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Finding a Way Out of the Rating Agency Morass
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PREPARED STATEMENT
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THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES
regarding
THE ROLE OF CREDIT RATING AGENCIES IN THE STRUCTURED FINANCE MARKET
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As the problems spewing out of the subprime meltdown seem to consume broader and deeper swathes of our financial markets daily, the blame game is progressing in earnest. The rating agencies are natural targets, having waved their magic wands over tranches and tranches of ugly subprime loans, turning them into shiny investment grade paper vacuumed up by yield-hungry fiduciaries. Now that midnight has passed, those awful loans are showing their natural forms to the chagrin of unhappy investors who fell under the rating agency spell.

No question, the improvident application of investment grade ratings to questionable securities appears to be producing some fairly severe repercussions – the perhaps one to two hundred billion in potential losses in subprime loans; the markdowns from hedge funds who can't trade out of their securities except at huge losses; the outflows experienced by money market and mutual funds who, tinged with the subprime tar, are scurrying to meet the redemption demands of nervous investors. The real pain, however, will result from the longer term impact of credit markets that failed to function properly – from housing markets working off the overhang of illusory price appreciation engendered by poorly conceived subprime loans, to pension funds taking writedowns on securities they thought were as good as gold, and finally to lingering questions about the integrity of just about anything with a credit rating stamped on it. And if a lasting credit seize up in the bedrock commercial paper and repo markets brings down a major financial institution or two, subprime and the rating agencies will be tagged as bigger financial villains than tulips, junk bonds or dotcoms.

That would be wrong. First, subprime is not the source of all evil; it is merely the first eruption of a disease which has been growing in structured finance for some time. Second, while the rating agencies were instrumental in inflating the subprime bubble, and they will certainly be fighting challenges on the propriety of their actions for years to come, the primary culprit is a slapped together regulatory matrix that gave the raters virtually unchecked power to designate what securities were deemed safe enough for the portfolios of our most important financial institutions -- without accompanying responsibility or accountability and with only a mere whisper of supervision.

That the rating agencies fall a little short as protectors of our capital base was evident before now. Unfortunately, the seeming one-off nature of previous blow-ups resulted in only minor fixes, leaving the rating agencies generally free to do what they're paid to do – issue ratings. This time though, the blow-up is not confined to one company or security, but to the entire asset class of structured finance. Thanks to the prestidigitations of financial engineering, rating agencies facilitated the production of structured finance securities and vehicles at a fantastical rate under the now clearly mistaken, and commonly held, assumption that they could all be treated for rating purposes just like corporate bonds.

Once again, members of Congress will be scrutinizing the rating agency system; in light of the revelations of recent events, they must act to finally fix it.

The History of the Rating Agency System

The first credit ratings were probably those provided to colonial importers who needed some way to know which of the many shopkeepers and retail establishments who bought their goods were actually worthy of credit. By the late 1800s, entrepreneurial businessmen were applying the same rating concepts to the just developing US stock and bond markets. John Moody was the first to reduce ratings to simple, uniform metrics, greatly facilitating their ease of use. His company was soon joined by others including Standard Statistics Company, Poor's Publishing Company (the latter two ultimately merging to become Standard & Poor's) and Fitch Publishing Company[1].

The usefulness of ratings did not go unnoticed by regulators. Early on, the Federal Reserve Banks used ratings to help them evaluate the quality of bank investment portfolios. In 1931, the Comptroller of the Currency made the bold move of ruling that bonds held by national banks which were rated BBB or higher could be held on bank books at cost while those rated lower would have to be held net of some discount. Five years later, the Comptroller went even further, banning the purchase of bonds with less than a BBB rating – a move which shocked the subject banks. The ruling certainly added value to ratings provided by the numerous service providers, but after a period of growth following those pronouncements, rating agency performance appeared to be modest at best over the next few decades. [2]

In 1975, the Securities and Exchange Commission dramatically changed the fortunes of a few select rating agencies. Responding to the losses suffered as a result of the Penn Central Railroad bond default[3], the SEC adopted Rule 15c3-1 under the Securities Exchange Act of 1934 in an

