



Role of Credit Rating Agencies as Risk Information Brokers

Study prepared for the Anthony T. Cluff Fund

Prepared by
Russell Walker, Ph.D.
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THE FINANCIAL SERVICES ROUNDTABLE 
Financing America's Economy

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Executive Summary

THE RECENT FINANCIAL CRISIS THAT shook the world caused many to question how such a large and looming financial risk could be underestimated or missed by so many. Regulators charged banks and lenders with fraud and various lending-related infractions. Investors charged investment bankers and credit rating agencies with offering inappropriate risk data and ratings and specifically inaccurate ratings based on nebulous risk data. In fact, as details of the conditions that led to the crisis became clearer in its aftermath, we have come to learn that many of the risky mortgages and loans that were part of the U.S. subprime market were securitized into products that received very favorable ratings by credit rating agencies (CRAs), and that key risk information from the issuers and CRAs did not make it to investors. Investors and regulators relied on ratings of credit-backed securities for the purposes of assessing risk and making investments. CRAs relied on data provided to them by the issuer of the security. Often this data was incomplete, poor, or even purposefully obfuscated by the issuer, in order to secure a higher rating that might be available otherwise. Regulators and investors contend that CRAs likely were operating with less due diligence than needed and were providing ratings based on a market outlook that was not realistic. CRAs charged that ratings were not about considering all outcomes in the future, but about point in time estimates, and that ratings on bonds and securities may be inherently different. The debate continues, and the need for clear, consistent, and reliable risk information is still largely unmet. Clearly, something was missed. Investors and regulators did not have access to the risk information that was desperately needed.

Credit rating agencies have come under great scrutiny since the financial crisis. Even the meaning and value of a rating, especially on a credit-backed security, is now questioned by investors and regulators. Recent testimony to the Securities and Exchange Commission (SEC) and the U.S. Congress suggest that regulators and lawmakers view CRAs with disfavor, if not distrust. Investors have echoed this distrust. The role of credit rating agencies, especially in the credit-backed securities market, is highly questioned by many, but the reality is that a risk broker is needed to make capital markets efficient.

In the recent Dodd-Frank legislation, there is a direct call to impose new regulation on CRAs, and to require attestation that CRAs conform to new rules of doing business, limiting conflicts of interest and strengthening the science behind the ratings process. In the coming years, the SEC is tasked, under the Dodd-Frank Act, with studying the overall business model for CRAs, and making recommendations to Congress on alternative business models, especially in the credit-backed security market. With this in mind, and the great attention that CRAs have received, it is clear that the financial services industry should also consider the role and future of CRAs and offer direction on how CRAs can serve market participants going forward. There are some government officials and regulators that believe that the credit rating agencies should be highly regulated or even revert to not-for-profit cooperatives. However, the importance of risk information in markets suggests that the role of an *independent, third-party, risk information intermediary* is needed in the investment and banking communities to facilitate the buy-sell process. An operating model for CRAs that is less dependent on regulation, and more driven by market needs, is superior and should be identified if possible. This study is focused on identifying such a business model.

The movement of capital is facilitated by the presence of *independent, third party, risk information brokers*. This suggests that CRAs serve a very important role in financial markets. CRAs have served successfully in this capacity in bond markets for many years. The issuer-pay model has many positive attributes in the bond market. The reality of the issuer-pay model, as deployed by CRAs for complex credit-backed securities, is that it produces an asymmetry of information between the security issuer and the CRA, and creates temptations from conflicts of interests between the CRA and issuer. Regulators and investors alike have challenged the CRAs on grounds that ratings in the credit-backed security market do not easily incorporate non-issuer data, that issuers of the securities are not long the securities resulting in conflicts of interest that unsolicited ratings are nearly impossible, and that transparency in ratings is poor. Additional criticism is directed at poor visibility to the underlying loan data, a weak historical record on the part of CRAs for producing ratings of credit-backed securities, inadequate surveillance by CRAs on a regular basis, and a general lack of clarity on model assumptions and market outlooks embedded in ratings. Many of these points are also specifically addressed in the Dodd-Frank Act and reiterated by investors. The conflicts of interest that arise under the issuer-pay model make many of these points difficult to address without directed and specific legislation.

As regulators consider new business models and regulation for CRAs, it is worth considering a business model deployed successfully by the credit bureaus, whereby the credit bureaus sell, via a subscription, risk data and risk scores to banks for the purposes of consumer lending. This subscription model to providing information is a departure from the current issuer-pay model used by CRAs, but offers a powerful emphasis on the role of CRA as *risk information brokers*. The credit bureau model offers third-party independence in ratings, data disclosure and transparency to investors, and underlying data that support the generated risk scores. Furthermore, investors pay for the services, reducing conflicts of interests with issuers. As investors' interest are more likely to drive the CRAs under this model, more frequent and thorough surveillance of ratings can be expected, as CRAs will compete to earn investor business on communication of risk updates. The disclosure of underlying risk data allows investors and third parties, including regulators, to consider specific economic stress-tests, access data to confirm risk reviews, and answer questions about credit-backed securities. As with the credit bureau products, missing and poor data is openly disclosed in this model, implicitly penalizing issuers for poor or missing data.

With CRAs then competing on providing detailed risk information, the industry can be expected to innovate on new risk scores and updates that meet investor needs. With investors being more numerous than issuers, it is unlikely that any one investor could influence the CRA and generate a conflict of interest, as was seen under the issuer-pay model. The change to such a model appears to be most needed in the credit-backed securities market. The CRA use of the issuer-pay model appears to work well in the bond market, and the legislation directed at CRAs is most poignant in the credit-backed securities space.

This change to the subscriber-pay business model, with an emphasis on risk information transfer (as seen in the credit bureau business model), offers a new opportunity for all participants involved in the credit-backed securities market. First, investors will gain access to much desired and needed risk information. Regulators are then provided a lens into the risk inherent in the credit-backed securities market. Moreover, the structural issues inherent in the issuer-pay model are mostly resolved, suggesting that detailed regulation may even be avoided. Finally, CRAs will be returned to the much trusted and much needed role of *independent, third-party, risk information brokers*.

Background

DURING THE RECENT FINANCIAL CRISIS, the credit rating agencies (CRAs) were criticized for providing ratings on credit instruments, such as mortgaged-backed collateralized debt obligations (CDOs) that did not fully incorporate the risk of such products, especially under market and economic stress. Investors challenged that the ratings did not provide additional information that would allow for stress-testing or economic-driven modeling. While the crisis revealed that due diligence by investors and regulators alike may have been lacking, the role of CRAs, such as Standard and Poor's, Moody's, and Fitch, is in doubt, and investor confidence in their ratings is low.

CRAs, originally and primarily, were an investor's source for credit risk information and evaluation on corporate bonds and other corporate notes. Over time, these agencies developed complex and proprietary models to rank credit risk, ultimately using a rather coarse rating scale, but one that provided investors a perspective on the likelihood of default. In many ways these models, developed for the corporate bond market, became trusted, and valued by the investment community.

Built on their comfort and familiarity with commercial debt, investors grew to appreciate that top ratings, such as AAA, were virtually immune to credit risk. The AAA rating was, more or less, associated with U.S. Treasury debt, and, for investors, the rating came to mean no history of default, and very little to no chance of imminent default. Meanwhile, the investment community for structured products subsequently grew, and there was a proliferation in the securitization of everything from auto loans to student loans and mortgages. Investors sought comfort knowing that such products were of investment grade, and they looked to CRAs for guidance. CRAs worked hand in hand with investment banks to offer ratings on these novel products, especially for those banks securitizing mortgage and other real estate loans.

The comfort and familiarity built during the many decades when CRAs rated primarily corporate bonds resulted in many investors informally re-purposing credit rating agencies as outsourced risk management services. In fact, various regulatory provisions on debt investment from Basel, as well as statutory liquidity requirements of insurance firms, often related directly to CRA rating levels. Owing to this, the regulatory bodies had also grown to rely on the ratings of CRAs as a measure of credit risk quality.

Although the importance of ratings is well appreciated, the impact of ratings on novel products is only now being understood. The CRAs offered ratings with little visibility into information-based risk scores and even less supporting data to substantiate the ratings. For complex and novel products, many investors reverted to treating CRAs as risk management surrogates, and assumed that risk scores used in bonds had the same dimensions of quality as they did in the CDO space. In essence, AAA in the bond markets, with its low default rates, provided the basis for how to interpret AAA in the CDO space. However, interpreting the AAA rating has an implied credit risk. Does the rating and credit risk hold for other asset classes? Does the rating have an implied default rate or other key financial or economic assumptions? These two questions should have been asked before investors snapped up CRA-rated CDOs and other new credit-backed products. The performance of these ratings *ex-post facto* raised eyebrows: "Ninety-one percent of the

[AAA] securities backed by subprime mortgages issued in 2007 have been downgraded to junk status, along with 93 percent of those issued in 2006 and 53 percent of those issued in 2005. On Jan. 30 2008, Standard & Poor's downgraded over 6,300 subprime residential mortgage-backed securities and 1,900 CDOs.”¹ These poor performance levels and drastic downgrades, which resulted in severe losses, raised many questions about how CRAs should operate. Questions are most common concerning transparency in the business model and analytical methodology inputs.

The lack of transparency in model assumptions, the models themselves, and the rating agencies' evaluation of new instruments, were tested during the recent crisis. The assumptions and methodologies used in the process of rating complex credit instruments require greater attention to, and more consideration of, credit risk. Moreover, the recent crisis raised concern on whether a simple and coarse rating is sufficient for evaluating complex credit-based products, like collateralized debt obligations.

Going forward from the recent financial crisis, investors and regulators have questioned the role and appropriateness of credit rating agencies to deliver useful risk information. This has resulted in a significant amount of legislation in the Dodd-Frank Act of 2010 being directed at CRAs and the SEC, calling for many future studies on the role of CRAs, and even their business model. Some even call for nationalizing the CRAs or at least their function. Many want more regulation of CRAs, some even call for disbanding the CRAs, while others ask for more competition in the CRA space. All of these reactions are fueled by the failure of CRAs to provide investors information that was desperately needed and presumably available.

Investors and regulators have also questioned the credit rating agencies on the potential for conflict of interest and moral hazard. First, with immense profits at stake, CRAs might easily be tempted to expand ratings to products that are difficult to rate. Second, the predominate model for payment of CRA services, in which originators pay despite the fact that the need for the service is most demanded by investors, calls into question the inherent moral hazard and asymmetry of information at work within CRAs. Some argue that these phenomena may have resulted in an optimism bias towards the ratings offered to investment bankers on novel instruments. Moreover, these may also have emerged from rating agencies exercising lax rating procedures that did not rigorously analyze the data from the product originators.

An operating model for credit rating agencies is needed to prevent such lax behavior and mitigate the moral hazard issue as much as possible. Given the surprises in the recent financial crisis, investors are in need of meaningful credit risk information now more than ever.

