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Recommended Citation

WHITE, LAWRENCE J., "Good Intentions Gone Awry: A Policy Analysis of the SEC's Regulation of the Bond Rating Industry" (2006). *New York University Law and Economics Working Papers*. Paper 69.
http://lsr.nellco.org/nyu_lewp/69

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Good Intentions Gone Awry:
A Policy Analysis of the SEC's Regulation of the Bond Rating Industry

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Abstract

This paper discusses the SEC's regulation of the bond rating industry. Until a few years ago this specific branch of SEC regulation was largely unknown outside the agency and the bond rating industry itself, even among knowledgeable Washington insiders. But the SEC has actually regulated the industry since 1975: by limiting entry, in an indirect but powerful way. As a consequence, incumbent bond rating firms are protected; potential entrants are impeded; and new ideas and technologies for assessing the riskiness of debt, and thereby the allocation of capital, may well be stifled.

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

Fortunately, there are better ways to achieve the desired goals – ways that would permit the SEC to cease these entry restrictions and nevertheless allow safety-and-soundness regulation of financial institutions to proceed in desirable directions. If the SEC were to exit from its role as the entry regulator of the bond rating industry, financial markets' participants could then make their own decisions as to which firms and methods offer the best information as to the default probabilities and other relevant parameters with respect to debt issuances.

This paper expands on these themes.

JEL Classification Numbers: G18, K23, L59

Keywords: Securities and Exchange Commission, entry regulation, bond rating industry, nationally recognized statistical rating organizations

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I. Introduction

As of the summer of 2005, the U.S. Securities and Exchange Commission (SEC) continues to have a full plate of prominent regulatory issues: corporate governance, implementation of the 2002 Sarbanes-Oxley legislation, oversight of the accounting industry, mutual fund governance, hedge fund regulation, etc. Lurking in the background, however, is a different and less well known problem of SEC regulation -- but one that has potentially important ramifications for the operation of efficient capital markets in the U.S.

This problem concerns the SEC's regulation of the bond rating industry. Until a few years ago this specific branch of SEC regulation was largely unknown outside the agency and the bond rating industry itself, even among knowledgeable Washington insiders. But the SEC has actually regulated the industry since 1975: by limiting entry, in an indirect but powerful way. As a consequence, incumbent bond rating firms are protected; potential entrants are impeded; and new ideas and technologies for assessing the riskiness of debt, and thereby the allocation of capital, may well be stifled.

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

Fortunately, there are better ways to achieve the desired goals – ways that would permit the SEC to cease these entry restrictions and nevertheless allow safety-and-soundness regulation of

financial institutions to proceed in desirable directions.

The remainder of this paper will expand on these themes.¹

II. Some Background.²

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

In the U.S. today there are only three general-purpose debt rating firms of any significant size: Moody's; Standard & Poor's (S&P); and Fitch. Moody's is the largest. It is currently a free-standing corporation, having been spun off by Dunn & Bradstreet in 2000 (which acquired Moody's in 1962). Moody's had revenues of \$1,438 million in 2004, of which 91% was derived from its bond rating activities; 63% of its revenues arise from its U.S. activities.

S&P's bond rating activities are embedded in S&P's wider financial information activities (e.g., the compilation of stock market indexes), and S&P itself is part of McGraw-Hill. Consequently, far less is known about the specifics of S&P's bond rating activities. Fitch is distinctly the third-place bond rater. It is part of a French conglomerate and has a larger relative presence in Europe than in the U.S.

There are a few smaller bond rating firms, and at least one specialized firm (A.M. Best) that focuses on the obligations of the insurance industry. But the major general-purpose bond rating firms number only three, and historically their numbers have fluctuated only within a narrow range

¹ This paper draws heavily on White (2002, 2002-2003, 2005).

² Further background can be found in Cantor and Packer (1995), Fridson (1999), Partnoy (1999), White (2002), Hill (2004), and, more generally, Levich et al. (2002).

of three to five since the 1920s.

