Credit Rating Agencies and the Financial CHOICE Act

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Introduction

Credit rating agencies (CRAs) provide judgments—typically in the form of a letter grade—about the creditworthiness of bonds that are issued by corporations, governments, and packagers of asset-backed securities. The lenders in credit markets, including investors in bonds, always try to ascertain the creditworthiness of borrowers, in making their decisions.[150] Credit rating agencies are, hence, one potential source of such information for bond investors.

Starting in the 1930s, and until the passage of the Dodd-Frank Act in 2010, financial regulators generally required that financial institutions rely on the judgments of the rating agencies in making their bond investments; these regulations, motivated by the desire for safety in bond portfolios, have played a major role in thrusting the agencies into the center of the bond markets.

It may not be surprising, therefore, that the major rating agencies in the U.S. played a central role in the housing bubble and then in the subsequent subprime mortgage debacle of 2007-2008.[151] The successful sale of the mortgage-related debt securities that had

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[150] Equally important, more creditworthy borrowers want to distinguish themselves from less creditworthy borrowers, so that the former can receive better borrowing terms.

[151] The three major CRAs are Moody's, Standard & Poor's, and Fitch. By creating a category ("nationally recognized statistical rating organization," or NRSRO) of rating agency that had to be heeded and then subsequently maintaining a barrier to entry into the category in 1975, the Securities and Exchange Commission (SEC) further enhanced the importance of the three major rating agencies. See, for example, Altman, Oncu, Richardson, Schmeits and White (2011), and White (2013).

subprime residential mortgages and other debt obligations as their underlying collateral depended crucially on these CRAs' initial ratings of these securities. When house prices ceased rising and began to decline, these initial ratings proved to be excessively optimistic—especially for the mortgages that were originated in 2005 and 2006—and the mortgage bonds collapsed, bringing large parts of the U.S. financial sector crashing down as well.[152]

In order to better understand how credit ratings played such an important role in the financial crisis, consider the following illustrative examples: On page 122 of AIG's 2007 annual report, AIG reported that $379 billion of its $527 billion in credit defaults swap notional amount exposure to AAA-rated asset-backed securities sold by its now infamous financial products group was written not for hedging purposes but to facilitate regulatory capital relief for financial institutions. Meanwhile, Citigroup and ABN AMRO performed their own form of alchemy by financing, respectively, $93 billion and $69 billion worth of AAA-rated securities off-balance sheet through so-called "special purpose vehicles" (SPVs). Similarly, in an 18-month period, UBS increased its holdings of AAA nonprime mortgage-backed securities from $5 billion to over $50 billion which, as it turned out, was small relative to the $308 billion of such securities accumulated by Fannie Mae, Freddie Mac and other government-sponsored enterprises (GSEs). In fact, according to a Lehman Brothers report from April 2008, of the $1.64 trillion of these securities outstanding, an astonishing 48% was held by banks, broker-dealers and the GSEs.

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[152] Today most market participants agree that the quality of collateralized debt obligation ratings was poor, even on an *ex ante* basis. A large theoretical and empirical literature in academia has developed over the last several years, commenting on the quality, and especially the inflation, of ratings. (See, for example, Ashcraft, Goldsmith-Pinkham, and Vickery (2010, 2011), Becker and Milbourn (2011), Griffin and Tang (2011, 2012), and He, Qian, and Strahan (2011, 2012), among others.)

What was going on? These securities offered attractive yields but, because of their AAA status, required little or no regulatory capital. And, of course, all of the firms mentioned here effectively failed, or would have, in the absence of a government bailout, during the financial crisis.