The role of CRAs is actively under consideration by investors and regulators. There are government officials that believe that the CRAs should be highly regulated or even revert to not-for-profit cooperatives. I challenge this and firmly believe that the role of an *independent, third party, risk information intermediary* is necessary for fluid operation of capital markets. This study will examine the specific need for such a risk information intermediary and identify how credit rating agencies can and should compete on risk information to meet that need.

¹ "What About the Raters?" New York Times, May 1, 2010 Editorial by Editor in Chief

Producing a strong, independent, third-party that serves as a risk information broker would return trust to the market of CDOs and other such novel credit instruments. With a more robust CRA operating model, the absence of risk information on such financial instruments should be made transparent to investors and drive the proper market pricing on products with minimal risk information. Credit rating agencies can then be the brokers that enable such risk information. This well-functioning system is fundamental to the operation of banks and the efficient flow of capital from lenders to borrowers, as banks and investors need a basis of trade for credit instruments and securitized products. This study will highlight how the credit rating agencies can become trusted and valued participants in the banking system, while also ensuring their role in the efficient flow of capital.

Project Study and Process

THIS PAPER WILL EXAMINE THE issues inherent in how CRAs have operated, and how, as information brokers, they can meet the needs of investors and regulators, while still allowing for the innovation of new products demanded by financial markets. The information needs of the investment community and regulators are also examined, in order to propose an industry-viable CRA business model. Special consideration will be given to the availability of information on complex instruments like CDOs. The paper will examine and compare and contrast the issuer-pay model and the subscriber-pay model for CRAs.

Efforts to date have focused on mitigating the conflict of interest in the CRA business model and adding additional governance and regulation. Although these goals attempt to resolve issues in the business model, regulation often stifles innovation. Moreover, the ability to learn more about credit instruments is not fundamentally addressed through regulation. Regulation and second-level oversight will drive credit rating agencies to err on the side of overestimating credit risk and sharing requested information, as opposed to competing on information. There has yet to be a model, of my discovery, that addresses the structural issue of how risk information is conveyed and transformed by the credit rating agencies.

In the research phase of this study are gathered comments, testimonies, and requests from major communities of interest to the credit rating agencies. These communities include both investors and regulators.

The research approach has been one that includes capturing insights from many investment communities and significant regulatory groups, with some important points repeatedly emphasized. In general, a great deal of frustration and distrust is exhibited about the CRAs, especially in the structured product space.

An overview of the Dodd-Frank Act is also provided, as directed towards CRAs, and follows in the next section.

Synopsis of “Dodd-Frank Wall Street Reform and Consumer Protection Act” as Directed to Credit Rating Agencies

THE DODD-FRANK WALL STREET REFORM and Consumer Protection Act, also and herein referred to as the Dodd-Frank Act, provides the SEC new powers in regulating CRAs and, specifically calls for new regulation, transparency, and reporting of CRAs. As this Act is expected to have an impact upon the financial services industry broadly, and CRAs in a potentially transforming manner, this paper examines the major points raised in the Dodd-Frank Act and its implications on the CRAs.

In this section, the legislation directed to CRAs in the Dodd-Frank Act is reported. Implications and outlooks for the CRAs are also reported. “Subtitle C: Improvements to the Regulation of Credit Rating Agencies” is the section of the Act that specifically addresses the CRAs. The entire text of Subtitle C is provided in the Appendix of this paper. The following is a synopsis of the legislation, as related to CRAs.²

Reported Congressional Findings on Credit Rating Agencies

1. **Deemed to be of national public interest:** “Because of the systemic importance of credit ratings and the reliance placed on credit ratings by individual and institutional investors and financial regulators, the activities and performances of credit rating agencies, including nationally recognized statistical rating organizations, are matters of national public interest.”
2. **Need of public oversight and accountability:** “Credit rating agencies, including nationally recognized statistical rating organizations, play a critical ‘gatekeeper’ role in the debt market that is functionally similar to that of securities analysts.” “Such role justifies a similar level of public oversight and accountability.”
3. **Held to commercial standard of liability:** “...credit rating agencies are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers.”
4. **Conflicts of interest:** “In certain activities, particularly in advising arrangers of structured financial products on potential ratings of such products, credit rating agencies face conflicts of interest that need to be carefully monitored.” Monitoring is presumably to be done by the Securities and Exchange Commission.

² Dodd-Frank Act, Subtitle C: Improvements to the Regulation of Credit Rating Agencies

5. **Inaccurate ratings had a role in the crisis and must be prevented:** “In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely influenced the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies.”

Focus on Internal Processes and Reporting

A significant portion of the Dodd-Frank Act calls for new regulation and reporting on internal processes at CRAs and the role of management in overseeing and verifying the integrity of ratings. The major points of this include:

1. **Reporting to the Securities and Exchange Commission**

All CRAs shall report to the SEC an annual report with the following:

- a. Description of the responsibility of the management.
- b. Demonstration of and assessment of the effectiveness of internal controls.
- c. Attestation of the CEO of the CRA or other equivalent executive on the integrity of the ratings.

2. **Limitations on employment and compensation imposed by the Act**

The Dodd-Frank Act also addresses concerns related to misconduct by employees, the issues of conflict of interest in employee roles at CRAs, and requires the establishment of a chief compliance officer at CRAs. The Act also extends the reach of the SEC in regulating CRA operations, employment, and compensation. Major points of this section of the Act includes:

- a. The SEC may limit the role and activity of individuals alleged of misconduct.
- b. The SEC may suspend or revoke the registration of the CRA that does not have adequate financial and managerial resources to consistently produce “credit ratings with integrity.”
- c. The SEC shall issue rules to prevent the sales and marketing functions from influencing the ratings.
- d. The SEC shall revoke the license of CRAs that violate such rules to be formed by the SEC.
- e. The SEC shall review the code of ethics at each CRA annually and review information stored by the CRAs to evaluate the occurrence of any conflicts of interest.
- f. CRAs must report to the SEC employee transitions that pose a conflict of interest.
- g. Compensation of the compliance officer at a CRA shall not be linked to the firm’s overall financial performance, in order to ensure independence of the compliance function.

3. Annual reporting requirements

It appears that the Dodd-Frank Act will require specific attestations from executives, and that all CRAs will enforce a code of ethics. Although it is hard to project the use of this, it is likely that any future misdeeds (through the eyes of the SEC) can be linked to such reporting, posing unique and extreme liabilities for the attesting executives. Specifically, the Act requires reports on changes to code of ethics and conflict of interest policies, as well as certification that the report is complete and correct.

4. Establishment of the Office of Credit Ratings

The Dodd-Frank Act also requires that SEC develop a formal Office of Credit Ratings as a first step in standardizing ratings and strengthening the internal rigor behind ratings. This is to promote accuracy in the credit ratings, and to protect users of credit ratings. Additionally, this will likely provide the SEC clarity on addressing issues related to ratings going forward.

5. Disclosure by CRAs

A major concern in the Act is the need for transparency by CRAs in reporting. The Act calls for this transparency and reporting through the following points:

- a. Rules of Transparency: The SEC shall develop rules that require each CRA to publicly disclose information on the initial credit ratings issued for each type security, for evaluating accuracy and evaluation of different CRAs.
- b. Rules of Content: The SEC shall pass rules that require CRAs to disclose:
 - i. Ratings in order to compare across CRA organizations.
 - ii. That ratings are clear and informative.
 - iii. Range of historical data for performance evaluation.
 - iv. Published publicly and made widely available.
 - v. Attestation that rating was not influenced by other business functions such as sales and marketing.

6. Credit rating methodologies

The SEC shall prescribe rules that govern the methodologies of the CRAs. These rules shall:

- a. Ensure credit ratings are data (quantitative and qualitative) driven.
- b. Ratings are approved by a board within the CRA.
- c. Changes to methodology are consistently applied across ratings of all types.
- d. CRA publicly discloses reasons for change in methodology.

7. Disclosure of data used by CRAs

As Congress expressed concern over the use of data and assumptions in CRA ratings and the models used to develop such ratings, the Act empowers the SEC to require specific data disclosures from the CRAs. The SEC shall require by rule disclosure and transparency in:

- a. The assumptions underlying the CRA models.
- b. The data used to determine the ratings.
- c. Frequency of surveillance and reporting by the CRA.

- d. Investor relevant information to be used to better understand the ratings.
- e. Main qualitative assumptions.
- f. Assumptions of correlation of defaults across assets in structured products.
- g. The potential limitations of the ratings, types of risks excluded, such as liquidity risk.
- h. Information on the uncertainty of the ratings, accuracy, and quality of data used.
- i. Statement to the extent that data used in the ratings was reliable.
- j. Explanation of factors that might lead to credit rating changes.
- k. Magnitude of the change in ratings expected for different market conditions.
- l. Historical performance of the rating.
- m. The expected probability of default, the expected loss in the event of default.
- n. Disclosure of the five most important assumptions in the formulation of the rating.
- o. The impact of these five assumptions on the rating.

8. Governance and Boards of Directors:

The Dodd-Frank Act provides direction on how the Board of Directors of a CRA shall be constructed. Independence is a desired attribute in the board members.

9. Consideration of information from sources other than the issuer in rating decisions

The Act requires the CRAs demonstrate the use of data from sources other than the issuer of securities, as noted in the language that CRAs shall use data other than that provided by the issuer.

10. SEC rules on degree of employee qualification

It appears that the SEC will take a deeper interest in the qualification of individuals at CRAs executing and developing ratings. It is noted as:

The SEC shall issue rules within one year of this Act that limit the rating function to individuals that meet standards of training, experience, and competence.³

11. Universal rating symbols

As CRAs were challenged on the meaning of ratings in the context of default of other conditions that result in delay of investor payment, the Act requires that the SEC formally define rules to provide clarity on the issue of defining default. The Act requires that:

³ Dodd-Frank Act, 2010

The SEC shall issue rules that require the CRAs to establish, maintain, and store data and definitions on:

- i. Default
- ii. Failure to make timely payments
- iii. Not making payments

12. Removal of statutory references to credit ratings

The Dodd-Frank Act removes language from previous legislation that references “investment grade” or credit ratings as a benchmark for credit quality. In general, credit quality is replaced with “sufficient credit worthiness.” Reliance on credit ratings is directly reduced by this regulation.

Future Studies Required to Congress on CRAs

The Act calls for many studies to be conducted that consider various aspects of CRA operations, business models, and use of data. Such reports are broadly due to Congress within 1–3 years of the passage of the Act. The outlook is that the SEC is empowered to advise Congress on future changes needed to the CRA, likely including new rules or legislation. The SEC shall undertake studies on:

1. Study of credit rating agency standardization

This study shall to be returned to Congress no later than one year after passage of the Act and shall evaluate:

- a. Standardizing the ratings and terminology across CRAs.
- b. Standardizing market stress conditions for the purposes of market risk modeling.
- c. Requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations.
- d. Standardizing credit rating terminology across asset classes.

2. Study of independence of CRAs

An additional study, due within three years of the date to Congress, shall evaluate the:

- a. Independence of CRAs.
- b. How the independence of CRAs has an impact upon the ratings issued.
- c. The management of conflicts of interest at CRAs.
- d. The impact of rules that limit CRAs from business with certain issuers.