Why so few? Partly, there are fundamental economic forces at work. Economies of scale and scope are surely important in allowing a rating firm to gain a reputation as a reliable rater across a variety of industries, time periods, and economic situations. Reputation is important for market participants who are trying to deal with asymmetric information. Also, investors may prefer to keep track of just a few rating scales in assessing bonds, just as college admissions offices surely prefer dealing with only one or two standardized entrance examinations in assessing potential admitees.

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

III. A Brief History.³

John Moody published the first public bond ratings, for railroad bonds, in 1909. Poor's Publishing Co. followed in 1916; the Standard Statistics Co. began issuing ratings in 1922 (S&P was formed through the merger of the two in 1941; McGraw-Hill absorbed S&P in 1966); and the Fitch Publishing Co. began its ratings in 1924. The standard business model for bond rating firms was that they sold their ratings to investors.

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

A major change occurred in the 1930s. In 1930 the Federal Reserve began using ratings in its informal judgments about the suitability of the bond portfolios of its member banks. In 1931 the Office of the Comptroller of the Currency (OCC), the federal regulator of nationally chartered

³ For more detail, see Sylla (2002).

banks, formally required banks to use current market prices ("mark to market") for any bonds in their portfolios that were below "investment grade"; e.g., below a "BBB" rating, which was (and still is) S&P's designation of investment grade; but they could continue to value bonds that were rated at BBB (or its equivalent) or higher at original purchase cost.

The OCC followed in 1936 with a far more draconian measure, which persists to the present day: Banks could not hold bonds in their portfolios that were below investment grade.

The impact of these regulatory measures was significant: For the first time, government regulators were *requiring* major transactors in the bond markets to pay attention to the ratings of the bond rating firms.

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

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

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

of their bond obligations certified by the rating firms.⁴

IV. The SEC's Original Regulatory Actions.

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

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

Over the next few years other financial regulators adopted the SEC's NRSRO category designation, so that the regulators' requirements as to the use of bond ratings would mean the required use of only the NRSROs' ratings. Further, the use of bond ratings for financial regulatory purposes greatly expanded during the 1980s and 1990s. The SEC, for example, again invoked the NRSRO category in 1991 when it declared (in Rule 2a-7) that no more than 5% of the assets of money market mutual funds could be invested in low rated commercial paper. And, more recently, in 2001 the regulator of Fannie Mae and Freddie Mac (the Office of Federal Housing Enterprise Oversight) linked its minimum capital requirements for Fannie and Freddie to the NRSROs' bond

⁴ See, for example, Cantor and Packer (1995) and Fridson (1999).

ratings of the insurers that often provide mortgage insurance on the mortgages that the two enterprises buy and hold or securitize.⁵

The SEC was not wholly dormant with respect to the new category that it had created. In 1982 and 1983 it designated Duff & Phelps and McCarthy, Crisanti, & Maffei, respectively, as NRSROs. And in 1991 and 1992 it designated IBCA (a British rating firm) and Thomson BankWatch, respectively, as specialized NRSROs for the obligations of banks and financial institutions only. However, mergers among these entrants and with Fitch subsequently removed all of the entrants from the field by the end of 2000, leaving only the original three grandfathered incumbents as the NRSROs. Since then, the SEC has designated two additional NRSROs: Dominion Bond Rating Services (a Canadian firm) in early 2003, and A.M. Best (the specialized insurance company evaluator) in early 2005.

An important point of regulatory process is worth noting: The SEC did not state any explicit criteria for admission into the NRSRO category at the time of the grandfathering of the original three NRSROs, nor did it state any criteria at the time of its subsequent approval of the six entrants. These approvals did not occur through any formal and transparent regulatory process. Instead, the SEC staff simply sent “no action” letters to the six firms, effectively blessing them with NRSRO status.

