



Republican Policy Committee

The Need for Reform in the Credit Rating Agency Industry

Credit rating agencies provide a vital service to investors who seek analysis of debt before investing. For the last thirty years, the Securities and Exchange Commission has created barriers to competition through the Nationally Recognized Statistical Ratings Organization (NRSRO) designation process, which currently only “recognizes” five firms. Representative Fitzpatrick has introduced legislation (HR 2990) that reforms the NRSRO process and fosters competition and transparency within the industry. This paper explains the current process as well as its problems and provides an analysis of HR 2990.

What is a credit rating agency?

Credit rating agencies began in 1909, when John Moody sold lists of ratings of railroad bonds. Since then, the credit rating industry has grown dramatically and continues to play a vital role in the market.

Credit rating agencies are responsible for evaluating debt and rating an institution’s ability to repay a loan. These ratings are an important factor in determining interest rates for borrowers and predicting defaults on loans for investors. By analyzing the creditworthiness of a company, investors have the ability to fully understand the company’s debt.

Today over 130 credit rating agencies provide ratings on the creditworthiness of companies, bonds, countries, asset-backed securities, commercial paper, private placements, certificates of deposit, preferred stocks, medium-term notes and shelf registrations. These credit ratings are essentially a risk management tool for investors and clearly impact the market.

Credit rating agencies provide a scale of ratings that illustrate varying degrees of creditworthiness. Several companies, for example, use a scale from A to D, with three subcategories for each. The four highest ratings (AAA to BBB) are considered investment grade, while the four lowest (BB to D) are below investment grade. While scales and systems may vary among companies, they each provide a mechanism to educate investors about debt.

How are NRSROs designated?

In 1975, the staff of the Securities and Exchange Commission (SEC) established the Nationally Recognized Statistical Rating Organization (NRSRO) designation as part of a broker-dealer Net Capital Rule being issued. This rule permitted brokers to hold less capital if they held securities rated investment grade by SEC-designated NRSROs. At that time, SEC staff designated three rating agencies as NRSROs. While over 130 credit rating agencies exist, only five NRSROs exist today; the three originally designated and two designated within the last three years.

The process of designating an NRSRO remains unclear and has been the subject of significant criticism. According to the SEC, “the single most important factor in the Commission staff’s assessment of the NRSRO status is whether the rating agency is ‘nationally recognized’ in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings.”¹ Ironically, “nationally recognized” has never been defined and empowers Commission staff to define it on a case by case basis.

Additionally, there are significant barriers to entry for small firms. To be designated, a firm must be “nationally recognized,” but the only way for a smaller firm to be “nationally recognized” is to get the NRSRO designation. The Department of Justice has called this standard a “nearly insurmountable” barrier to entry.²

Enron / WorldCom

Ratings from NRSRO firms have been fairly reliable historically, but several recent major examples of failure have highlighted the need to reform the NRSRO process. The two largest NRSROs – S&P and Moody’s – rated Enron and WorldCom at investment grade just prior to their bankruptcy filings. In other words, Enron and WorldCom were said to be safe investments while they were collapsing financially.

According to the SEC, “In the case of Enron, the credit rating agencies displayed a disappointing lack of diligence in their coverage and assessment of that company...there is little to hold them accountable for future poor performance.”³ Oversight hearings and investigations found similar problems with credit rating agencies prior to Enron’s bankruptcy. A report issued by the Senate Government Affairs Committee found that “the credit rating agencies were dismally lax in their coverage of Enron. They didn’t ask probing questions and generally accepted at face value whatever Enron officials chose to tell them. And while they claim to rely primarily on public filings with the SEC, analysts from Standard & Poor’s told committee staff that not only did they not read Enron’s proxy statement, they didn’t know all the information it contained.”⁴

A lack of competition and transparency

While there are over 130 credit rating agencies, only five are NRSROs. Two of those agencies were approved in the past two years. Understandably, this designation is often viewed as an endorsement by the federal government. In fact, NRSROs are the only agencies whose ratings can be used in the SEC’s safety and soundness regulations.

As a result of their “recognized” status, NRSROs dominate market share. S&P and Moody’s currently have about 80% of the credit ratings market. In some cases, states and institutions are required to get ratings from an NRSRO before investing.

Furthermore, oversight hearings have recently highlighted abusive practices by several NRSROs. These practices include requiring companies to purchase services beyond ratings and charging for unsolicited ratings. Additionally, some rating agencies have diversified their businesses and provide consulting services, which some have argued could be a conflict of interest since they may be consulting for companies they rate.

In a recent rulemaking, the SEC claimed: “The greater competition in the market for credit ratings and analysis could provide for more credible and reliable ratings.”⁵

Conclusion

Through the NRSRO designation process, a select few agencies are given the federal government’s “recognition,” while all others are provided with no clear path towards designation. As a result of these artificial barriers to competition, a select group of credit rating agencies dominate the market.

A free market economy relies on removing barriers to competition and fostering opportunities for all companies to succeed. Educated investors should be making decisions about the reputation of credit rating agencies – not the federal government.

Representative Fitzpatrick, who has introduced the Credit Rating Agency Duopoly Relief Act (HR 2990), appropriately claimed that the current designation process “creates an uncompetitive marketplace, stifles competition from other rating agencies, lowers the quality of ratings and allows conflicts of interest to go unchecked. It is bad for the market and it is hurtful to the individual investors.”⁶

HR 2990 brings meaningful reforms to the NRSRO process. Most importantly, it eliminates the SEC staff’s process that “recognizes” certain credit rating agencies and replaces it with a process that allows agencies to voluntarily “register.” Registration will be open to all credit agencies (similar to the registration regime for brokers and mutual fund managers) that (1) have been in business for more than three years, (2) disseminate ratings on the internet or other readily accessible means, and (3) provide systematic procedures to manage conflicts of interest. This reform, alone, will level the playing field and eliminate the government’s authority to limit competition. HR 2990 also takes an additional step and requires the SEC to issue a rulemaking to prohibit abusive practices in the industry.

Additionally, this legislation includes reporting and recordkeeping requirements that will help educate investors on ratings performance, conflicts of interest and procedures to protect non-public information.

The Credit Rating Agency Duopoly Relief Act was passed by the Financial Services Committee on June 14, 2006 by voice vote.

(Footnotes)

¹ Securities and Exchange Commission, Report on the role and Function of Credit Rating Agencies in the Operation of the Securities Markets, January 2003

² Department of Justice, Comment Letter on 1997 proposed rule by SEC regarding NRSROs, March 6, 1998

³ Securities and Exchange Commission, Report on the role and Function of Credit Rating Agencies in the Operation of the Securities Markets, January 2003, page 4

⁴ Senate Government affairs Committee, Press Release, October 7, 2002

⁵ Securities and Exchange Commission, Proposed Rule for Definition of Nationally Recognized Statistical Rating Organization, April 25, 2005

⁶ Representative Michael Fitzpatrick, Statement in the Congressional Record, June 28, 2005