures in its NRSRO registration application.[125] It did not, however, require that the rating agencies disclose the data underlying its statistical models or other methodologies applied to the individual securities being rated.[126]

Though a valiant attempt at reform, CRARA was ineffective. While CRARA aimed to generate more competition among NRSROs by establishing clearer guidelines for the qualification of NRSRO status, it required that a rating agency be in business for at least three years before the SEC could accredit it.[127] Moreover, it required that an agency applying for NRSRO status provide written certifications from at least ten "qualified institutional buyers."[128]

> These provisions create a Catch-22: securities that do not receive high ratings from agencies accredited as NRSROs cannot be used as regulatory capital and are therefore difficult to market; but an agency cannot be accredited unless it can rate securities for at least three years and get recommendations from at least ten satisfied clients.[129]

CRARA was also ineffective in that it ignored many of the concerns expressed by the SEC, such as transparency in the rating

120. *See* Lowenstein, *supra* note 12.
121. *See* Mendales, *supra* note 4, at 1385.
122. *Id.*
123. *See* Dennis, *supra* note 17, at 1114.
124. *See* Kisgen & Strahan, *supra* note 18, at 9.
125. *See* Mendales, *supra* note 4, at 1386.
126. *Id.*
127. *Id.*
128. *Id.*
129. *Id.*

process.[130]

The rating agency business has remained unchanged because no one bothered, or *wanted* to change it before. "The rapid increase in demand for ratings of mortgage based securities and CDOs created an environment in which the benefits of inaccurate ratings outweighed potential costs."[131] First, the profits generated from issuing ratings on mortgage-backed securities were immense, regardless of their accuracy.[132] Second, evidence that investment banks would pay higher fees to rating agencies that awarded them higher ratings suggests that rating agencies cared less about their reputation than the amount of fees they earned.[133] Third, there was such a high demand for the ratings of mortgage-backed securities that the investors themselves seemed to care less about the reputation of the rating agency or the accuracy of the rating.[134] Finally, because rating agencies are not subject to liability when their ratings are included in prospectuses, their liability costs are so low, it is not a deterrent to issuing inaccurate ratings.[135]

The above rationales for inaccurate ratings really highlight the point – *do people really care?* Last summer, the SEC announced plans to reform the rating agency business, but pressures by big investors squashed them.[136] Evidently, the investors involved in the rating process see no reason to fix what may not necessarily be broken. There were a host of other factors besides the inaccuracy of credit ratings that contributed to the 2007 financial meltdown. However, with so much exposed now, an economic recovery may depend in part on a reform of the rating agencies. Investors must stop depending so heavily on ratings, but what investors still depend on must be truthful and accurate. "'If credit remains paralyzed, small banks cannot finance the housing demand. They have to take [investment banks] these mortgages and move them to a global audience . . . . That can't happen unless the world trusts the gatekeeper.'"[137]

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130. *Id*. at 1387.
131. *See* Dennis, *supra* note 17, at 1133.
132. *Id*.
133. *Id*.
134. *Id*.
135. *Id*.
136. *See* Surowiecki, *supra* note 6, at 25.
137. *See* Hall, *supra* note 7.

V. NECESSITY FOR REFORM

Though investors may not want the ratings business to change, and despite previous reform failures, in the wake of the housing market collapse it is clear that the rating agencies deliberately underestimated the risks of mortgage-backed securities in pursuit of their own self-interests, to the detriment of investors, and ultimately, the market.[138] The only way to prevent rating agencies from remaining conflicted gatekeepers is to impose some type of reform that will eliminate the greed and deceit from the rating agency business. As the rating agency business stands now:

> [It] provides a ready-made excuse for failure: as long as you're buying AAA-rated assets, you can say you're being responsible. After the housing crash, though, we know how illusory those AAA ratings can be. It's time for investors to face reality: working with a fake safety net is more dangerous than working without any net at all.[139]

One dominant view of regulation of rating agencies is the "reputational capital" theory. The "reputational capital" theory holds that a rating agency's interest in maintaining a reputation for accurate ratings will be sufficient incentive to insure accurate ratings by that rating agency.[140] In the 1920s, near its inception, the rating agency business did operate along a "reputational capital" model.[141] When a rating agency issued its rating, investors and analysts would comment on, and often disagree with the agency's rating.[142] With this type of investor involvement, rating agencies were driven to issue accurate ratings. There was no correlation between the fee a rating agency received and the rating it issued. Under a "reputational capital" theory, a reputation for accurate ratings alone would bring in business.