In the typical view of the role of ratings in the financial crisis, investors were asleep at the wheel because of the government's "seal of approval" of rating agencies. But the above description shows that it was not only investors who were tricked here but also taxpayers. How did this happen? Because the issuer pays the agency that rates the issuer, there is a huge conflict of interest to shop the security around until the issuer gets the desired rating, leading to inflated ratings.[153] There are numerous academic studies, as well as controversial testimony by former rating agency officials, that ratings were indeed inflated. And because the government had set its regulatory structure around these ratings, investors like AIG, Citigroup, ABN AMRO, UBS, Fannie Mae, Freddie Mac and, for that matter, Merrill Lynch and Lehman, among others, engaged in risky activities while having insufficient capital buffers due to the inflated ratings. Rating agencies effectively acquiesced with, and in some ways contributed to, this alliance between investors and issuers. It is arguable that the crisis could not have transpired the way it did without the rating agencies planted at the center of the financial system.[154]

[153] Of course, the rating agencies care about their long-run reputations, which would be a force to offset the conflict of interest. See, for example, Klein and Leffler (1981). But the short-run profit temptations to accede to an issuer's desire for a higher rating can overwhelm the long-run concerns, as apparently happened with respect to mortgage-related debt securities.

[154] Some of the papers that describe and analyze the conflicts of interests between CRAs, issuers and investors include Bolton, Freixas, and Shapiro (2012), Efing, Matthias, and Hau (2015), Griffin, Nickersen and Tang (2013), Richardson and White (2009), Mathis, McAndrews, and Rochet (2009), Skreta and Veldkamp (2009), and Stanton and Wallace (2012).

The Dodd-Frank Act: Six Years On

As a response to the impact that credit ratings had during the financial crisis, the Dodd-Frank Act instituted major changes to the manner in which CRAs were to be regulated. Most important, Dodd-Frank tried to address two major issues: the conflict of interest that is inherent in the “issuer-pays” model and the regulatory reliance on ratings.[155]

Aside from these major issues, Dodd-Frank prescribed new rules for internal control and governance, independence, transparency, and liability standards. It established an Office of Credit Ratings at the SEC to “administer the rules of the Commission (i) with respect to the practices of NRSROs in determining ratings, for the protection of users of credit ratings, and in the public interest; (ii) to promote accuracy in credit ratings issued by NRSROs; and (iii) to ensure that such ratings are not unduly influenced by conflicts of interest.” (Title IX, Subtitle C, Sec. 932, “Enhanced Regulation, Accountability and Transparency of Nationally Recognized Statistical Rating Organizations.”)

While oversight of NRSROs was needed, some of the Dodd-Frank provisions were quite onerous in terms of compliance, while appearing to yield only modest benefits. Since many of the costs of complying with the regulation are fixed or lumpy, it is more burdensome and costly for smaller firms. In turn, this makes it difficult for smaller firms to survive, and for new firms to enter the business, and innovation, which often is embodied in new firms, may be discouraged. This imposes a relatively heavier burden on innovative start-up rating firms, thereby strengthening the dominance of, and entrenching, the larger rating agencies. For example, Dodd-Frank focuses on “inputs” such as transparency as to their methodology rather than on “outputs” that would be

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[155] For a detailed analysis of the reform of credit ratings agencies in the Dodd-Frank Act, see Altman, Oncu, Richardson, Schmeits and White (2011).

directly related to the accuracy of the ratings. Too much emphasis on transparency of the methodologies may endanger the intellectual property of the CRAs and, again, discourage innovation. Indeed, since Dodd-Frank was passed in 2010 the market share of the three large NRSROs – Fitch, Moody's, and S&P – has not decreased substantially, which *ex ante* may be surprising, given the past financial crisis.[156]

With respect to regulatory reliance, Dodd-Frank changed the way that regulators would use credit ratings to assess the risk of financial institutions. Sec. 939A of Dodd-Frank called for the regulatory agencies to review their reliance on ratings and, where possible, to eliminate such references and find alternative ways of achieving their regulatory goals. Note that while it did not mandate these eliminations, Dodd-Frank called for a more flexible creditworthiness standard. In particular, regulators ought to be looking at market risk, liquidity risk, model risk and even measures of default risk, in addition to credit ratings (e.g., those embedded in market prices).