V. Good Intentions Gone Awry

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

⁵ For a more extensive listing of the regulatory use of NRSRO ratings, see U.S. Securities and Exchange Commission (2005); see also Partnoy (2002).

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

Having addressed it, the SEC opted for a restricted "who": the three grandfathered incumbents, and only six entrants permitted during the subsequent 30 years! Potential entrants -- smaller domestic firms, and foreign rating firms -- have been ignored. Indeed, a major reason for IBCA's purchase of Fitch in 1997 (with the Fitch name persisting) was IBCA's impatience in being restricted to a narrow NRSRO category and not being granted broad NRSRO powers.

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

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

VI. Do the Incumbent Bond Rating Firms Meet a Market Test?

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

The previous sentence may seem quite strong, especially in light of well-documented evidence that bond ratings do correlate well with average default rates: Higher rated issues default less frequently than do lower rated issues.⁶ But this result alone is no indicator of whether the rating firms provide extra and useful information to the bond markets. The ratings might simply be reflecting market outcomes (e.g., interest spreads of various bond issues against comparable Treasury obligations), rather than the other way around.

Arguably, a better test would be whether a *change* in a major rating firm's rating of an issue causes a significant change in the pricing of that issue. And, indeed, the changing of a bond rating by Moody's or S&P can cause the price of that bond to change.⁷ Doesn't this market reaction indicate that the bond rating firms are providing useful information about the likelihoods of bond defaults to the markets?

Not necessarily. The regulatory "cliff" for banks' holdings of bonds -- "investment grade" (BBB or better, in the S&P rating system) -- provides a good illustration of why the responsiveness of bond prices to rating changes may not reflect changes in market beliefs about default probabilities. Suppose that S&P downgrades a bond from AA to A. The market's likely (negative) reaction would be a decrease in the equilibrium price for the bond (and thus an increase in its interest yield). This reaction could be an indication that the market has learned something new about the increased default probability of the bond. *Or the market's reaction could simply be a recognition that the bond has gotten closer to falling off the BBB cliff, with the consequent decrease in price that*

⁶ See, for example, Basel Committee on Bank Supervision (2000).

⁷ For a summary, see Jewell and Livingston (1999).

would surely follow when banks could no longer hold the bond. Even if market participants believed that S&P's change was erroneous and that there had been no change in the underlying probability of default on the bond, the decrease in the bond's price would still be a sensible reaction to the bond's closer proximity to the BBB cliff.

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

VII. The SEC's Original Proposed Criteria.

In 1997, the SEC proposed regulations that would have specified criteria for admitting any new firms into the NRSRO category (if the SEC were to permit any new entry).⁸ The proposed criteria for admission (in the SEC's own regulatory language) were as follows:

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

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

3) use of systematic rating procedures that are designed to ensure credible and accurate ratings;

4) extent of contacts with the management of issuers, including access to senior level management of the issuers; and

5) internal procedures to prevent misuse of non-public information and compliance with these procedures.

⁸ See U.S. SEC (1997).

The shortcomings of the SEC's proposed criteria were readily apparent. First, criterion (1) would have constituted an obvious "Catch 22" barrier to entry; criterion (4) also had this quality, since non-NRSROs would have difficulties in establishing managerial contacts. Further, criteria (2) through (5) essentially focused on *inputs* into the rating process, rather than on *outputs* (say, accuracy in predicting bond defaults); firms with innovative technologies that didn't meet the input criteria would have flunked the SEC's admissions test.

Mercifully, the SEC never acted on its regulatory proposal.