Interestingly, scholars still supported the "reputational capital" theory in 2002 finding that a "lack of official public scrutiny does not appear to affect ratings accuracy because of the de facto accountability

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138. *See* Dennis, *supra* note 17, at 1114.

139. *See* Surowiecki, *supra* note 6, at 25.

140. *See* Dennis, *supra* note 17, at 1114.

141. Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 640 (1999).

142. *Id*.

of rating agencies through reputation."[143] It was then hypothesized that the NRSRO designation of a rating agency would act as an indirect form of merit regulation.[144] An NRSRO designation signified government approval, therefore an NRSRO should have been driven to issue accurate ratings because it had a government-like reputation to uphold. Since 2002, however, it has become apparent that neither merit regulation by way of an NRSRO designation nor "reputational capital" is sufficient to promote rating accuracy among the rating agencies.

Another view of rating agency reform suggests that giving more rating agencies NRSRO designation could radically alter the incentive of rating agencies to issue accurate ratings.[145] As the system stands today, NRSROs are private profit-maximizing entities that will always maximize short-term benefits with long-term losses likely suffered.[146] The addition of more NRSRO-designated entities creates more competition among NRSROs, potentially cutting profits from an NRSRO that is not issuing accurate ratings.

Rating agencies' contribution in the most recent financial crisis suggests that reputation and merit-based reform alone will not change the current behavior and business models of the rating agencies. Something must be done to restrict the rating agencies so that their ratings lose a little bit of their aura and investors trust them a little bit less. The government is in the best position to restrict the powers of the rating agencies by enacting legislation that reforms their business models.

Curtailing investor reliance upon ratings, and particularly inaccurate ratings, begins with reducing the notion that rating agencies are fully endorsed and supported by the government. One proposal suggests that NRSROs should be changed from "nationally recognized statistical rating organizations" to "nationally registered statistical rating organizations."[147] Though it may be difficult to change the implication of "NRSRO" when the acronym itself does not change, the use of the term "registered" versus "recognized" removes a sense of endorsement

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143. Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 15 (2002).

144. *Id*.

145. *See* Kisgen & Strahan, *supra* note 18, at 23.

146. *See* Dennis, *supra* note 17, at 1132.

147. *Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee Hearing*, *supra* note 9 (statement of Spencer Bachus, Member, H. Comm. on Financial Services).

by the government.

Others suggest removing NRSRO designation all together. Moody's itself favors doing away with the official designation,[148] but without any type of rating agency registration, we will revert back to the problem of "ratings according to whom?"[149]

As discussed in Part III of this paper,[150] the rating agency business did not do its due diligence with respect to rating mortgage-backed securities. "This system will not get fixed until someone credible does the necessary due diligence"[151] and many propose that legislation be enacted to ensure that rating agencies follow a high standard of review, much like that followed by the GSEs.[152] At minimum, Congress should impose regulations that require NRSRO designated firms to have sufficient analytical and operational resources in their company.[153]

The rating process needs to become more transparent "so that a rating is more than a 'black box' representing the unregulated label placed by a credit rating agency on the creditworthiness of securities so complex that even financial institutions cannot use traditional securities disclosure to evaluate risks embodied by a CDO."[154] In an attempt to make the process more transparent, the SEC proposed new regulations that "would require the disclosure of all information provided to an NRSRO for the formulation of a rating by issuers, depositors, underwriters and other parties involved in issuing securities . . . ."[155] However, the SEC proposal says nothing about the nature or reliability of the information provided to NRSROs by these entities.[156] Moreover, this proposal could create a new type of competition among rating agencies. Instead of competing for higher fees, rating agencies could begin "compet[ing] for business by offering high[er] ratings based on minimal documentation."[157] Less documentation means that rating agencies may give uninformed opinions, once again leading to the

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148. Lowenstein, *supra* note 12.

149. *See supra* notes 18-21.

150. *See supra* notes 103-115.