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[1] Frank Partnoy, "The Siskel And Ebert Of Financial Markets?: Two Thumbs Down For The Credit Rating Agencies," Washington University Law Quarterly, vol. 77, no. 3, 1999, pp. 636-639.
[2] Ibid., pp. 647-648, 687-690.
[3] "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs" Report of the Staff to the Senate Committee on Governmental Affairs, October 8, 2002.

effort to ensure that broker-dealers were adequately capitalized. Under the so-called net capital rule, the SEC required broker-dealers to maintain a certain amount of "net" capital which would be computed by deducting from their net worth certain percentages of the market value of debt securities, with such "haircuts" to be a function of how risky or illiquid those securities were perceived to be. Out of convenience, as much as anything else, the SEC delegated the job of risk categorization to certain prominent rating agencies (S&P, Moody's and Fitch) which it designated as "Nationally Recognized Statistical Rating Organizations", or "NRSROs", effectively establishing those fortunate few as the gatekeepers to the investment grade bond-buying audience.

It is notable that, in coming up with the NRSRO system, the SEC held that it was appropriate to apply lower haircuts to securities "that were rated investment grade by a credit rating agency of national repute, ***because those securities typically were more liquid and less volatile in price than securities that were not so highly rated"***(emphasis added).[4] The fact that the SEC clearly equated the term "investment grade" with liquidity was never memorialized in legislation, process or definition. The failure to do so allowed the NRSROs to apply the investment grade label at will – even to the highly illiquid structured finance securities responsible for many of the problems we suffer today.

Rating Agency Regulation and Oversight

With that 1975 stroke of a brush pen, the ratings issued by those first NRSROs became immediately more valuable than those issued by undesignated competitors. Since, in addition to forgoing any definition as to what it expected of an investment grade security, the SEC also took a pass on characterizing what an NRSRO was – or even a process for how they should be run or supervised – the few agencies blessed with the NRSRO designation effectively received a huge, costless windfall. The only substantive regulatory overlay was the no action letter process, through which the SEC could let the world know that it believed a particular rating agency was qualified to be an NRSRO -- which primarily meant that a rating agency was big enough to be "nationally recognized". As many observers have since pointed out, the need to be nationally recognized to become "nationally recognized" creates a bit of a catch-22 for aspirants to NRSRO status.

Since 1975, the SEC has effectively acted as the guardian of the NRSRO system, although its authority was ill-defined at best. The few actions taken by the SEC in respect of rating agencies only served to entrench the already privileged status of the existing NRSROs. First, the SEC exempted NRSROs from Regulation F-D, thereby giving them the right to receive confidential, non-public information from issuers without that information being subject to public disclosure. While this exemption was necessary to allow the rating agencies' access to information deemed important to the fulfillment of their credit assessment function, it also made their ratings more valuable, because of the non-public information presumably embodied in them. Second, under

[4] SEC Report on the Role and Function of Credit Rating Agencies in the Operation of Securities Markets, January 2003.

Rule 436 of the Securities Act, the SEC shielded "NRSROs from liability under Section 11 of the Securities Act in connection with a securities offering . . . <which> means that NRSROs are not even held to a negligence standard of care for their work".[5,6] Again, while the SEC had reason to enact this exemption, it left the NRSROs, for all intents and purposes, responsible to no one.

Notwithstanding the rather cavalier way the NRSRO system was constructed, and the complete failure to temper the grant of what turned out to be a very powerful franchise with some appropriate level of accountability, a swarm of other regulators followed the SEC's lead in delegating risk classification to the NRSROs. Over the next three decades, reliance on NRSROs was a common theme in the design of investment rules across all levels of the financial markets. By 2003, the SEC noted that NRSRO ratings had become "widely used for distinguishing among grades of creditworthiness in federal and state regulations"[7] including in various SEC regulations issued under the 1933 Act, the Exchange Act, the Investment Company Act of 1940 (including Rule 2a-7 which pertains to money market funds), the Federal Deposit Insurance Act, various state insurance codes which rely on NRSRO ratings to determine the appropriateness of investments held in insurance company portfolios, a plethora of guidelines applying to public and private pension funds, and even internationally, most recently in the Basel II guidelines which are to be implemented over the next few years to regulate international bank capital.