3. Study of alternative business models

The Comptroller General of the United States shall conduct a study on alternative means for the operation and competition of CRAs. This report is due to the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives, no later than 18 months after passage of the Act.

4. Creation of an independent professional analyst organization

The Comptroller General of the United States shall commission a study to evaluate the merits of establishing an independent professional analyst organization. This study is due 1 year after the passage of this Act to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.

5. Study and rulemaking on assigned credit ratings

The SEC shall carry out a study (due 24 months after passage of the Act to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives) that considers:

- a. The credit rating process for structured finance products under the issuer-pay and subscriber-pay model, with consideration to conflicts of interest.
- b. A model by which a third party assigns the opportunities to rate structure asset products.
- c. Alternative models for compensating CRAs that promote increased accuracy and decreased conflicts of interest.

Credit Rating Agencies as Risk Information Brokers

THE CRAs ORIGINATED AT A time when investors found accessing information on corporate debt nearly impossible. Investors have the same needs today, in particular as it relates to new products, like CDOs. In this capacity, the rating agencies offer a powerful and much needed service, that of an *independent, intermediate, third-party, risk information communicator*, which facilitates trade and opens markets. This role is highlighted repeatedly in markets of all types, all around the world. Even the trading of commodities and precious metals is built on the role of a market intermediary that guarantees or verifies product quality and authenticity. Markets are known to operate efficiently with the communication of risk, especially through independent information brokers or market enablers, where conflicts of interest are minimal or non-existent, and reputation in quality is demanded. The credit rating agencies, with some new offerings or adjustments to their business model, are uniquely positioned to offer this important third-party risk information brokerage. In many financial markets, the exchange house holds this role. In others, the role of a third-party certification (as in the diamond industry) provides the buyer confidence and presumably protection from the seller's ability to deceive the buyer. Such a function is still very valuable in the financial markets. This should include offering insights on new credit products, while also offering the banking community a standard and trusted language for credit risk rating.

Credit Rating Agency Business Model – Issuer-pays for Ratings

IN LIGHT OF THE CRITICISM that the CRAs have received for their role in the financial crisis, it is fair to consider the business model at work and how CRAs have been compensated. Indeed, the recent Dodd-Frank Act requires that:

“The Comptroller General of the United States shall conduct a study on alternative means for compensating nationally recognized statistical rating organizations in order to create incentives for nationally recognized statistical rating organizations to provide more accurate credit ratings, including any statutory changes that would be required to facilitate the use of an alternative means of compensation.”⁴

The very business model by which the CRAs operate is subject to study and redesign.

The “bond model” or “issuer-pay model” is the traditional business model by which CRAs evaluate publicly traded debt; it was often the case that the firm issuing debt would engage CRAs. The bonds were evaluated at the expense of the firm or originator, often termed the “issuer.” However, before the 1970s, CRAs operated on a business model whereby the investors paid (known as a “subscriber-pay model”), through a subscription fee or a fee for a physical copy of the CRA reports. The industry wide shift to issuer-pay was in many ways a movement to protect the firm from revenue challenges arising from the easy reproduction of rating publications.

The move to an issuer-pay business model allowed the CRA to gain access to more information from the issuer, in principle. In fact, much information shared by the issuer to the CRA may be offered under protected client-provider privilege. The goal was also to provide CRAs greater clarity into firm strategy and performance, in order to issue a more complete and data-driven rating than might be available using strictly publicly available data. CRAs have also argued that relying on an issuer-pay model encourages a more rapid flow of information from the issuer to the marketplace, and such data that can be shared via the issuer would not rely on a lengthy market-discovery process. Such a theory may hold water in the bond market, but likely requires reexamination in the securities market.

This does introduce a conflict of interest, and a motivation for the issuer to paint a rosier picture than might be the case, the issuer knows that it will be required to return to the CRA and the bond market for future lending. This would imply that, over the long-term, temptations to disguise debt are, in part, checked by the need to establish credibility and trust with the CRAs and the bond purchasing community. The motivation of the issuer and its role in the investment is a great differentiator between the bond issuer model and the security issuer model.

4 Dodd-Frank Act, Section 939D

Some of the key aspects of the issuer-pay model in the bond market include:

- 1. Role of issuer provided (non-public) data:** The CRAs gained access to issuer-provided data. This disclosure presumably was in the best interest of the issuer and the CRA in detailing true debt positions and enhancing the value of ratings to investors. The CRA serves as an information broker, transferring risk related information from the issuer to the investors.
- 2. Issuers remain involved for a long period:** Issuers remained invested for the long-term in the investment in their firm. In this, the willingness or temptation of the issuer to disguise data is more or less limited to optimism in their underlying business model. The issuer has to live with the rating and future downgrades and the impacts of corporate cost of capital not only in just one issuance, but also over a long period. Moreover, the issuer is in a position to actively (presumably) execute corporate strategy that would improve its position and even its rating. It is in the best interest of the issuer to share information and to do so in a manner that cultivates a positive reputation amongst CRAs and investors.
- 3. Role of unsolicited ratings:** CRAs can issue unsolicited ratings—such ratings do not benefit from any private issuer information, meaning that an issuer is at a distinct disadvantage in an unsolicited rating. This suggests even more that issuers reach-out to a CRA in the process of issuing bonds, further enabling even more data to be brought to the marketplace.
- 4. Transparency in data:** Although the recent decade has witnessed the likes of Enron and WorldCom, most issuers of debt have transparency, sincerity, and legitimacy in their business models and a willingness to share insight on how new funding will promote business growth. This is key, as investors can publicly examine the strategy of a firm. CRA ratings can be questioned by investors in light of updated firm performance. Leading firms in industries and important industries can fairly be measured. Credit ratings on corporate debt can be vetted against the transparent firm data in annual reports and SEC filings, requiring that CRAs consider such data. In fact, a failure to adequately respond to the Enron situation brought great criticism and punishment to the CRAs.
- 5. Availability of leverage ratios of the issuer:** As it relates to corporate debt, issuers of debt must share information about all existing debts and even past debt servicing. As one might expect, CRAs look to the level of overall debt at a debt-issuing firm as one key indicator of the firm's ability to repay the debt. This is measured by many metrics that consider the degree of leverage or borrowing position of the issuer. Tracking such an indicator is also a key for a CRA in determining if debt might degrade. In fact, many of the quantitative models deployed by CRAs do model debt levels relative to asset levels, as in Merton models, for the purposes of determining the riskiness of such debt.

6. **Strong historical record for credit ratings:** The long track record of CRAs rating corporate debt and providing credit rating scales that corresponded to relatively well understood conventions of investment grade versus non-investment grade provided credibility to ratings. Investors and analysts understand the implications of downgrade in terms of the underlying credit risk. Such credit risk could also be paired with other public or market data about the issuer for confirmation.
7. **Regular surveillance with data:** Regular surveillance by CRAs on corporate debt required that CRAs provide analysis that was directionally consistent with market and firm conditions. Regular surveillance also provided the investors meaningful updates to bond rating changes—changes driven by firm performance. Issuers of firms seeking debt were also checked by regular surveillance to execute corporate strategy and share meaningful information, or experience the costly results of debt downgrades.
8. **Ratings based on market outlook:** A key aspect of rating corporate debt is the outlook for the firm in the marketplace. This is more than asking if the firm is currently on solid ground. This asks if the firm is positioned to repay future debt—key to debt rating. Investors in corporate debt rely heavily on CRA quantitative analysis and qualitative comments on how market conditions will have an impact upon the issuer and its debt repayment in question.

This model was successfully applied to municipal bonds, sovereign debt, and other debt where the issuer was responsible for the use of the borrowed capital for investment in a venture.

As the CRAs embarked on rating securitized products and novel products in the securitized space, such as mortgage-backed CDOs, the positive attributes of the issuer-pay model in the corporate bond space were challenged, diminished, or not realized due to other market forces at work.

Credit Rating Agency Business Model – Issuer-pays for Securitized Product Ratings

CRA'S HAVE OFFERED RATINGS ON securitized products for many years. Many of the securitized products included asset-backed securities (ABS), such as mortgage-backed securities. Prior to the crisis of 2007-2009, U.S. mortgages were perceived by investors and CRAs as safe investments, subject to a great deal of pre-payment risk. Additionally, U.S. mortgages were generally standard, and lending practices at the point of origination were rather strict. Many of the mortgages issued in the U.S. previous to the mid-1990s were Federal Housing Administration (FHA) conforming, or low credit risk, meaning that resulting CRA ratings on mortgage-backed ABS were generally positive. In fact, to many investors, investment in U.S. mortgages was perceived as nearly as safe an investment in U.S. Treasury bills.

As with corporate debt, the CRAs operated on a model by which the issuer of the security would pay for the rating. In many ways, this was fair, as it was the issuer that had the information needed by the CRA for the rating, and the securitized product was one that came from a bank that might have even originated the loans. In looking at each of the positive attributes developed in the CRA issuer-pay bond model, we see some structural challenges that in part, explain why CRA ratings in the securitized space failed investors.

- 1. Role of issuer provided (non-public) data:** The CRAs relied on data provided by the issuers of asset-backed securities, like CDOs. However, unlike a corporate bond, the investment bank in a CDO issuance was rarely close to the underlying credit data, such as the mortgage applications and loan details. The issuer of the CDO likely did not even participate in the mortgage origination process. Some claims are that CRAs only used coarse portfolio averages of mortgage data in assessing CDO tranches. We now know that a significant number of subprime mortgages suffered from fraud, and other misstatement of key credit risk data, meaning that the CRAs had no understanding of key underlying data—the creditworthiness of specific mortgages. In corporate debt, the CRA could examine the issuer and their prospect for repayment based on market conditions and firm specific conditions. However, mortgage-backed CDOs required an analysis of thousands of mortgages, often with data that were suspect or unavailable, and it little such analysis was conducted by CRAs.
- 2. Issuers remain involved for a long period of time:** Issuers of CDOs and other mortgage-backed securities were not long the investment, but were exiting mortgage positions. The difference with a corporate debt is striking. First, corporate debt issuers are invested for the long-term in their firm. Second, investment banks are compensated for the sale of asset-backed securities, and thus are incentivized to move more products. Some investment banks were not only short the mortgages by the act of selling, but also took counter positions to the CDOs being sold, in expectation of making earnings of imminent rating downgrades.