VIII. Recent Events, and a New Proposal

The bond raters and their special position received a brief flurry of attention in February and March of 2002. After Enron declared bankruptcy in early December 2001, the financial press (and then Congressional staffers) noticed that Moody's and S&P had persisted giving "investment grade" ratings to Enron's debt until a few days before the company's bankruptcy filing. Newspaper stories were written, and Congressional hearings were held. The SEC promised to look into the matter. To make sure that the agency did so, the Sarbanes-Oxley legislation that was passed in July 2002 contained a specific provision (Sec. 702) that instructed the SEC to compile a report for the President and the Congress, within 180 days, that studied "the role and function of credit rating agencies [firms] in the operation of the securities market" including "any barriers to entry into the business of acting as a credit rating agency, and any measures needed to remove such barriers..."

The SEC duly submitted its report to the Congress in January 2003.⁹ The report raised a wide range of questions and issues concerning NRSROs and their actual and potential regulation, but it provided little analysis and no answers or recommendations. In the following year (in June 2004) the SEC issued a "concept release" in which it invited public comment on an even wider range of questions (but again providing little analysis).

⁹ See U.S. SEC (2003).

Finally, in April 2005 the SEC again proposed a set of criteria for defining NRSROs,¹⁰ which will now be examined in greater depth.¹¹

A. The proposed definition

The SEC proposed to define the term "NRSRO" "as an entity (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (ii) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and (iii) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with these procedures." (SEC proposal, pp. 20-21)

With respect to the first component, the SEC proposed that "publicly available" ratings would mean that the NRSRO's credit ratings "must be disseminated on a widespread basis at no cost." (SEC proposal, p. 23)

With respect to the second component, the SEC proposed that "generally accepted in the financial markets" would mean that the NRSRO's ratings be linked "to the views of the predominant users of securities ratings." (SEC proposal, p. 28)

With respect to the third component, the SEC proposed that "systematic procedures", "manage conflicts of interest", "prevent misuse of nonpublic information", and "sufficient financial resources" would encompass: "(i) the experience and training of a firm's rating analysts"; "(ii) the average number of issues covered by analysts"; "(iii) the information sources reviewed and relied upon by the credit rating agency and how the integrity of information utilized in the ratings process

¹⁰ See U.S. SEC (2005).

¹¹ This section draws heavily on White (2005).

is verified"; "(iv) the extent of contacts with the managements of issuers, including access to senior level management and other appropriate parties"; "(v) the organizational structure of the credit rating agency"; "(vi) how the credit rating agency identifies and manages or proscribes conflicts of interest affecting its ratings business"; "(vii) how the credit rating agency monitors and enforces compliance with its procedures designed to prohibit the misuse of material, nonpublic information"; "and (viii) the financial resources of the credit rating agency." (SEC proposal, pp. 32-33)

B. The problems with the proposed definition

As was discussed above, the value that a credit rating organization provides to the financial markets is to help those markets deal with the uncertainties of the creditworthiness of borrowers. If the service is provided effectively, it helps potential lenders "pierce the fog" of asymmetric information so as to determine the gradations of the creditworthiness of borrowers, and it helps the more creditworthy of borrowers "stand out from the crowd" and make their greater creditworthiness known to prospective lenders. Since the event that concerns most lenders is the default by the borrower (and then the extent of loss, given default), default predictions are at the core of an effective credit rating service. This is the "output" that the financial markets care most about.

Unfortunately, the overall orientation of the proposed definition would be to favor incumbent NRSROs and to use "inputs" rather than "outputs" as the criteria for defining a NRSRO.

With respect to the SEC's first component, the proposed requirement that the NRSRO's ratings "be disseminated on a widespread basis at no cost" would mimic the business model of the incumbent NRSROs, which charge the issuers for their ratings. There are, of course, other business models, such as one in which the users of the rating (e.g., investors) pay for the information. Since the important feature should be the "output" efficacy of credit rating services, the SEC ought not to be dictating a specific business model for credit rating organizations. Further, the SEC did not indicate how quickly or by what method this dissemination should occur.