151. *See* Hall, *supra* note 7.

152. *See supra* notes 71-72.

153. *Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee Hearing*, *supra* note 9, at 6 (statement of Robert F. Auwaerter, Principal and Head of the Fixed Income Group, Vanguard Group).

154. *See* Mendales, *supra* note 4, at 1363-64.

155. *Id*. at 1403.

156. *Id*.

157. *Id*. at 1404.

problem of inaccurate ratings.

The SEC proposed to further increase transparency in the rating agency business by requiring that all information used in ratings become available to all NRSROs, not just the rating agency providing the rating.[158] Full disclosure to all rating agencies is meant to act as a peer-to-peer check system, but under the proposed rule, NRSROs are under no obligation to verify each other's information.[159] There is a concern that full disclosure to all rating agencies will universally limit disclosure because issuers may not wish to share all information with all rating agencies.[160] If an issuer is not willing to share all of its information with its rating agency because it fears full disclosure to all NRSROs, again, rating agencies may give uninformed opinions, leading to less reliable ratings.

Realistically speaking, the most effective approach to a more transparent rating system involves a two-step due diligence requirement by which professionals employed by issuers and underwriters provide complete and verified data to the rating agencies who then document the statistical models they apply to the data and their application.[161] In addition, issuers and underwriters should be required to provide rating agencies with a wide array of information. The rating agencies themselves are already requesting a greater amount of information[162] in an attempt to catch any fraud that may have worked its way into a security.[163]

In addition to increased transparency in the rating system, and because a rating is an essential component in a CDO, the rating agencies should be subject to regulation beyond that imposed by CRARA, and much like accountants and underwriters, the SEC should take the helm in enforcing these regulations.[164] In addition, the SEC should consult with and create an independent body, comparable to the Public Company Accounting Oversight Board.[165]

158. *See* Dennis, *supra* note 17, at 1146.

159. *Id*.

160. Auwaerter, *supra* note 153.

161. *See* Mendales, *supra* note 4, at 1415.

162. *See* Dennis, *supra* note 17, at 1127.

163. *See* Lowenstein, *supra* note 12. For example, rating agencies would want to ensure that each of the loan applications for the underlying mortgages in a mortgage-backed security were not fraudulent.

164. Mendales, *supra* note 4, at 1409-10.

165. *Id*.

> This body would include representatives of the rating agencies themselves, the SEC, the Federal Reserve, and other government regulatory agencies making use of the rating process, along with representatives of the legal and auditing professions, and professional economists. Its functions would include evaluating the effectiveness of statistical models used by the rating agencies, assuring that the agencies update the models frequently based on experience and macroeconomic conditions, and assuring that the agencies properly apply the models, both in the initial issuance of securities and in periodic review of the ratings.[166]

NRSROs argue that an independent oversight board would force rating agencies to have similar views and stifle their ability to issue valuable opinions.[167] However, an independent oversight board could create a baseline standard that each rating agency must follow when issuing ratings.[168] As a baseline, rating agencies would be free to impose higher standards on themselves, which could give a rating agency a competitive edge. The oversight board should frequently update its baseline to prevent a rating agency model that looks backward, while our lives, and investments, move forwards.[169] In addition, in light of the recent economic events, it is reasonable to require an asset-backed security to meet a minimum standard in order to receive a top rating, and the creation of an independent oversight board would create those guidelines.[170]

In 2009, the House of Representatives proposed a bill to amend the Securities and Exchange Act of 1934 and address the recent shortcomings of the rating agencies.[171] The Accountability and Transparency in Rating Agencies Act ("H.R. 3890") "builds on the Administrations [sic] proposal and takes strong steps to reduce conflicts of interest, stem market reliance on credit rating agencies and impose a liability standard on the agencies."[172] This bill is an important step

166. *Id*.

167. *See* Dennis, *supra* note 17, at 1148.

168. *See* Mendales, *supra* note 4, at 1410.

169. *See supra* notes 103-110. The rating agencies' failure to account for the deterioration of underwriting standards and their models based on historical data resulted in inaccurate ratings that contributed to the 2007 financial crisis.

170. *Id*.