3. **Role of unsolicited ratings:** CRA ratings in the CDO space were almost exclusively on a solicited basis. Issuers were not troubled by the prospect of another CRA offering an unsolicited rating on a CDO. Fees for solicited ratings were generally \$300,000-\$1,000,000, or more, on mortgage-backed securities.⁵ Temptations and expectations in sales did more to cloud the relationship between CRAs and issuers.
4. **Transparency in data:** Unlike with the bond model, where an investor can question the strategy or intent of the issuer, a mortgage-backed CDO offers little transparency to the strategy of the underlying borrower, the home buyer. For instance, were the mortgages mostly second homes, or homes purchased with intent to rapidly refinance or sell? Such questions are fundamental to evaluation of a bond, but were mostly unanswered in mortgage-backed CDO products. Investors in CDOs had little more than a coarse credit rating at the time of CDO issuance for answering any related questions.
5. **Availability of leverage ratios of the issuer:** Traditionally, home mortgage originators exercised caution in lending practices and standards, requiring homeowners to have large equity positions in homes and sufficient income levels to meet the servicing or mortgages. As the mortgage origination process decoupled from the securitization process of mortgages, and product proliferation and innovation in the mortgage industry ramped up, some home owners could take out larger mortgages and increase personal leverage ratios. Personal debt in the U.S. was at an all time high just before the crisis of 2007-2009. In fact, one must question whether the right data to even measure individual leverage were adequately reported by CRAs through ratings.
6. **Strong historical record for credit ratings:** The long track record of CRAs rating corporate debt served as a mark or trust of credibility as investors, hungry for higher-return fixed income products, looked to new mortgage backed securities for investment opportunities, like CDOs. However, CRAs had little track record in modeling the risks of such products, and the industry overall had little experience with dealing with mortgage default, especially on a widespread basis. The last U.S. real estate market downturn, previous to the 2007-2009 crisis, was in 1991. Owing to this experience deficit, the investment community and CRAs had little experience with modeling real estate downturns and little historical record for third-party evaluation of ratings.
7. **Regular surveillance with data:** It appears that many of the mortgage-backed CDOs were rated at issuance. They were more or less untouched by the CRAs until it was clear that rapid and numerous downgrades were in order, given the investor outcry for answers on rapidly elevating defaults. A great strength in corporate debt ratings from CRAs is that ratings are offered in conjunction with data, both quantitative and qualitative. However, they are highly comparative against previous quarters, and offer an outlook for future periods. Such

⁵ SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

detailed data should also be provided for asset-backed securitized products, as opportunities to compare ratings against previous period ratings would be key.

8. **Market outlook:** In the SEC hearings, there were questions about the role of CRAs in the subprime mortgage market. Many asked how more or less “junk grade” could have ever been “investment grade.” Some explanations were that CRAs only used the data provided by the issuer (presumably with little or no professional vetting) and offered, “Point in time estimates.” The nature of all credit risk modeling is to provide an assessment of the risk of default over the life of the loan or over some reasonable foreseeable time frame. Point in time ratings are inadequate in all forms of credit risk assessment, especially if investors cannot expect the rating to persist at least until the next scheduled surveillance.

These points suggest that CRAs are positioned differently in the securitized product space versus the bond space, and that a different business model may be needed. Specifically, one that provides greater communication of risk information to investors. Let us consider the perspective of investors next.

Perspectives from Investors

OVER THE PAST FEW DECADES, bond investors have become comfortable with bond ratings provided by CRAs, as they have been relatively reliable. However, there have been instances when they were slow to react, as seen in the Enron freefall, and in the downgrading of financial services firms during the 2008-2009 financial crisis.

A few key points should be taken from the bond-rating model. Investors find CRA ratings useful, and investors simultaneously have access to publicly traded company data beyond ratings. Moreover, bond ratings may be solicited or unsolicited by the firm. Solicited ratings are conducted with the consent of the bond-issuing firm, whose interest includes favorable ratings for reducing the costs of capital. This is in contrast to unsolicited ratings, where the motivation of the CRA is to provide the investment community insights that are demanded. Delving a bit deeper into the role of unsolicited bond ratings shows that the demands of the investor provides a model for how CRAs can service investor needs over issuer needs and interests. Specifically, research indicates that 17.8 percent of companies reported having received unsolicited ratings.⁶ In effect, CRAs must also generate reasonably attractive revenue on unsolicited ratings, or else these ratings would not occur at such a high rate.

In publicly traded firms, investors often have available information about firm performance that allows for questioning and reevaluation of the CRA ratings. Information may come from many sources, including annual reports, media leaks, and prevailing sentiment about a firm's forward-looking prognosis in a given industry. Bond ratings are examinable, given other information such as quarterly reports, providing investors a mechanism for assessing bond ratings. Although it is true that solicited bond ratings offer firms the opportunity to share private information during the rating process, investors have the ability to align public information with ratings. Investors can then determine their tolerance for any rating's discrepancy that public information does not explain, and make a validated and informed risk-based decision. The accessibility of data offers two desirable outcomes: a means by which the investor can check the ratings for reasonableness, and a limit to the CRA's ability to promote ratings outside of products that have clear data support.

The role of investors in considering additional information relevant to bond ratings also highlights several key points. Along with a bond rating, CRAs provide investors commentary and some basis for the evaluation, such as details from annual reports, market conditions, or unique conditions facing the firm in question. This supplementary information provides investors insights into why particular ratings have been issued in the bond market. Although this information is not perfect, and is far from complete, the investor is given a level of transparency that allows for an information transfer between the CRA and the investor. The investor values this information largely because it comes from a party presumed to be free of conflict from the firm in question. Although, in solicited bond ratings, there is a potential conflict as the CRA is driven to conform to ratings that are consistent with publicly available information.

⁶ Why Do Firms Pay for Ratings When They Can Get Them for Free? Gan, 2004.

CRA Concerns from Investors in Structured Products

OVER THE PAST FEW DECADES, growth in the capital markets has allowed for securitization of regular payment products, such as mortgages, auto loans, and credit card debt. The investment community has also grown comfortable with norms in the real estate market, and how mortgage-backed securities provide an opportunity for fixed income investment with risk bounded by the presumed safety of U.S. real estate. The innovation in financial instruments has also brought to the market a host of new products that, for the most part, has remained untested and unverified until recently.

CRA's have played an important role in facilitating the sale of structured products. In particular, products with novel origins or new mechanics might receive ratings that allowed investors to consider these products as part of a fixed-income investment. The following quote from the Comptroller of the Currency of National Banks details this misappropriation:

“The rating agencies perform a critical role in structured finance—evaluating the credit quality of the transactions. Such agencies are considered credible because they possess the expertise to evaluate various underlying asset types, and because they do not have a financial interest in a security’s cost or yield. Ratings are important because investors generally accept ratings by the major public rating agencies in lieu of conducting a due diligence investigation of the underlying assets and the servicer.”⁷

The investment community includes parties with different asset outlooks, with some investors looking for minimal risk and predictable coupon payments, others looking for mispriced risk, or speculators seeking higher risk investments. All of these investors desire information about the products and, to some extent, look to credit ratings to determine what is believed, or known, about the asset in question.

In the wake of the 2008-2009 crisis, issues emerged that suggest the rating approach for structured products, such as CDOs and other complex products, were not credibly executed by the CRA's.⁸ A few years ago, when the housing market was in rapid appreciation mode, investors looked to rating agencies with the same trust and expectation for information on mortgage-backed securities as had been observed in bond ratings. However, information made available to investors about the CDOs did not allow for direct or easy verification of the underlying credit risk, especially under changing economic conditions.

7 Comptroller of the Currency Administrator of National Banks, Comptroller's Handbook, Asset Securitization, November 1997 via SEC Hearing on Credit Rating Agencies, April 23, 2010; Internet; available at <http://levin.senate.gov/newsroom/supporting/2010/PSI.LevinCoburnmemo.042310.pdf>. Page 3.

8 http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf (cached and available at http://search.sifma.org/search?q=cache:1YvzemJwkI:old.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf+CRA+recommendations&access=p&output=xml_no_dtd&ie=UTF-8&client=SIFMA&site=SIFMA&proxystylesheet=SIFMA&oe=UTF-8)

Investor trust in the CRA ratings of novel financial products, especially CDOs and other securitized products, has significantly waned since the financial crisis. The overall role and reputation of CRAs have also been called into question by the investment community. The Chartered Financial Analyst (CFA) Institute reported that, when asked about CRAs, “60% of its members felt that credit ratings from national Credit Rating Agencies were not valid. Similarly, 60% indicated that these ratings were not useful in making investment decisions.”⁹ The CFA Institute also recognized the difference between CRA performance in the bond market and in structured products: “Rating agencies should use rating nomenclature or categorization that distinguishes structured products from both corporate and commercial paper ratings to help investors recognize the differences.”¹⁰ The Council of Institutional Investors has called for even more action: “Reliance on [CRA] ratings should be greatly reduced by statutory and regulatory amendments. Market participants should reduce their dependence on ratings in making investment decisions.”¹¹

The investment community has also pushed for better information from the CRAs. In the bond markets, years of ratings and performance history has given way to acceptance of what a rating means with respect to credit risk. However, there is still debate about what an “investment grade bond rating” should mean, in terms of eminent and near-term default likelihood. In the structured product space, there is recognition that new products introduce new risks, and may be void of detailed information for adequate risk management. The CFA Institute has held that “CRAs should refrain from rating new structured products until the statistical data are sufficiently robust to produce a defensible rating.”¹² The CFA Institute concludes this because “new structured products rarely have sufficient performance data to enable rating agencies to have an adequate basis for a rating. Only after sufficient data is available to help the analyst recognize how these instruments will function in different circumstances should a rating be given.”¹³ Thus, while credit rating is valued, more importance is placed on the availability of the underlying data needed to support the credit risk decision. The emphasis on completeness of data is also of concern in the CFA opinions.

In all of these calls for action, the investment community has not proposed the dissolution of CRAs, despite acknowledging that grave errors were made in the structured products space. Still, there is a need to communicate information about products to permit the buy-sell function which otherwise would not be fluid, and which, if flawed, could impede capital flows. This was best captured by Deborah A. Cuning, executive vice president and chief investment officer for the Federated Investors Money Market Funds, on behalf of the Securities Industry and Financial Markets Association, during the SEC Roundtable for CRAs, April 13, 2009. She stated, “The credit rating agency research and the ratings are a valuable input into that minimal credit risk determination, but they represent data, they represent reference points in my independent analysis. They are not the end result.”¹⁴ She emphasized, in the same testimony, “The need

9 http://www.cfainstitute.org/Survey/cra_poll_results.pdf

10 Global Association of Investment Professionals, “Rating Terms,” Internet; available at http://www.cfainstitute.org/ethics/topics/Pages/rating_terms.aspx

11 Investors' Working Group, “U.S. Financial Regulatory Reform,” July 2009; Internet; available at [http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%20Working%20Group%20Report%20\(July%202009\).pdf](http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%20Working%20Group%20Report%20(July%202009).pdf). Page 11. Also available at www.house.gov/apps/list/hearing/financialsvcs_dem/schacht.pdf

12 Global Association of Investment Professionals, “Reasonable Basis for Ratings,” Internet; available at http://www.cfainstitute.org/ethics/topics/Pages/reasonable_basis_for_ratings.aspx

13 Global Association of Investment Professionals, “Reasonable Basis for Ratings,” Internet; available at http://www.cfainstitute.org/ethics/topics/Pages/reasonable_basis_for_ratings.aspx

14 Securities and Exchange Commission, “Roundtable to Examine Oversight of Credit Rating Agencies,” 15 April 2009, Internet; available at <http://www.sec.gov/spotlight/cra-oversight-roundtable/cra-oversight-roundtable-transcript.txt>. Section 119.

for greater transparency and disclosure.” This demand for greater transparency entails greater information on historical CRA ratings, especially for new products, where the rate and trends in credit downgrades by the CRA can be questioned. As such, this is a call for CRAs to publish greater information on their performance, allowing for the ever-important back-testing function in credit risk modeling. In the same SEC hearing, Paul Schott Stevens, president and chief executive officer (CEO) of the Investment Company Institute, added that, “First and foremost, investors need better disclosure about credit ratings and the ratings process.” Others on the same panel discussed the value in having CRAs set a floor for quality and information. This notion that ratings are not the end, but simply the starting point, in the investor’s path to assessing a product’s credit and market risk is key. Also raised at the same time was the point that missing information is not the same as negative information.¹⁵ With better transparency, investors can better gauge the impact of missing information. In the case of novel products, the rating with a single letter grade obfuscates the impact of missing information on the underlying credit risk.