Warning Signs

The history of NRSROs has not been without its share of unhappy surprises including Washington Public Power Supply System, the bankruptcy of Orange County and, more recently, Enron.

After all three major NRSROs failed to downgrade Enron until the eve of its collapse, a specific provision of the Sarbanes-Oxley Act of 2002 required the SEC to investigate rating agency performance. In the ensuing report issued in January, 2003, SEC staffers concluded that "the credit rating agencies displayed a disappointing lack of diligence in their coverage and assessment . . . ***because the credit rating agencies are subject to little formal regulation or oversight, and their liability traditionally has been limited by regulatory exemptions and First Amendment protections, there is little to hold them accountable for future poor performance***" (emphasis added).[8] Further, "the credit rating agencies' approach to Enron fell short of what the public had a right to expect, having placed its trust in these firms to assess corporate creditworthiness for the purposes of federal and state standards. ***It is difficult not to wonder***

[5] "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs."
[6] NRSROs have also argued that their ratings are merely "opinions" and, as such, are subject to the same First Amendment protections for free speech afforded other publishers.
[7] SEC Report on the Role and Function of Credit Rating Agencies in the Operation of Securities Markets, January 2003.
[8] "Report On The Role And Function Of Credit Rating Agencies In The Operation Of The Securities Markets As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002, Executive Summary," January 2003.

whether lack of accountability – the agencies' practical immunity to lawsuits and non-existent regulatory oversight – is a major problem" (emphasis added).[9]

Numerous Congressional committees have also held hearings in the last few years, ostensibly to address concerns regarding the lack of oversight in connection with NRSRO activities, the reliability of ratings, the potential conflict of interest created by a business model which depends on compensation from those being rated and a general concern that the existing NRSROs effectively comprise a government-granted oligarchy. After years of deliberations and committee meetings and hearings, Congress finally produced the Credit Rating Agency Reform Act of 2006, described by one observer as possibly "a high-water mark of a particular type of hands-off regulatory model".[10] Despite a consistent stream of criticisms that the rating agencies lacked independence, reliability and accountability, the final Act focused almost solely on addressing the barriers to entry perceived to exist for rating agencies seeking to achieve NRSRO recognition.[11]

From the viewpoint of the current NRSROs, the mild new requirements imposed by the Act for recordkeeping and reporting are a small price to pay for the benefits the Act is giving them. As Moody's itself pointed out, the Act "contains important new protections for the industry" (that would be the "NRSRO" industry) including the preservation of existing legal protections for the publication of their credit "opinions"[12], prohibiting the SEC from "regulating the substance of ratings" and directing the SEC to "narrowly tailor" its rules.[13,14] Thanks to the Act, it appears to be business as usual for the NRSROs.

NRSRO Profits and the Age of Structured Finance

As the reliance on NRSROs became increasingly hardwired into the regulation and supervision of our financial and investment markets, the profitability of the so-designated NRSROs[15] grew

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9 Ibid.
10 Oxford Analytica, "Credit Crisis Hurts Rating Agencies", Forbes.com, August 14, 2007.
11 Even the Act's ability to increase competition may be limited. John Dizard writes in the Financial Times ("Reform unlikely to dent rating agencies' armour", April 16, 2007) that the rules "say, yes, we will consider letting you compete with Moody's and S&P. But you must replicate their entire structure, balance sheet, and staffing. You must have this in place, without being recognized by us, for at least three years, all the while somehow charging for this un-"recognized" service."
12 "Opinions" is the operative word; characterizing a rating as an opinion is integral to the rating agencies' reliance on protection from prosecution under the First Amendment.
13 Moody's Corporation, "2007 Investor Day Presentation," June 5, 2007.
14 Moody's recently cited the Credit Agency Reform Act of 2006, and the limitations it imposes on state-level regulation, to defend itself in a lawsuit by Lloyds TSB Bank PLC which seeks recompense from Moody's for alleged flaws in ratings it issued on Natural Century Financial Services, prior to that firm's spectacular 2002 blow-up (see "1st Amendment Bars Ratings-Based Claims: Moody's", Marc Tracy, Securities Law 360, September 7, 2007).
15 While other rating agencies including Duff & Phelps, Thomson BankWatch, McCarthy Crisanti & Maffei, Inc. and IBCA Ltd. also at one time received NRSRO designation via no action letters, all were ultimately purchased by one of the big three, leaving those to dominate the ratings business just as they had prior to the creation of the NRSRO concept. Today, AM Best, DBRS, Japan Credit Rating Agency, Ltd. and Rating and Investment