With respect to the SEC's second component, the proposed requirement that the NRSRO's ratings be "generally accepted in the financial markets" and linked "to the views of the predominant users of securities ratings" would create a "Catch 22" problem quite similar to the one that would have been created by the SEC's 1997 proposals discussed above. It would strongly favor the incumbent NRSROs, since it is the incumbent NRSROs' ratings that must currently be heeded by the financial markets (for the reasons discussed above). As was discussed above, the NRSRO designation itself creates a barrier to entry -- a barrier to a start-up rating organization's ratings' gaining the attention of issuers and users in the financial markets.

With respect to the SEC's third component, the proposed criteria again (as was true of the 1997 proposals) would focus largely on "inputs" (e.g., the training of analysts, contacts with managements of issuers, etc.) rather than on "outputs" (efficacy in predicting defaults). Further, some of the criteria (e.g., contacts with management) are another form of dictating the business model (since it might be possible to use company reports, financial market data, and statistical analysis to predict defaults effectively, without ever directly talking with a company's senior management). Also, some of the criteria (e.g., average number of issues covered by analysts) run the risk of being used perversely. An increase in the average number of issues covered by analysts might be a sign that the rating organization is stretching its resources too thinly -- or it could be an indication of improved efficiency and innovation by the rating organization. Only an orientation toward outputs could properly distinguish between the two possibilities.

As an additional matter, the SEC's proposal is silent as to whether the NRSRO definition and criteria would be applied to incumbent NRSROs and, if so, how this application to incumbents would occur. Would all incumbents be initially subject to a formal review? Would there be subsequent periodic formal examinations of incumbent NRSROs? At what intervals? With what possible outcomes? But without such formal examinations of incumbents, the SEC's proposal creates (as has the SEC's designation until now) the possibility of a permanent NRSRO designation

for a rating organization, despite persistent slipshod ratings subsequent to a designation.

Finally, as an over-arching matter, the final establishment of a definition and criteria for the NRSRO category would serve to solidify the NRSRO concept itself. This would be a serious public policy error, since the existence of the NRSRO category forces the SEC into the role of evaluator of bond-rating organizations and thus inherently creates an unnecessary barrier to entry and interferes with a market-determined process of success or failure for the organizations.

As of the late summer of 2005 the SEC had not taken any final action on any of its proposals.

IX. What Should the SEC Do?

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

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

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

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

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

The SEC might lead the way by simply withdrawing its own safety delegations and eliminating the NRSRO category, thereby exposing the other regulators' safety delegations as the specific sinecures that they are.

If this wholesale withdrawal of safety delegations is considered too radical or utopian, then any "plan B" would have to keep the NRSRO designation, so as to deal with the bogus rating firm problem. But then the SEC must cease being an artificial barrier to entry for firms that want and are qualified to become a NRSRO. It must actively consider applicants and have a transparent process for reviewing incumbents as well as potential entrants. Its criteria must be centered on *outputs* -- the efficacy of firms in predicting bond defaults -- rather than on the inputs that were the focus of its 1997 and 2005 proposals.

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

XL Conclusion

The current formal system of bond ratings may be important for the efficiency of U.S. capital markets – or it may not be. The current major bond rating firms may be the best raters – or they may not be. The current analytical methods used for bond ratings may be the best available – or they may not be.

The difficulty, as this paper has demonstrated, is that the SEC's current system of NRSRO regulation, and other financial regulators' reliance on it, has greatly reduced, if not eliminated, the ability of the participants in the financial markets themselves to make their own judgments about these matters. In short, we currently lack market tests with regard to all of these questions.

The SEC's involvement in NRSRO regulation is understandable, albeit badly flawed. Any sympathy for the SEC, however, should not prevent recognition of the path that the SEC could and should take to extricate itself from this unfortunate situation – a path that this paper has outlined. The capital markets will surely benefit from a quick exit. Unfortunately, the SEC currently seems intent instead on greater involvement in NRSRO regulation, rather than less. One can only hope that at some point – preferably sooner rather than later – the leadership of the SEC will see the error of its ways and change course.

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