Many argue that CRAs did not have access to all of the needed information for the rating of novel products, like CDOs and CDOs-squared. Although lawmakers and investors may say that rating such products without adequate information may be negligent, the most direct way to validate CRA ratings is to provide investors a view into the underlying data considered in the rating. This will discourage CRAs from generating less than credible ratings and ideally provide the investors greater trust in them as meaningful risk information brokers.

The information needed by investors in structured products is essentially the same as what would be needed to provide a thorough credit risk assessment. Yet, the call for greater transparency means many things to many investors. For some investors, there is a request for disclosure of methodologies deployed by the CRAs. Others request detailed input factors and assumptions made by the CRA in arriving at the letter rating. The Securities Industry and Financial Markets Association (SIFMA) Credit Rating Agency Task Force recently published its opinions on their investment community’s need for more information from CRAs. SIFMA posits that the typical information shared by CRAs on structured products “was generally insufficient for investors to understand CRA rating methodology with respect to particular structured securities; no one could determine what assumptions and adjustments the CRAs employed.”¹⁶ This suggests a need for the investors to be able to back-test the ratings based on input data and other assumptions, such as macro-economic conditions. In sum, a demand from the investment community for more information in vetting the underlying credit risk.

¹⁵ <http://www.sec.gov/spotlight/cra-oversight-roundtable/cra-oversight-roundtable-transcript.txt>

¹⁶ Securities Industry and Financial Markets Association, “Recommendations of the Credit Rating Agency Task Force,” July 2008, Internet; available at <http://www.sifma.org/issues/item.aspx?id=21391>. Page 5.

Perspective from Regulatory Organizations

THE REGULATORY COMMUNITIES HAVE A DEEP interest in the future of CRAs. The SEC is charged with oversight of the CRAs. In 2006, Congress passed the Credit Rating Agency Reform Act (P.L. 109-291). This Act was, in many ways, the result of the poor and slow reaction by CRAs to downgrade corporate debt of companies under scrutiny for fraud. Specifically, such reactions for Enron and WorldCom caused investors to question the role and value of CRA ratings. The law allows the government to formally define the role of Nationally Recognized Statistical Rating Organizations (CRAs with government endorsement), while also prohibiting the SEC from regulating the substance, criteria, or methodologies used in credit rating models.¹⁷ The Dodd-Frank Act also provides the SEC greater authority over the regulation of CRAs and the use of ratings by banks.¹⁸

Because the regulatory organizations rely on ratings to assess the worthiness of bank assets, there is a need for regulators to peer into the underlying elements that go into a credit rating. In the recent SEC hearing on the Role of CRAs, the issue of risk and inaccuracy of models was brought to light by the Congressional Subcommittee:

“The models used by Moody’s and [Standard and Poor’s] S&P provided thousands of ratings that turned out to be inaccurate. They did so, in part, because the models did not contain adequate performance data for subprime, interest-only, option ARM, and other high-risk mortgages that had come to dominate the housing market, and did not contain adequate data for higher risk borrowers. According to the Congressional Research Service, the models failed to understand the likelihood of falling house prices, attached the wrong weights to the effect of falling house prices on loan default rates; and miscalculated the interdependence among loan defaults.”¹⁹

The conclusions reached by the Congressional Research Service call attention to specific pieces of information that should have been made available, not just to investors, but also to regulators. This has at least two powerful applications from the regulatory perspective. First, it provides the SEC some insight into the quality of CRA ratings. The reference to “performance data for subprime, interest-only, option ARM, and other high risk mortgages that had come to dominate the housing market,” suggests that regulators are also interested in reviewing the underlying credit data to review the quality of the ratings and overall CRA performance. This would likely best be accomplished by deploying independent third parties to assess samples of data from the thousands of ratings. In a sense, this would allow some vetting or verification of the ratings vis-à-vis evaluating ratings’ evaluators.

17 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C. (available at levin.senate.gov/newsroom/supporting/2010/PSI.LevinCoburnmemo.042310.pdf)

18 Dodd-Frank Act: Subtitle C

19 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C. (available at levin.senate.gov/newsroom/supporting/2010/PSI.LevinCoburnmemo.042310.pdf)

Second, the information about emerging credit instruments would be extremely valuable for regulators in monitoring the rise of other future asset bubbles from novel financial instruments. Notably, credit details and trade volume data would also enable regulators a view into systemic risk and flows of capital to potentially risky credit-backed assets. Measuring this from CRA ratings would provide the regulators a centralized and convenient source of trend data on capital markets and movements that would signal an asset bubble.

This ability to utilize underlying credit data from CDOs, or other instruments, would also allow regulators to call on leading banks and insurance firms to adjust capital reserves, in a manner that is connected not just to CRA ratings, but also to detailed data on the underlying credit-backed assets. The resulting lens into the product details would provide the regulator and banker alike a more complete sense of when ratings and actual credit risk warrant intervention. This would offer reassurance for banks that purchased CDO tranches with high ratings and did not anticipate any likelihood of default.

Making available to regulators and third-party verifiers information about the underlying credit risk will also spur the CRAs to proactively update models and data. Another quote from the aforementioned SEC hearing highlights how little updating occurred previously:

“In 2007, S&P testified that: ‘[W]e are fully aware that, for all our reliance on our analysis of historically rooted data that sometimes went as far back as the Great Depression, some of that data has proved no longer to be as useful or reliable as it has historically been.’ The former head of the RMBS group at S&P told the Subcommittee that he believed their model needed updating, but that the company chose not to commit the resources to do so.’”²⁰

In a business model that demands a comprehensive publishing of risk data, CRAs would be rewarded for modifying their practices to meet investor and regulator needs. CRAs that fail to meet these needs would be identified and perceived poorly. Therefore, CRAs can succeed only if they can serve the role of risk information brokers and meet investor needs.

²⁰ SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C. (available at levin.senate.gov/newsroom/supporting/2010/PSI.LevinCoburnmemo.042310.pdf)

Proposed Model I: Strengthening the Issuer-pay Based Model

THE POSITIVE ATTRIBUTES OF THE issuer-pay model as exhibited in the bond market, can with some adjustments, be regained in the asset-backed securitization market. It is not clear that these adjustments can be made without regulation. The following examines these changes needed to realize the benefits observed in the bond market ratings.

- 1. Role of issuer provided (non-public) data:** The CRAs must take a more active role in vetting the underlying data used in creating the ratings of new securitized products. This might mean refraining from ratings, if data is dubious, incomplete, or otherwise unavailable. On a broader level, CRAs might even consider becoming more of a data confirming service, not simply a rating firm. The opportunity and ability for CRAs to leverage and examine data on asset-backed securities must be enhanced, either through a defined process, or through a verification process that checks for such a use of key data. Regulations under the Dodd-Frank Act calls for specific process governance at CRAs. The impact of this might bring further attention to issues related to underlying credit data in asset-backed securities.²¹
- 2. Issuers remain involved for a long period of time:** Issuers of CDOs, and other mortgage-backed securities, should be required to retain a long position in the securitized product (for some reasonable period of time), in order to check conflicts of interest and temptations to obfuscate data on undesirable securities. As corporate debt issuers are long their stock, making issuers of CDOs also long the CDO (in part) will put “skin into the game” and require that products also meet the issuer’s investment grade. The issuer of the CDO now becomes a stronger participant in the vetting of assets worthy of securitization, instead of simply serving to provide the platform for securitization. CRAs may also provide the reporting on the issuer’s position and report when positions change, as such information may prove to be important risk signals to other investors.
- 3. Role of unsolicited ratings:** By making more of the underlying data used as part of the rating process available to investors, the CRAs can provide investors an opportunity to verify and check ratings for correctness or other market assumptions. Such transparency can also allow an investor to solicit an independent rating agency or other such qualified firm to provide an independent unsolicited rating on a questioned security. Such a process is also paramount to restoring trust in the use of ratings in the securitized space.

²¹ Dodd-Frank Act, Subtitle C.

- 4. Transparency in the data:** The complexity of CDOs has been examined by many. There is little reason for CDOs to be built in a manner where combinations of high quality loans and low quality loans are mixed. CDOs, and the underlying assets, should be grouped by CRAs, and rated accordingly. In many instances, issuers combined loans of varying qualities to make the perceived portfolio value higher. Providing structure to the CDO, based on underlying loan quality will also make the tasks of the CRA more attainable in rating securitized products. Publishing and making public key data on the loans in the security will also allow independent vetting of the security and allow investors to apply scenario-driven models for the purposes of stress-testing and risk analysis under extreme market conditions. CRAs might also rank CDOs based on complexity, transparency of underlying data, and homogeneity of underlying loans. Such data and perspectives would be highly valuable to investors. Reporting such data would also encourage issuers to produce CDOs that conform to standards that help in risk assessment.
- 5. Availability of leverage ratios of the issuer:** Although it is challenging to measure leverage ratios for individuals, as income is less transparent than in corporate lending, various metrics can be used to provide surrogates. For example, the use of credit rating bureau data and the total debt for an individual measures against median incomes for the neighborhood would be a start. Such analysis by the CRA would provide investors a sense of leverage on the part of the underlying borrowers. Presumably, such data would even drive more consistent ratings, as leverage ratings unsafely increase. Tracking and updating such information would also be a key advancement that CRAs could offer.
- 6. Strong historical record for credit ratings:** Trust and confidence in CRA ratings of asset-backed products will only return with the development of a long history of ratings, complete with downgrades and upgrades, made available for post-analysis and re-examination. This will take time, but steps such as the publication of the ratings, underlying data, and related commentary will be needed for independent researchers to establish fair pricing models for rated securitized products. CRAs should publish such ratings to develop a historical record of accomplishment of ratings for structured products.
- 7. Regular surveillance with data:** Investment grade ratings at issuance, punctuated with downgrades during a crisis, are insufficient for investors and regulators. Even if a CDO is not deserving of a downgrade, the CRA doing a regular surveillance can provide commentary and outlook on the product because it is helpful in building a meaningful historical record. Confirmation of ratings after analysis as part of surveillance is important to investors; it builds confidence in the rating process. In addition, regular surveillance can ideally detect slight bumps that are the precursors of large jolts. Regular surveillance should be a frequent undertaking by CRAs on securitized products, instituting a regular data flow from the issuer or product servicer.