apace. Fortuitously, just prior to the 1975 imposition of the Net Capital Rule, the bigger rating agencies had changed their business models. While formerly they generated revenues from ratings users, under the new model, they were paid by the issuers who were seeking the ratings.[16] Of course, the value imparted to ratings by the Net Capital Rule and the others which followed did wonders to generate issuer demand for an NRSRO ratings stamp. Today, those rating agencies blessed with NRSRO status are among the most profitable companies in America. Moody's, for example, the only one of the big three which is a standalone public company[17], is a veritable cash machine, consistently delivering 50% operating margins. For the past five years, its pretax margins have made it the third most profitable company in the S&P 500[18].

If the NRSRO label was a moneymaker before, the development of structured finance vehicles made it a goldmine. Public filings by Moody's indicate just how lucrative the NRSRO business has become now that financial engineering has entered the picture. Since 2000, Moody's revenues have more than tripled, with the most important source of growth coming from its ratings in structured finance. In 1995, Moody's structured finance business was responsible for a mere $50MM in revenues. By 2006, however, its structured finance revenues had soared to $848MM, accounting for 54% of Moody's ratings revenues with the biggest contributions to those structured finance revenues provided by residential mortgage backed securities and credit derivatives including Collateralized Debt and Collateralized Loan Obligations (CDOs and CLOS, respectively) [19].

The structured finance business[20] is more than just a terrific revenue generator, it is likely the rating agencies' most profitable business line. Rating agencies charge nearly three times as much for structured finance ratings as they do for corporate bond work[21], and while the work may be harder given the complexity of the structured finance models and the greater rating agency involvement as compared to corporate bond work, some of those extra fees clearly drop

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Information, Inc. are also recognized as NRSROs, however, according to Moody's, it, S&P and Fitch are responsible for 95% of global ratings with shares of 39%, 40% and 16% respectively.

[16] The change may have been motivated by a desire to get away from the free rider problem whereby a lot of users simply cribbed the ratings information from someone else. Partnoy, p. 653.

[17] Fitch Ratings is owned by Fimalac, S.A. and S&P is a unit of McGraw-Hill Companies.

[18] Jesse Eisinger, "Overrated," Portfolio.com, September 2007.

[19] Moody's Corporation, "Investor Day Presentation," June 5, 2007.

[20] In its simplest terms, structured finance is the pooling of assets and the subsequent sale of tranched claims on the cash flows generated by the assets. Thus, a structured finance vehicle can be a simple mortgage-backed structure where the interest and principal payments from a pool of mortgages are used to satisfy the obligation of various layers of debt used to purchase the pooled assets. The least risky layer of debt, which might be AAA-rated, would essentially have the first claim on the cash flows. The lowest layer of the structure, which might be an equity layer, would, conversely, be the first to absorb losses in excess of any structural protections built into the vehicle. If losses from a pool exceeded the amount of the equity layer, than the lowest debt level would absorb additional losses until that layer was used up and so on up the capital structure. Pools can also be constructed from "layers" or debt sold on other pools; a CDO of CDOs, or CDO^2 is comprised of rated and unrated securities issued by other CDOs.