Since Dodd-Frank, changes to the U.S. financial regulatory environment for ratings agencies have occurred—slowly but steadily. For example, by 2012-2013, bank regulators had removed both references and reliance on credit ratings. Instead, regulators placed the burden on each bank to provide a reasoned basis for its choice of information about its bond portfolio and the suitability of these bonds for that bank. In an important sense, this approach parallels the bank regulators' approach for commercial loans and other types of unrated loans that banks hold. Note that a bank is not prevented from using one or more CRA's ratings; but the bank has to have a reasoned basis for doing so. On the positive side, regulatory reliance was a feature of regulatory capital arbitrage, which, in turn, was a key factor underlying the financial crisis. On the negative side, this burden adds yet another level of compliance

[156] See USSEC (2016), especially Chart 5 on p. 15.

for banks, further adding to their costs. Moreover, allowing the banks to, in effect, model the risk of their bond portfolios may not solve the regulatory capital arbitrage issue.

Along with bank regulators, the SEC moved at a similar speed with respect to its capital requirements for broker-dealers and most other references to ratings.[157] The SEC took longer with respect to withdrawing references to ratings vis-à-vis its regulation of money market mutual funds. Those references were eliminated only in September 2015 (five years after Dodd-Frank). In other areas of the financial system, the Department of Labor (DOL) has not (to our knowledge) removed its references to ratings in its regulation of defined benefit pension funds (under ERISA). And, similarly, the state regulators of insurance companies (which were not covered by Dodd-Frank) have not eliminated their reliance on ratings.

There is some evidence regarding the informativeness of credit rating events, defined as changes in ratings, as a result of Dodd-Frank.[158] Informativeness is measured through the impact of credit rating changes on the pricing and liquidity of corporate bonds, controlling for bond characteristics. Following the passage of Dodd-Frank, Jankowitsch, Ottonello and Subrahmanyam (2016) find that the informativeness of rating changes is low when regulation favors better-rated securities, especially when their cost of information acquisition is high. However, following the increase in litigation risk and the dismantling of rating-contingent regulation enacted by Dodd-Frank, rating changes led to significantly stronger market reactions, but not for all securities. These results may be linked to differences in information-related costs and underlying credit risk across securities.

If all regulators cease relying on ratings, then the argument for regulating CRAs becomes much weaker. Since the bond markets are

[157]Note that it was a revision to its capital requirements for broker-dealers in 1975 that originally led the SEC to establish the aforementioned NRSRO system.
[158] See Jankowitsch, Ottonello and Subrahmanyam (2016) for details.

largely institutional, the “investors” in these markets are largely bond portfolio managers who should be expected to have a reasoned basis for where they seek their information about bonds. The portfolio managers ought to be able to understand the dangers of the issuer-pays model and also to learn from their mistakes.

Because credit ratings, however, do include independent information above and beyond what is in the market, it seems unlikely, and inefficient, for regulators to drop all forms of reliance (even if indirect).[159] Indeed, by providing financial institutions and regulators flexibility in terms of measuring creditworthiness, some form of regulatory reliance remains. To the extent that this is the case, the aforementioned conflict of interest issue still exists, and this “market failure” calls for some type of additional regulation.[160]

With respect to the conflict of interest issue, Section 939D of Dodd-Frank calls for a study of new regulatory structures for how ratings for asset-backed securities (such as residential mortgage-backed securities) might be assigned and, if no better alternative is found, to implement one based on a ratings board (which would be housed in the Office of Credit Ratings at the SEC) to assign CRAs to issuers (the Franken Amendment).[161]

The main idea underlying the Amendment is that these issuers would no longer choose the rating agency for their initial rating, but instead must go through a centralized clearing process. Specifically,

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[159] See, for example, Ederington, Yawitz, and Roberts (1987), Goh and. Ederington (1993), Hilscher and Wilson (2016), and Kliger and Sarig (2000).