8. **Market outlook:** CRAs should provide ratings based on an agreed to period, say one year, or three years, with quantitative and qualitative outlooks for how financial products will trend. Of course, investors would like all ratings to be correct, and CRAs will suffer the challenges predicting ratings of securitized products. However, a market outlook produces a level of justification and grounding that permits the investor an opportunity to question if the outlook is reasonable. In the same way that CRAs evaluate corporate debt, as a function of market conditions that will likely impact the issuing firm, CRAs should also consider economic outlooks, U.S. real estate projections, employment conditions, and expected interest rate movements in providing analysis and ratings on securitized products.

Many of the above changes are called for in the Dodd-Frank Act, or are left for future study by the SEC. Contributions from investors, CRAs, and other market participants are needed, as changes to the CRA model are contemplated. Next, it is important to consider the extreme alternative of the issuer-pay model, namely the subscriber-pay model, which is well at work in the credit-bureau model.

Proposed Model II: Risk Information Brokers: The Subscriber-pay Model or Credit Bureau Model

WHEN CONSIDERING CRAs AS RISK information brokers, it is useful to look to the consumer credit lending business as a model worthy of examination. The role of risk information brokers was developed in the consumer credit markets by credit bureaus such as Fair Isaac, Equifax, and Experian, which score individuals on credit risk through a proprietary score, such as the FICO score. The parallel to CRAs is striking in this dimension, but there is an important difference: the credit bureaus have competed on information and have differentiated themselves based on the data they provide to the credit lenders. The credit bureaus specialize in gathering, verifying, and offering credit lenders key data on personal loans such as days past 30 days due, total debt, etc. In this manner, the credit bureaus, while providing a proprietary credit score, also sell data and serve as risk information brokers.

Retail banks and lenders have benefited from having the major credit bureaus compete on information. This competition amongst the credit bureaus stimulates innovation and the creation of new credit risk data offerings. The credit bureaus do not just bring new data to the lending business, but also new perspectives on the velocity of changes in credit risk, effects of macroeconomic changes on credit risk, and geophysical concentration of credit risk (as examples). This has provided retail bankers and lenders the ability to model market changes and other shocks to a portfolio of credit holdings. The investment community needs a similar capability for credit-backed securities.

A few key attributes of the credit bureau model are important to note when considering how CRAs can operate as risk information brokers:

1. **Third party independence:** Credit bureaus are independent, third-parties to the asset allocation decision in consumer lending.
2. **Competition:** Multiple credit bureaus operate, providing lenders choices in prices and products.
3. **Data disclosure drives risk scores:** Availability of underlying data drives credit assessments to be directionally consistent with the data sold to lenders. In many cases, lenders can use the underlying data to determine if the credit scores are directionally correct or valid.
4. **Investors pay for the data:** Buyers of the credit data are those making the asset (lending) investment. The value added goes to the lender that seeks guidance in the credit risk.
5. **Investors require regular monitoring:** The dynamic nature of consumer lending is acknowledged by lenders, which prompts credit bureaus to provide regular and frequent updates to changes in underlying credit data. Lenders pay for this data availability and actively use it to manage credit risk.

6. **Data fuels innovation:** Data availability supports innovation. Asset buyers demand new pieces of data and/or new frequencies of data, leading to more underlying credit data disclosure.
7. **Reporting of missing and poor data:** Data availability is an implicit statement of risk. Lenders are known to prefer borrowers with longer and more complete credit histories. Historical performance shows that so called “thin files” have higher credit risks.
8. **Data disclosure drives market efficiency:** Lenders can leverage data to exploit inefficiencies, driving markets ultimately to more efficient levels. The U.S. credit card market went through a series of great innovations in the use of credit data outside of FICO scores. This led to price differentiation and lenders making data available about borrowers at various credit risk levels, made possible by leveraging detailed credit risk data.
9. **Underlying data supports regulator needs:** Regulators can use credit bureau information to review the lending policies of banks. This provides regulators a view into the risk taken by lenders.
10. **Detailed data disclosure supports stress-testing:** The credit bureau information allows regulators and banks to consider how macro-economic movements, such as unemployment, will have an impact on a portfolio of credit-backed assets.
11. **Standardization of key risk variables:** Although the credit bureau industry compares firms and consumers on their performance to key risk variables, many variables in describing borrower performance are standardized. This facilitates interpretation and comparison of different credit bureau data.

The retail credit markets could not easily operate without the credit bureaus. Credit bureaus provide retail bankers an external and intermediary source of credit risk information on credit prospects. The immense role and value of credit bureaus is best appreciated by looking to international lending markets that lack standardized credit bureaus. In such markets, the lack of information inhibits lending and requires that retail bankers price debt blindly or under an assumption of high credit risk.

The success of the credit bureaus is not limited to the banks. In this model, consumers (individual, risk-posing entities) have a role in updating and correcting risk. Regulators have also used the credit ratings as a surrogate measure for lending appropriateness. This use of data extends to determining if particular lenders are taking on inappropriate levels of credit risk. Meanwhile, bankers have invested in decision-science teams to parse out the attractive risk segments in credit markets, like credit cards and auto loans, based not on credit bureau scores, but on the underlying data provided by the credit bureaus.

In the retail banking market, credit bureaus serve as important risk information brokers, in addition to selling a proprietary risk score. The FICO score, for example, is viewed as a meaningful and powerful credit risk metric. It is standardized, available with frequent and regular updates, and is complemented by a wealth of additional data that is consistent with the overall score, further increasing the respectability of the risk score. This provides credit lenders trust in the data and flexibility to analyze the data on their own measures.

Data Disclosure via CRAs as Risk Information Brokers

To examine how the credit bureau model of risk information brokerage can be leveraged by CRAs to communicate the much needed risk information on credit instruments, let us consider how products like mortgaged-backed CDOs might have been better disclosed with data under the credit bureau or subscriber-pay model. Below are some broadly defined data fields that should have been available to CDO investors.

- 1. Underlying individual credit fields:** As mortgages are inherently loans supported by individuals, the detailed credit file on the individuals in the CDO would help support the true credit risk and the evaluation of any correlation in credit risk. These data presumably exist and are known by the asset originator. Changes to the data would also be available at some interval by the loan servicer. Such data are used in retail credit functions, as it is close to standardized, and could conform to the most utilized credit bureau variables.
- 2. Collateralized asset:** In mortgage and auto loans, the value of the collateralized asset is key in determining recovery and default rates. For example, property data such as assessments, property statistics, and recent sales data would be immensely useful. Numerous firms are actively engaged in making real estate evaluations available, and CRAs are in a natural position to aggregate such data and combine it with credit data to provide the investor the needed details for credit risk evaluation.
- 3. Loan terms:** Without question, the availability of loan data at a granular level speaks volumes about the inherent credit risk in a CDO. Access to this data would allow investors to check for omissions and blatant errors. Publishing more details on loan terms in, say, a mortgaged backed CDO, versus say the average loan of the portfolio, will also allow transparency to the investor on the credit risk being taken.
- 4. Economic outlook and assumptions:** As part of any credit assessment, one must consider stress-testing for various economic conditions. Assumptions on performance are often made in bond rating outlooks by CRAs. Such an outlook on a mortgage portfolio, for example, would help investors understand the baseline outlook. It would be plausible for CRAs to sell specialized rating services that consider a more severe economic outlook than a base case.

Additional information on the formation of the CDO or asset-backed security and its underlying assets would provide investors clarity on the product but also allow for differentiation based on reputation and quality. Consider some fields on:

- 5. Originator details:** Data on mortgage originators would allow for best in class originators to be rewarded by the marketplace, thereby punishing those originators operating at sub par levels.
- 6. Servicer details:** Data on servicers would allow for differentiation among servicers.

7. **CRA rating historical performance:** Greater transparency and ease in tracking CRA ratings would provide the investor community an opportunity to match underlying data to ratings and develop a long-term perspective on rating performance and reliability.

During the meteoric increase in new structured products, the CRAs relied on information provided by the originated investment banks. SIFMA reveals, “CRAs generally performed only limited (and, in some instances, did not perform any) independent review or due diligence to confirm the accuracy of data provided to them in connection with the assets underlying structured securities, and performed limited independent confirmation of asset origination standards.”²² SIFMA further adds, “There are indications that some CRAs relied on information that may have been questionable or suspect on its face, taking into account market changes at the time.” Under a model by which CRAs can share underlying data, such a claim can be examined. The process of brokering such data would put reputational and regulatory pressure on the CRA to identify omissions and weaknesses in the data.

Such activities by participants in the CDO market would bring efficiency and differentiation to the market, and allow investors to evaluate risk, or deploy standard risk models.

CRAs as Risk Information Brokers under the Credit Bureau Business Model

Examining current concerns about CRAs with the credit bureau model in mind offers an opportunity to determine the value of adopting such a credit bureau model. This section examines how the major attributes of the credit bureau model addresses many of the concerns surrounding the current CRA model. In addition to providing a model whereby CRAs broker more risk information, the credit bureau model also addresses other concerns in the CRA business model, such as mitigating conflicts of interest with investment banks, and asymmetry of information. Let us examine the major attributes of the risk information broker model as applied to CRAs.

1. **Third party independence:** CRAs should remain independent of the credit originators. Independence in the source of credit risk data is a key attribute in building investor trust and a quality reputation. The SEC hearing on CRAs calls into question the improper influence of CRAs in the CDO space:²³

In a 2007 email to Moody’s CEO Ray McDaniel, for example, Moody’s chief credit officer wrote, “that the company’s analysts and managing directors were continually pitched by bankers, issuers, investors—all with reasonable arguments—whose views can color our credit judgment, sometimes improving it, other times degrading it (we drink the Kool-aid). Coupled with strong internal emphasis on market share & margin focus, this does constitute a risk to ratings quality.”²⁴

22 http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf

23 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

24 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

Decoupling the investment function from the rating function might also remove the pressure that CRAs have faced to offer high ratings. Consider the SEC report finding that, “Legal requirements that some regulated entities, such as banks, broker-dealers, insurance companies, pension funds, and others, hold assets with AAA or investment grade credit ratings, created pressure on credit rating agencies to issue inflated ratings making assets eligible for purchase by those entities.”²⁵

Instilling a business model whereby CRAs are indeed independent third parties, paid by investors, will directly limit the improper influence and conflicts of interest that are currently at work in the CRA business model for structured products.

2. **Competition:** Multiple CRAs should be allowed to operate and compete. The regulators should consider allowing new entrants, especially those that can bring to the market new sources of risk information. Competing on data versus product originations will change the game. Some current regulatory proposals call for having one CRA rate a particular structured product transaction. However, “Market participants may question whether legislation that leads to transactions having only one rating, assigned randomly, is consistent with recent regulatory efforts to promote competition in the ratings market and with the concept of greater diversity of credit opinions,” according to a spokesman for Fitch in the *Wall Street Journal*.²⁶ Moreover, the Congressional Subcommittee on CRAs found that, “Competitive pressures, including the drive for market share and need to accommodate investment bankers bringing in business, affected the credit ratings issued by Moody’s and Standard & Poor’s.”²⁷ Competing on data would require that firms outperform each other on a dimension that supports greater transparency and credit risk evaluation.
3. **Data disclosure drives risk scores:** Availability of the underlying data to investors and regulators will prevent CRAs from obfuscating ratings behind complex methodology. Independent validation by investors or services firms will require that CRA ratings be continually revised with available data.