[21] Moody's, for example, stated in an August 2007 Investor Presentation, that it charges 4.25 basis points (a basis point is 1/100th of a percent) for rating corporate and financial institutions but up to 11 basis points for complex structured finance issues. S&P charges up to 12 basis points for a CDO issue vs. 4.25 basis points for a corporate bond rating ("The Ratings Charade, Richard Tomlinson and David Evans, Bloomberg Markets, July 2007).

to the bottom line. In Moody's case, operating margins have increased from 48% in 2000 to 54% in 2006[22] and it is more than likely that the growth of structured finance is core to the margin improvement.

The profitability of structured finance goes to the heart of concerns about the coziness of the agencies' relationship with issuers. The raters don't get paid if they don't issue a rating, so much as they like to say that fact presents only a "potential" conflict of interest, it is undeniable that they have an enormous amount of self-interest vested in keeping the structured finance machine going.

And that machine could not go without the raters. Moody's has presented a chart which overlays the growth in its structured finance rating revenues on the growth in structured finance issuance. From 1997 to 2000, structured finance issues were around $500 billion a year. In 2001, the growth curve took off and never looked back, jumping to over $900 billion that year and growing from 2002 to the present day at a compound growth rate of nearly 30% annually. This year global structured finance issuance is expected to reach $3.3 trillion[23]. The growth rate of Moody's structured finance revenues has not only matched that of the issuances, it actually exceeded it.

The relationship is not surprising. As the Bank for International Settlements points out, "From the beginning, structured finance has largely been a "rated" market"[24]. It relies on the modeling of cash flows from pools of assets, which could be anything from residential home loans to slices of debt issued by other structured finance vehicles to hodgepodges of financial assets and derivatives. A critical aspect of the modeling process is determining how and whether the cash flows generated by the pooled assets can service the tranched claims on those cash flows[25] (the tranches generally consisting of layers of rated debt with an equity cushion on the bottom) and what level of credit enhancement (insurance, over-collateralization, a bigger equity cushion, for instance) might be needed to make sure the rated tranches really pay off as they're supposed to. It is the credit enhancement, along with the supposed diversification of assets (which presumes they won't all default at the same time), that allow structured finance vehicles to turn a collection of assets that individually would be considered very risky into 90% AAA securities.

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[22] Moody's Corporation, "2007 Investor Day Presentation," June 5, 2007.
[23] Moody's Corporation, "2007 Investor Day Presentation," June 5, 2007 and "Investor Presentation," August 2007.
[24] Report submitted by a Working Group established by the Committee on the Global Financial System, "The role of ratings in structured finance: issues and implications," Bank for International Settlements, January 2005.
[25] Ibid. "A key goal of the tranching process is to create at least one class of securities whose rating is higher than the average rating of the underlying collateral asset pool or to create rated securities from a pool of unrated assets. This is accomplished through the use of credit support specified within the transaction structure to create securities with different risk-return profiles. The equity/first-loss tranche absorbs initial losses, followed by mezzanine tranches which absorb some additional losses, again followed by more senior tranches. Thus, due to the credit support resulting from tranching, the most senior claims are expected to be insulated - except in particularly adverse circumstances - from default risk of the underlying asset pool through the absorption of losses by the more junior claims."

Now, in the absence of ratings, an investor interested in buying one of those tranched claims, say a senior piece of a mortgage-backed security comprised of subprime loans, would have to be able to analyze all the details of the individual assets (some of these structures have thousands and thousands of assets), the potential cash flows from each of those assets under all sorts of different scenarios (say 10,000 or so), and the possible correlation of each asset with all the other assets in the pool under all those scenarios. But that information is simply not available to outside investors, certainly not in the same way that information on a public issuer of a corporate bond is. Even if it was, few investors possess the modeling expertise to be able to use such information to make an investment decision.