[160] Bolton, Freixas, and Shapiro (2008), Mathis, McAndrews, and Rochet (2009), and Skreta and Veldkamp (2009), as examples, provide a theoretical justification for regulation based on the conflict of interest argument. The conflicts of interest that are addressed in these papers include ratings inflation that reflects the fact that the rating agencies are paid by the issuers, as well as the practice of so-called ratings shopping, whereby the issuer can troll the NRSROs for the best rating.

[161] See Mathis, McAndrews, and Rochet (2009), Raboy (2009) and Richardson and White (2009) for an economic discussion of possible resolution of the conflict of interest problem along the lines of the Franken Amendment.

a company that wants its structured debt to be rated would go to the ratings board. Depending on the attributes of the security, a flat fee would be assessed. From a sample of approved rating agencies, the ratings board would choose, most likely via lottery, the rating agency that rates the security.

While this choice could be random, a more palatable lottery design could be based on some degree of excellence, such as the quality of the ratings methodology, the rating agency's experience at rating this type of debt, some historical perspective on how well the rating agency has rated this type of debt relative to other rating agencies, past audits of the rating agency's quality, and so forth. The issuer would be allowed to gather additional ratings, but the initial rating would have to go through this process, which no longer allows the issuer to choose the rater.

In theory, such a scheme could simultaneously solve several issues: (1) the information free-rider problem,[162] because the issuer still pays; (2) the conflict of interest problem, because the rating agency is chosen by the regulating body; and (3) the competition problem, because the regulator's choice can be based on some degree of excellence, thereby providing the rating agency with incentives to invest resources, to innovate, and to perform high-quality work.[163]

As required by the Dodd-Frank Act, the Office of Credit Ratings Agency at the SEC had to prepare a report on assigned credit ratings, specifically addressing the Franken Amendment and other possible structures. This report was produced in December 2012.[164] The report does not take a position per se on the feasibility of the

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[162] This problem would arise under an investor-pays or "subscriber" model, since it may be difficult (especially in a digital environment) to prevent nonsubscribers from quickly (and without cost) obtaining the information, which would then discourage potential subscribers from signing up (and paying) for the information in the first place.
[163] See Altman, Oncu, Richardson, Schmeits and White (2011).
[164] See the SEC's "Report to Congress on Assigned Credit Ratings."

ratings board, but, along with the aforementioned benefits, does highlight several concerns, including the difficulty, complexity and cost of implementing and administering such a scheme (e.g., the expertise of the rating board members, the huge number of ratings that need to be assigned, the determination of the fee of the initial credit rater, the assumption that there would be a sufficient number of expert NRSROs participating, etc.) The mere fact that the SEC has made no progress toward implementing any such a scheme is telling. Moreover, there are potential constitutional issues related to imposing such a structure on private firms.[165]

The CHOICE Act and Analysis

As it pertains to credit ratings and ratings agencies, the Financial CHOICE Act changes the Dodd-Frank Act in two ways: (i) the SEC has exemptive authority for the Dodd-Frank Act's provisions if a provision creates a barrier to entry into the market for a potential NRSRO; and (ii) the CHOICE Act repeals the Franken Amendment.

As argued above, the Dodd-Frank Act imposed a multitude of regulations that are likely barriers to entry for new, and potentially innovative, NRSROs. While in theory the exemptive authority potentially corrects this issue, in practice, it requires that the SEC exerts this authority. A more efficient approach would be to provide immediate exemption to the Dodd-Frank rules for internal control and governance, independence, transparency, and liability standards for all NRSROs except the big three, and then to give the

[165] In its report, the SEC discusses several other options, but concentrates on one competing structure, the "Rule 17g-5 Program," which has been implemented. In this structure, the SEC calls for a mechanism by which non-hired NRSROs get access to the same information as the hired NRSRO to allow for a competing analysis of the ratings that were not solicited by the issuer. One problem with this program to date is that, while there has been some commentary provided by non-hired NRSROs, no competing ratings have been produced, presumably because NRSROs are not in the position of providing free ratings. Other issues relate to confidentiality of information.