In fact, SIMFA calls for greater due diligence by CRAs and greater data disclosure. In particular, it would like CRAs to provide investors “a description of qualitative factors relied upon by the CRA in its analysis,” and “a description of the key risks and sensitivities of the rating to key variables (as well as compensating factors) considered by the CRA in determining its rating, such as external changes that could cause a rating to change (e.g., a decline in home prices), including any stress-test results.”²⁸ In the asset-backed security market, SIMFA further calls for “what due diligence was conducted on the individual

25 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

26 Fitch Spokesman, The Wall Street Journal. “Rating Agencies Face Curbs.” May 12, 2010.

27 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

28 http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf

securities or assets in the collateral pool underlying the structured deal, and what if any individual components did not receive any due diligence review.” In effect, SIMFA is calling for the CRA to disclose its process and findings or all key underlying data of the asset-backed product.

Market norms suggest that CRAs that consistently provide ratings with greater transparency (more data centric) will undoubtedly be preferred by investors in the post crisis environment. More information from CRAs and more trust from investors will surely go hand-in-hand. A spokesperson from Moody’s noted that Moody’s “supports the goals of enhancing the transparency and accountability of the ratings process.”²⁹

- 4. Investors pay for the data:** Buyers of the underlying data should be investors. Indeed, CRAs should have a suggested (if not regulated) fee structure for originating structured products. The SEC, in Congressional hearings on this matter, raises concerns over the role of high fees charged by CRAs in rating CDOs. This inherent conflict of interest with respect to fees is well-captured by the following testimony to the SEC and Congress:

“One concrete example of how revenues could affect ratings is suggested in an email exchange in June 2007. A Moody’s analyst told a Merrill Lynch investment banker that she could not finalize a CDO rating until the ‘fee issue’ was resolved. The investment banker responded: ‘We are okay with the revised fee schedule for this transaction. We are agreeing to this under the assumption that this will not be a precedent for any future deals and that you will work with us further on this transaction to try to get to some middle ground with respect to the ratings.’”³⁰

The fees and services to monitor and update structured products will provide other opportunities for revenue. In the meantime, the inherent conflict of interest currently at work is curbed as preference for higher quality monitoring of structured products by investors grows.

- 5. Investors require regular monitoring:** The investors’ interests are often different from the product originators’ interest. In this clash of interests, the investor has a need for quality risk information over the long term. Consider the findings from the SEC hearing on CRAs over these incongruent concerns:

“The surveillance of existing rated products was also inadequate. First, the surveillance groups lacked the resources to properly monitor the thousands of rated products, with backlogs of RMBS [Residential Mortgage-Backed Securities] products requiring analysis. Secondly, the RMBS surveillance groups failed to retest existing products after

29 Moody’s spokesperson. The Wall Street Journal. “Rating Agencies Face Curbs.” May 12, 2010.

30 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

ratings model changes, despite the fact that many of them contained the same assets and risks that the model was revised to evaluate. Testing the existing deals would have resulted in a significant number of downgrades that might have upset investment banks and investors.”³¹

SIFMA adds that, “Surveillance should be conducted with sufficient frequency to allow market participants to take into account on a real-time basis the underlying market changes and issue- or issuer-specific events having an effect on rated securities. This ongoing analytical process should also work to incorporate qualitative marketplace factors into the ratings (e.g., shifts in the housing market).”³²

Data disclosure with regular and frequent monitoring supports the investor’s need to track assets over a long period of time. Quality monitoring further develops trust and reinforces a valuable reputation for the CRA, likely resulting in increased revenue opportunities.

- 6. Data fuels innovation:** Data availability supports innovation, and investors have continued to clamor for new and more information. If CRAs are to adjust their position and take on the risk information role, opportunities to aggregate data on new structured products will surely emerge. The SEC report tangentially touches on this issue: “Despite record profits from 2004 to 2007, Moody’s and Standard & Poor’s failed to assign sufficient resources to adequately rate new products and test the accuracy of existing ratings.”³³

Also, consider that “Moody’s and Standard & Poor’s each rated more than 10,000 RMBS securities from 2006 to 2007, downgraded a substantial number within a year, and, by 2010, had downgraded many AAA ratings to junk status.”³⁴ Regular publishing on performance and data inputs to the models will require that the CRAs apply ratings and rating changes in a manner that is directionally consistent with the data.

CRA revenues were not driven by innovation in products or quality in ratings, but rather were link to the outcome of rating engagements. As a correction to this practice, many of the current regulatory proposals call for CRAs to be awarded transactions on a lottery basis or other regulatory-driven bases. CRAs, like all businesses, perform best under markets with competition, yet CRAs must also be positioned to benefit from investments in due diligence, methodology, and be rewarded for competing against each other. Credit-rating firms would have less incentive, under the proposed lottery allocation model, to compete with one another, pursue innovation, and improve their models, criteria, and methodologies. “This could lead to more homogenized rating

31 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

32 http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf

33 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

34 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

opinions,” said a Standard and Poor’s spokesperson to the *Wall Street Journal*.³⁵ Disclosure of data will ease investor concerns over fees for more and new data products that support the credit risk evaluation function. CRAs will then be ideally positioned to bring new data to the markets and aggregate data from originators servicers, trustees, etc., while supporting the buy-sell function that is key to markets.

7. **Reporting of missing and poor data:** Missing data is also a variable and in fact a statement of risk. In offering a risk assessment, CRAs should provide investors details on what input was unavailable and what data was omitted. Although some investment groups charge that CRAs should not rate when key data are missing, the publication of missing data will surely draw the attention of investors and drive prices to a level that will presumably account for the missing data. More likely is that credit products with missing data will not be preferred in the market, driving investment banks and product originators to complete data capture.

As we know now, the recent mortgage meltdown included rampant fraud. In addition to reporting missing data, CRAs should be operating in a manner that encourages the reporting of suspicious or fraudulent data. The SEC report finds “From 2004 to 2007, Moody’s and Standard & Poor’s knew of increased credit risks due to mortgage fraud, lax underwriting standards, and unsustainable housing price appreciation, but failed adequately to incorporate those factors into their credit rating models.”³⁶ In particular, consider the following:

“In August 2006, for example, an S&P employee wrote: ‘I’m not surprised, there has been rampant appraisal and underwriting fraud in the industry for quite some time as pressure has mounted to feed the origination machine.’ In September 2006, another S&P employee wrote: ‘I think it’s telling us that underwriting fraud, appraisal fraud and the general appetite for new product among originators is resulting in loans being made that shouldn’t be made.’”³⁷

8. **Data disclosure drives market efficiency:** As we have seen from the CDO market, bid prices can fall precipitously when risk is misunderstood and underlying data unavailable. This is understood by the SEC findings that describe the impact of drastic credit downgrades with little transparency on the underlying data:

“Mass downgrades by Moody’s and Standard & Poor’s, including downgrades of hundreds of subprime RMBS over a few days in July 2007, downgrades by Moody’s of CDOs in October 2007, and downgrades by Standard & Poor’s of over 6,300 RMBS and 1,900 CDOs

35 Standard and Poor’s Spokesman via The Wall Street Journal “Rating agencies Face Curbs.” May 12, 2010.

36 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

37 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

on one day in January 2008, shocked the financial markets, helped cause the collapse of the subprime secondary market, triggered sales of assets that had lost investment grade status, and damaged holdings of financial firms worldwide, contributing to the financial crisis.”³⁸

The ability for investors to screen for inefficiencies and arbitrages in market pricing allows assets to ultimately be priced commensurate with the best available information. For investment banks and product originators, having a fluid, efficient market provides comfort that structured products can be sold at reasonable prices. For investors and banks holding such assets, the additional efficiency provided by risk information should also reduce the volatility in market risk of assets like CDOs. Transparency in information would presumably reduce the volatility in asset prices seen during the crisis and provide buyers and sellers alike a lens into what is reasonable.

- 9. Underlying data supports regulator needs:** Regulators have long desired a lens that would provide insight into the risk of structured products, especially as these products become more and more popular. Under current regulation, the SEC is directly limited by how it can regulate CRAs. As noted by the SEC report to Congress, “The U.S. Securities and Exchange Commission is barred by statute from conducting needed oversight into the substance, procedures, and methodologies of the credit rating models.”³⁹

However, under the model by which CRAs share underlying data, regulators could require CRAs to publish a summary of structured product data fields for analysis by regulatory bodies. Additionally, regulators could audit specific structured products for intensive validation and post analysis to evaluate underlying systemic risks in the economy and detection of asset bubbles.

- 10. Detailed data disclosure supports stress-testing:** A thoughtful stress-testing of the underlying data within a CDO should be considered. With only a coarse rating, investors, and regulators are left with simple models that assume default rates or transition probabilities per rating. With detailed credit risk information, cause and effect models could examine the impact of unemployment on specific regions, correlations in credit losses, and other loss drivers arising from changes in the credit details of the structured asset. CRAs might even position themselves to offer this service to investors, especially those requiring low asset volatilities.
- 11. Standardization of key risk variables:** Although CRAs use similar scales for rating bonds and instruments, standardization is needed at the input variable level and for historical data. SIFMA calls attention to this issue of publishing historical performance of CRA ratings and recommends, “CRAs publish verifiable, quantifiable historical information about the performance of their ratings in a format that facilitates the ability of investors and others to compare the performance of different CRAs directly.”⁴⁰

With the issuer-pay model and subscriber-pay model as two examples of how CRAs might operate, especially for securitized products, a comparison of these models across a few key attributes should be of interest to regulators and investors alike. A summary of this comparison is provided in the following table.

38 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

39 SEC Hearing: Wall Street and the Financial Crisis, The Role of Credit Rating Agencies. Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, April 23, 2010, Washington, D.C.