A variant on this tranching proved to be a major catalyst of the growth of the structured finance market, and that was the use of CDOs specifically designed to hold lower rated or unrated tranches[26]. Once the NRSROs attached investment grade ratings to the bulk of a structured finance vehicle's securities, those issues were relatively easy to place, particularly as they tended to have a higher yield than comparable corporate bonds. The lower grade or mezzanine debt issues and equity layers were more problematic. In a stroke of financial engineering genius, structurers devised the concept of creating CDOs to hold all those issues that couldn't be sold otherwise. Through model magic, a bunch of low-rated securities could be bound together with a little credit enhancement and, again, mostly funded with AAA debt. A problem with placing the equity of that CDO? No problem. That's what CDO^2s are for[27].

Of course none of this would have worked, except perhaps on a very limited scale, without the full-hearted involvement of the NRSROs. The opacity of structured finance vehicles makes the rating agencies' imprimateur absolutely essential to the placement effort. Without that rating metric there would be many fewer investors willing or able to take on the risk of a structured finance black box. With the ratings, however, particularly the investment grade ones which cloak the majority of all the structured finance securities sold, all doors were opened.

<u>The Subprimal Urge</u>

For a number of years, structured finance seemed to be the fair-haired child of the perfect marriage between the rating agencies and Wall Street. The speed with which vehicles could be created and sold encouraged a steady stream of innovation and more and newer kinds of products were originated to meet the appetite of investors desperate for a little extra yield on their investment grade instruments.[28] The fact that many of these products had never existed before (credit default swaps, for example) or that the models were for the most part completely unvetted

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[26] CDO, or collateralized debt obligation is a generic term for a structured finance vehicle that holds some form of debt security. Included in this category are CLOs (collateralized loan obligations), CBOs which hold corporate bonds and ABS CDOs which hold a variety of asset-backed paper.

[27] A CDO^2 is a CDO which holds tranches of other CDOs; it is essentially a repackaging of other CDOs. "Synthetic" CDO^2s do not hold the actual CDO tranches; rather they are comprised of derivatives, generally credit default swaps, which reference other CDOs or asset-backed securities.

[28] "In the early 1990s, there were fewer than twenty asset types securitized, but today the number exceeds two hundred." Moody's Corporation, "2006 Annual Report," p. 19.

and unseasoned raised concerns among a few veterans of the finance world, but for all intents and purposes the structured finance engine was set on full throttle. With the housing market one of the biggest generators of financial paper, it was only a matter of time before financial engineers set their sights on the subprime market.

Home mortgages had been securitized successfully for many years under the auspices of Fannie Mae and Freddie Mac (Government Sponsored Enterprises or "GSEs"). What made those securitizations work was the fact that originators had to make sure that both borrowers and loans satisfied a laundry list of GSE requirements. That "conformation" process ensured that the resulting pools of loans were relatively homogenous and, with years of experience demonstrating the behavior of these loans, quite susceptible to predictable modeling.

Subprime was something else again. Not only was there no standard by which subprime loans were measured, but, in addition, the subprime loans that were originated in the last few years were of a completely different complexion than anything that had ever existed before. Not that any of that was of concern to the securitization market; it seemed that no matter how crazy these loans got, the rating agencies and issuers could find a model and a structure that would tolerate them. The optimism with which these loans were viewed knew no bounds and, by 2006, subprime loans which were barely a blip on the screen a few years earlier accounted for 20% of all residential mortgage securitizations (the slightly more upscale but also troublesome Alt-A loans kicking in for another 15%).

Of course, to get there, all those who participated in the securitization process had to take some mighty leaps of faith concerning the quality and future performance of the loans they were moving into the structured finance market. From 2004 on, in the face of rising interest rates and a dwindling pool of prime borrowers, lenders, particularly the private, non-bank originators who were so active in these markets, relaxed their already shaky lending standards to attract enough subprime borrowers to maintain their book of business. According to one source, interest only and 40-year amortization loans, which were not a factor at all in 2001, appeared on the subprime borrower menu and by 2005 and 2006 were present in nearly 1/3 of securitized subprime loans. Silent seconds, which allowed a borrower to buy a house with no money down, accompanied a mere 1% of the 2000 vintage securitized loans; by 2006, they were present in 25% of the cases[29]. As troublesome as these features are on their own, they look even worse when combined with other dubious loan attributes like low doc/no doc, one and two year teaser rates and option arms. This process of systematically weakening a loan until you can make it work for a borrower, academically referred to as "risk layering", is almost certainly responsible for what will ultimately be the horrendous performance of the 2006 vintage subprime securitizations.