SEC the right to impose such rules on other NRSROs, presumably at a time when these NRSROs reach a certain scale.

Of course, increasing competition for NRSROs is a potential problem if the conflict of interest for the issuer-pays model remains in place and is not addressed.[166] As we argued above, even without official regulatory reliance, credit ratings still play an important role in the regulatory framework. Increasing competition can lead to a race to the bottom. Therefore, it is crucial that the regulation of ratings agencies addresses the conflict of interest within the issuer-pays model.

The CHOICE Act repeals the Franken Amendment, which was one attempt at such a solution, but offers no alternative in its place. Because the Franken Amendment was never implemented, the CHOICE Act's repeal is somewhat moot. Nevertheless, the Act does provide some rationale for its repeal.

The CHOICE Act advances three arguments for why the Franken Amendment is harmful: (1) It conflicts with the mandate to reduce the regulators' reliance on ratings; (2) It conveys the impression that the government has approved the rating and, thus, encourages reliance on the rating; and (3) The requirement that rating agencies participate in the Franken mechanism for assigning agencies to rate asset-backed securities deters entry and reduces competition.

First, as argued above, reducing ratings bias and discouraging the use of ratings are not incompatible. The Franken Amendment deals with how ratings are produced, while other Dodd-Frank provisions focus on how the ratings would be employed in practice by regulators. The idea that if ratings are not used for risk regulations, they will disappear is not realistic. Many investors will still want a

[166] For various thoughts on competition in the ratings industry, see, Baghai, Servaes, and Tamayo (2014), Becker and Milbourn (2011), Griffin, Lowery, and Saretto (2014), Griffin and Maturana (2016), Kashyap and Kovrijnykh (2016), Mathis, McAndrews, and Rochet (2009), White (2013) and Xia (2014).

simple statistic to describe the risk characteristics of an asset. Even regulations that reduce reliance on ratings have mostly employed ratings as at least one of the inputs into the risk assessment. Hence, there are good reasons for even flawed ratings not to disappear. For every investor to collect and process this information individually is extremely costly. If every investor must bear this information cost to invest in debt, few will invest, and the cost of debt could skyrocket. That would inhibit the entry and expansion of all kinds of firms. Asking firms to provide risk information themselves is fraught with even more conflict of interest problems than are present for ratings. Therefore, CRAs enjoy the benefits of economies of scale and thus generate more information, even if some of it is flawed.

Second, it is not hard to make clear that ratings chosen by the NRSRO lottery are not "officially sanctioned" ratings. In fact, the lottery should serve as a visible reminder of the problems and risks that are associated with ratings reliance. If regulators do not trust ratings enough to rely on them, why would an investor, upon seeing that there is a lottery designed to ameliorate the bias in ratings, conclude that the government guarantees it? It's like saying that there should be no national weather service because that might convey the idea that the government guarantees the accuracy of the chance of rain. In addition, of course, most of the investors in question here are professional, institutional traders, not gullible innocents.

Third, there is no reason that a lottery assignment of rating agencies should necessarily discriminate against new entrants. In fact, the chance of being assigned to a new entrant could be bolstered to support new rating agencies and encourage diverse viewpoints. In fact, it would be much harder to encourage entry and support new entrants without such a mechanism that can direct business their way.[167]

We endorse the idea that regulators should find wider sources of reliable information on the creditworthiness of borrowers. We believe that this investigation is compatible with improving the incentives to rate structured credit products accurately. Ultimately, someone needs to incur a sizable fixed cost to collect and process information in order to assess credit risk. The question is: Who will bear this cost and what will their incentives be? Bond issuers could provide this information, but they will want to minimize reported risk to reduce their credit costs.[168] Investors could collect this information on their own, but that is extremely duplicative and costly. Investors who incur high information costs will only do so if they expect a large return, which would only happen if the assets were cheap, and debt issuance therefore expensive for firms that wish to grow. The government could assess all credit risk. But that is costly for government and risks politicization. Finally, some third party can assess risk. But that third party will need to be compensated, by either buyers or sellers. Either alternative creates a conflict of interest. The Franken Amendment offers a solution by setting out a third-party compensation mechanism that rewards providers of accurate, unbiased information. If it is not be implemented, then some similar alternative should be put in place.