171. H.R. 3890, 111th Cong. (2009) (Oct. 21, 2009 draft).

172. Press Release, H. Comm. on Financial Services, Financial Services Committee Approves Bipartisan Credit Rating Agencies Reform Bill (Oct. 28, 2009), *available at* http://www.house.gov/apps/list/press/financialsvcs_dem/pressCRA_102809.shtml.

towards reform of the rating agencies because "[a]s gatekeepers to our markets, credit rating agencies must be held to higher standards. We need to incentivize them to do their jobs correctly and effectively, and there must be repercussions if they fall short. This bill will take such steps."[173]

H.R. 3890 expands on initial legislation proposed by the Administration in that it (i) clarifies the ability of an individual to sue NRSROs, thus making NRSROs more accountable with respect to their ratings; (ii) adds a new duty to supervise an NRSRO's employees and authorizes the SEC to sanction supervisors for failing to do so; (iii) requires each NRSRO to have a board with at least one third independent directors and those independent directors are responsible for overseeing policies and procedures aimed at preventing conflicts of interest; (iv) enhances the responsibilities of NRSROs with respect to conflicts of interest that arise out of the issuer-pays model, and contains new requirements aimed to mitigate those conflicts of interest; (v) requires greater public disclosure of information regarding the internal operations and procedures of NRSROs; and (vi) requires that when an employee of an NRSRO goes to work for an issuer, the NRSRO review the work of that employee to make sure that all procedures were followed and proper ratings were issued and report that information to the SEC.[174]

CONCLUSION

As we begin to recover from the 2007 financial crisis, it is clear that by giving mortgage-backed securities the top ratings and underestimating the risk of default and foreclosure, rating agencies made a significant contribution to the financial meltdown. Rating agencies were initially established to provide investors with a reliable, standardized rating of the creditworthiness of a security. However, with time, a few regulatory "rubberstamps" and a voracious market requiring immediate ratings, rating agencies became booming, profit-driven businesses. The rating agencies were doing so well, it seemed that they could do no wrong. That is, until 2007, when it was discovered that the CDOs with the highest ratings were worth far less than their face

173. *Id*.
174. *Id*.

amounts.

Revenues, conflicts of interest and the regulatory schemes themselves may have all contributed to these inaccurate ratings. With the financial world pointing blame at the rating agencies, their empire as we once knew it, is bound to collapse. Many suggest that in order to prevent another financial crisis, we must reform the rating agency process. Reforming the rating agencies, however, may not be an easy task. Issuers and investors still crave high ratings, may still be willing to pay enormous fees for those ratings, and previous attempts at reform have failed. Moreover, where no one is quite sure what really went wrong with respect to the financial crisis and inaccurate ratings, legislation proposed to reform the rating agency business may fail to address misaligned incentives, and revise procedures that have worked all along.

That said, this paper argues that in order to prevent another financial meltdown, our best defense is to enact legislation that will reform the rating agencies, making the process more transparent and legitimate. This will best be accomplished by first granting the SEC with the power to enforce the regulation of rating agencies.

The SEC should curb investor reliance on the rating agencies by changing NRSROs from "nationally recognized statistical rating organizations" to "nationally registered statistical rating organizations." This change will help to remove some of the implicit government guarantee and endorsement from the rating agencies.

The SEC must next create an independent oversight board for the regulation of the rating agencies comparable to the Public Company Accounting Oversight Board. This oversight board can effectively make the rating process more transparent and legitimate by creating a baseline standard that each rating agency must follow when issuing ratings. This baseline standard must be updated frequently to account for such things as market trends in order to maintain the most accurate ratings possible.

Together with the independent oversight board, the SEC must make rating agencies more accountable for their ratings by imposing a two-step due diligence requirement and by requiring public disclosure of their rating methods. In addition, the SEC should be granted the power to sanction rating agencies that fail to fulfill their due diligence requirement or fail to uphold any standards set forth by the oversight board.

Even if less emphasis is placed on a credit rating, the U.S. financial markets still depend upon the ratings issued by the rating agencies.

Thus, to rid the world of rating agencies is not an option. However, in order to secure our financial markets, the rating agency empire needs to be reigned in and controlled. By way of SEC enforcement and an independent oversight board, a more transparent and legitimate rating agency business will do just that.