It is difficult, if not impossible, to estimate the potential damage from the too rosy forecasts and excessively rapid development of subprime securitizations: 1) There are structural problems with the subprime vehicles themselves, particularly with respect to the potential inability to do

[29] Statistics from Loan Performance and UBS as presented in a Presentation by Thomas Zimmerman, Managing Director, US Securitized Products, UBS, "The US Subprime Market: An Industry in Turmoil," March 2007.

modifications without violating the legal requirements of the structure or triggering the early release of collateral that make it difficult to predict the extent to which various loss mitigation efforts might successfully be employed. 2) There does not appear to be an easy way to capture the full range of securities and derivatives touched by subprime. The rise of synthetic structures which mimic the behavior of other assets, including subprime tranches, has magnified the impact of the pure dollar value of the actual loans securitized, as do bets placed through credit default swaps and other derivative instruments. 3) The dismal performance of the subprime securitizations is causing investors to question whether the same sort of structural and model issues are present in some of the other securitized products which were created just as rapidly over the past five years. The CLO market is clearly suspect, but at this point no structured finance vehicle is getting a bye.

What the Future Must Bring

Congress has asked all the questions that have been sprinkled throughout this document many times. The difficulty of achieving consensus answers, and concerns that any significant action will do more harm than good, always seem to block any real action. But the failure to act in a meaningful fashion allowed the NRSROs to unilaterally decide that trillions of dollars of completely illiquid securities were as safe as GE and Berkshire Hathaway bonds. And the fact that NRSRO activity in the structured finance arena was completely contrary to the SEC's original premise, that investment grade ratings should connote liquidity, seems to have escaped the notice of everyone involved in rating agency reviews over the years.

Now, though, with the full knowledge of the extent to which NRSRO pronouncements guide the investment decisions of so many of our institutions, Congress must define once and for all what investment grade is supposed to mean.

The other questions that should be addressed are not new ones but the current times provide a very different context from which to determine appropriate answers. Among the issues which should be evaluated are:

1) Regulatory oversight and supervision of the NRSROs. Notwithstanding the Credit Rating Agency Reform Act of 2006, the NRSROs are still effectively self-policing. In light of recent events, a review of the entire NRSRO oversight structure should be conducted.
2) Applicability of ratings. The accelerant fueling the growth of this generation of subprime and subprime linked securities was the willingness of the rating agencies to stamp them investment grade allowing them to be injected into the portfolios of yield-starved fiduciaries. It is the unfettered extension of ratings to illiquid, opaque structured-finance securities that is at the heart of our current problems. As a result, Congress must review the use of "NRSRO" ratings for securities or structures which lack liquidity, transparency and seasoning and, as well, the process and authority under which new asset classes are brought into the NRSRO investment grade world.

3) Compensation-driven conflicts of interest. The rating agencies have been paid enormous sums of monies by their structured finance clients, causing outsiders to question the impartiality and objectivity of the ratings.
4) Accountability. Unlike other professionals – accountants, lawyers and the like – the rating agencies have heretofore escaped liability when their ratings “opinions” prove wrong. Given renewed doubts about the objectivity of their performance, particular attention should be given to implementing measures which hold NRSROs accountable for their performance, perhaps in the manner of other professionals who function as “experts”.

Finally, if Congress wishes to remedy the defects that contributed to concerns that our financial markets were near meltdown, it must comprehend just how deeply NRSRO influence is entrenched in measures intended to protect capital in financial institutions and fiduciaries both domestic and internationally, including Basel II whose provisions to regulate international bank capital adequacy are being implemented as we speak. We believe past failures to recognize the pervasiveness of NRSRO activity contributed to a reduced sense of urgency on Congress’s part. Now is the time for Congress to take a more deliberate stand. We urge Congress to act.