[167] But it is, of course, possible that the actual practices of the selection board might tend to favor incumbents.
[168] One possibility for asset-backed bond issuances is that the issuer would have to release to the general public–and not just to the other NRSROs (as is currently true under Rule 17g-5, which we discussed in footnote 165—all of the information that the issuer provides to the rating agency that the issuer chooses. This would increase the likelihood that outside analysts might spot (and announce to the public) instances where the rating agency–either accidentally or as an effort to expand its market share—might unduly favor the issuer. And, in turn, this would make the rating agency more careful and diminish the conflict of interest. Such expanded information revelation should be quite consistent with the SEC general culture of encouraging securities issuers to release more information to the general public. See White (2013).

As an even more radical proposal: We urge the CHOICE Act drafters to carry through on their logic with respect to barriers to entry and to abolish the NRSRO category. Since almost all of the Federal financial regulators (except the DOL) have ceased their specific references to ratings in their regulations, the need for a category of approved (by the SEC) rating agencies to which those references would pertain—which was the origin of the NRSRO concept—has largely disappeared. Again, the financial regulators now require that their regulated entities directly justify their sources of information with respect to bonds, so, in principle, the SEC "blessing" for a specific set of rating agencies is contrary to the spirit of asking the regulated entities to justify their sources of information. And the regulation that surrounds the NRSRO category does raise barriers to entry.

Conclusion

The issuer-pays business model that is the standard for almost all credit rating agencies today embodies an obvious conflict of interest: The rating agency may be tempted to shade its rating of an issuer's bonds in favor of the issuer, so as to gain the issuer's business. Although this business model (which has been in place since the late 1960s) has not "blown up" in the areas of rating "plain vanilla" bonds, such as corporate and government bonds, the hundreds of billions of dollars of residential mortgage-backed and related securities were too tempting for the major credit rating agencies. The excessively optimistic ratings that these rating agencies assigned to these securities clearly played a significant role in triggering the financial crisis of 2007-2009.

It was no surprise, then, that the Dodd-Frank Act embodied provisions that entailed heavier regulation of the rating agencies by the SEC.[169] But this heavier regulation has also meant higher

[169] But, as we discussed above, Dodd-Frank concomitantly also encouraged financial regulators to reduce their reliance on ratings in their prudential regulation of their financial institutions.

barriers to entry for smaller creditworthiness advisory firms that might want to attain the status of a NRSRO that can be conveyed by the SEC. Dodd-Frank also specifically encouraged the SEC to explore an alternative mechanism—the Franken Amendment—for assigning raters to the issuers of asset-backed securities.

The Financial CHOICE Act largely leaves in place the added regulatory apparatus of Dodd-Frank. But it does provide the SEC with a greater ability to exempt rating agencies from otherwise mandated regulatory provisions, if those provisions would have the effect of raising barriers to entry. And it repeals the Franken Amendment.

We believe that the CHOICE Act could be more specific in its direction to the SEC to reduce the burden of regulation on smaller (and entrant) rating firms. And the repeal of the Franken Amendment is largely a moot point, since the SEC has never gone beyond the issuance of a report (which was mandated by Dodd-Frank) on the possible mechanisms (including the Franken Amendment) for assigning raters to issuers. However, the CHOICE Act drafters should be more forthright in acknowledging the dangers of the issuer-pays model and in encouraging the SEC to be more creative in considering alternatives. Further, we urge the CHOICE Act drafters to consider abolishing the NRSRO category itself, so as to lower the barriers to entry into the rating agency business generally.

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