40 http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf

Comparison of the Issuer-pay and Subscriber-pay Models

Attribute	Issuer-pay	Subscriber-pay	Initial Evaluation
Use of external data	The issuer-pay model does not prohibit the use of external data, but concerns over conflicts of interest with the issuer leads to further concern that CRAs would limit data not used or approved by the issuer	The subscriber-model openly promotes the use of external data and even provides a financial incentive for the CRA to cultivate such data, as the subscriber pays for such information and generally would be expected to pay for more data if found useful	Subscriber-pay models provide a greater incentive to the CRA for cultivating the use of external (non-issuer) data and limit the role of the issuer in providing the sole source of data
Availability of private data from issuer	The issuer-pay model makes it especially easy for the issuer to share non-public data with the CRA. The data may include details that otherwise are hard or impossible for the CRA to identify. Due to conflicts of interest, it is expected that issuers share more optimistic data	The subscriber-based model does not directly reward issuers for sharing confidential data. Although, some data can come from other parties or surveillance, this channel of information is limited in a pure subscriber-pay model	Issuer-pay models provide the CRA greater access to information from the issuer and access (in theory) to confidential and critical information
Conflicts of interest	Issuers that pay CRAs create a conflict of interest for the CRA and generate moral hazard. In general, the issuer's interests can contaminate the rating process. Moreover, there are a limited number of issuers, meaning that CRAs are especially concerned about issuer interests	Subscribers also pose a conflict of interest, but since there are likely many more subscribers than issuers, it is not expected that one subscriber could contaminate the rating process with its interest. Subscribers may push for ratings that are favorable in sales of assets or in maintaining liquidity thresholds	Conflicts of interest exist in each model. In general, the level of influence by any one subscriber is less than that of any one issuer, given that subscribers far outnumber issuers in the structured product market. Thus, a subscriber model would lead to fewer conflicts of interest between the CRA and any one counterparty
Transparency in data disclosure and methodology	Due to the private relationship between the CRA and the issuer, the disclosure of data gained from the issuer is limited. Additionally, approaches in methodology taken may be influenced by the issuer, meaning that disclosure of methodology may also be difficult	The subscribers generally expect disclosure of data and other opinions. Greater disclosure on methodology may not be expected when CRAs compete. However, CRAs may grow a business of providing additional stress-testing or subscriber-specific scenario analysis	It is not clear that any company would care to disclose data or methodology other than required by regulation or market forces. The move to greater transparency helps both the issuer-pay and subscriber-pay model in meeting regulatory and customer demands
Surveillance frequency	Without a call from the security holders, frequent, regular, and detailed surveillance of structured products is not encouraged by the issuer-pay model. It is not prohibited, but may be impeded if the issuer is expected to share data on a regular basis	Subscribers expect and pay for regular, frequent, and detailed surveillance. Market conditions suggest that CRAs would compete on these dimensions and earn business based on such quality measures of the surveillance	When revenue and demand are driven by investors (instead of issuers), it is expected that CRAs would rationally respond with greater surveillance, frequency, and attention. The subscriber-pay model provides these features in a structural manner

Attribute	Issuer-pay	Subscriber-pay	Initial Evaluation
Independence	As issuers provide many novel products in the structured asset class, independence from the CRA is questionable. As issuers create new products, CRAs pose a risk to the flow of information to investors	CRAs are not independent of subscribers, as some subscribers may push for special consideration. However, as subscribers outnumber issuers, quasi-independence is possible but reliant on the broad and diverse number of subscribers	It is difficult to achieve ideal independence in business models. In the issuer-pay model, it is clear that a few issuers may exert pressure on the CRAs. The larger number of subscribers in the subscriber-pay model suggests that independence from any one constituent is increased
Standardization of terms	There are not obstacles for standardization in the terms. In general, standardization of terms involves expectations of regulators and investors	There are not obstacles for standardization in the terms. In general, standardization of terms involves expectations of regulators and investors	Both the issuer-pay and subscriber-pay models can and do support standardization of terms. It is likely best for investors and regulators that the financial community standardizes key rating terminology
Stress-testing	Stress-testing is possible, provided the issuer can and does share the needed information on structured products	Stress-testing is possible, but requires that the CRA acquire details on the underlying assets in a structured product. This level of detailed information may be difficult to acquire without the issuer's cooperation	There are no structural limitations on stress-testing in the issuer-pay or subscriber-pay models, provided that sufficient disclosure of information is made by the CRA
Third-party evaluation	Third party evaluation of a CRA rating on a structured product is hard, as disclosure of information is poor and reliance on confidential data from the issuer is high	Subscriber-pay models are best operated when the data sold/shared can be used in a verification process. In such models, the subscriber builds confidence in the ratings and extends their use of those ratings	To the extent that subscriber-pay models operate with less private information (typically) and compete on data, it is expected that subscriber-pay models will support greater use of data by third-party evaluation. In the interest of restoring trust to the CRAs, some mechanism for third-party evaluation in the issuer-pay model will be needed
Regulatory implications	It is difficult to regulate a process that is significantly confidential or private. It requires disclosure and examination of large amounts of data. It is not clear how regulators should best approach a large data issue, as irregularities may require multiple investigations for discovery	The subscriber model inherently results in disclosure of data and in doing so provides investors and countless other parties' data for consideration. The review of such data by other parties provides regulators direction in which to search for irregularities	The regulatory requirements outlined in the Dodd-Frank Act increase the responsibility of the SEC in managing CRAs. There will be a new requirement to disclose data, methodology, internal processes, and rating accuracy assessments. This is a space in which regulators would appreciate greater direction from third-parties and investors in searching for rating irregularities

The issuer-pay model shows some structural weaknesses that must be addressed either through new laws or through business model reform. The Dodd-Frank Act addresses some issues in the issuer-pay model, such as the use of external data, conflicts of interest, standardization of terms, and transparency in models and data.⁴¹ Moreover, the SEC is required by the Dodd-Frank Act to undertake studies that explore how new business models for CRAs may address some of the structural weaknesses in the issuer-pay model. These points are sure to come up in such a study.

The subscriber-pay model is a major departure from the issuer-pay model, and offers the industry numerous benefits: use of external data, more transparency, mitigated conflicts of interest, and increased frequency of surveillance. If the subscriber, namely the investor, is the primary client for the CRA, and the subscriber's interest are met via the business model, it is expected that many of the issues troubling investors about CRA ratings will be resolved.

Moving to the subscriber-pay model does alter the economics of the CRA business, causing some conflicts as investors may force CRAs to represent their interest disproportionately, and access to proprietary data from issuers may be limited or reduced. Additionally, it is not clear that CRAs are currently able to process the large amounts of asset data needed to become efficient subscriber-pay rating providers, similar to credit rating agencies. It is clear though, that CRAs have undertaken acquisitions and improvements in the data tracking and data processing businesses.

⁴¹ Dodd-Frank Act, Subtitle C.

Economic Opportunity for CRAs – Implementing the Subscriber-pay Model

THE MOVEMENT TO A SUBSCRIBER-PAY model by CRAs, especially for securitized products, requires an implementation plan that is operationally uncomplicated, or one that is hard for investors to use. Should a plan develop in which investors pay for rating information on each asset would likely prove cumbersome and make accessing information about potential assets hard to acquire. CRAs should consider a model by which investors subscribe to a “category” of assets or securities. In such a model, the category may be a type of security, like a CDO, or even an issuer, like Goldman Sachs, or a time window on product issuance. Investors would pay CRAs a monthly or annual fee for receiving information from the CRA on the whole category, not just their specific holdings, allowing the investor to track assets outside of their holdings and not directly disclose specific assets being held. CRAs gain a more operationally efficient business model, which does not require specifics on an investor’s holdings, but a general category-level publication. CRAs may even elect to specialize in particular securities or categories to differentiate from each other, providing investors further choice on CRAs.

This potential business model also offers the CRAs a lucrative economic opportunity.

There are many more investors than there are issuers. Investors require surveillance and updates to the risk rating information, suggesting that investors offer CRAs a great deal of downstream business. The subscriber-pay model has worked in the past for CRAs and is a strong business model for credit bureaus. This rather simple, direct, category plan, offers investors an opportunity to track many assets of interest and CRAs via a rather scalable business model that ultimately brings much needed risk information to the marketplace.


CRAs should consider a model by which investors subscribe to a “category” of assets or securities.

This rather simple, direct, category plan, offers investors an opportunity to track many assets of interest and CRAs via a rather scalable business model that ultimately brings much needed risk information to the marketplace.


Conclusions and Recommendations

CREDIT RATING AGENCIES ARE UNIQUELY positioned to provide investors much needed information. They exist in a critical juncture wherein data from product originators, servicers, and investors can be aggregated. Although the crisis of recent times has highlighted distinct challenges that question the role of CRAs and their regulation, it is clear that their role in serving as an *independent, third-party intermediary* for the purposes of brokering risk

information is needed more than ever by investors and regulators alike. Their function and ability to provide data on financial products, especially credit-backed securities, will be instrumental in how such products can become trusted and valuable parts of our capital markets. By making the underlying data available to investors, CRAs can regain the trust and confidence of the investment community.



Credit Rating Agencies are uniquely positioned to provide investors much needed information.



By making the underlying data available to investors, CRAs can regain the trust and confidence of the investment community.

The current issuer-pay model (as deployed in the credit-backed securities market) has many structural weaknesses and suffers from conflicts of interest via the small number of influential issuers of securities. Additionally, the issuer-pay model does not necessarily reward CRAs for diligence and completeness in the use of external data, innovation of methodology, or frequency of securities

surveillance. Although the Dodd-Frank Act attempts to remedy some of the limitations in the issuer-pay model of CRAs through regulation, it appears modifications to the issuer-pay model, or a wholesale move to an issuer-pay model will be needed to address many of these weaknesses.

The issuer-pay model does offer opportunities for improvement, but largely the improvement in more thorough regulation and reporting as opposed to direct realignment of interests and stakeholders. It appears that many of the adjustments needed or required to the issuer-pay model under the Dodd-Frank Act, such as issuers maintaining positions in securities, and management of conflicts of interest at CRAs, will be enforced through regulation under the issuer-pay business model for CRAs. The movement to a business model that reduces reliance on regulation and encourages the transmission of risk information would seem preferable to investors and regulators alike.

The credit bureau model or subscriber-pay model, with an emphasis on the underlying credit data, whereby the investor pays for data and proprietary ratings, offers a compelling business model for future CRA operations in the credit-backed securities market. This model enables the market to reward CRAs for consistent quality and performance in evaluating ratings, and

permits CRAs to protect proprietary rating methodology. Yet, this also allows sufficient data disclosure for additional validation and encourages CRAs to innovate in the data space, bringing investors and all market participants more valuable pieces of information for assessment of credit risk. Finally, the model promotes competition amongst the CRAs, limiting the conflicts of interest between CRAs and investment banks, and offering regulators an invaluable awareness of the market's risk appetite for credit-backed securities.

Movement to a credit bureau or subscriber-pay model for CRAs would benefit investors, as their interests would be aligned with that of the compensation of CRAs. Such a subscription model is particularly needed in the credit-backed security market, where investor confidence in ratings and transparency of data is at low levels.

In such a move, the CRA product would shift towards providing data, indeed detailed data on risk, not simply coarse ratings. In such a model, CRAs would thus serve as *independent, third-party, risk information brokers*, meeting the needs of investors and regulators in understanding the risk in complex structured products.

The credit bureau model or subscriber-pay model, with an emphasis on the underlying credit data, whereby the investor pays for data and proprietary ratings, offers a compelling business model for future CRA operations in the credit-backed securities market.



Appendix: Text for Dodd-Frank Act as Directed to Credit Rating Agencies

H. R. 4173—497

Subtitle C—Improvements to the Regulation of Credit Rating Agencies

SEC. 931. FINDINGS.

Congress finds the following:

(1) Because of the systemic importance of credit ratings and the reliance placed on credit ratings by individual and institutional investors and financial regulators, the activities and performances of credit rating agencies, including nationally recognized statistical rating organizations, are matters of national public interest, as credit rating agencies are central to capital formation, investor confidence, and the efficient performance of the United States economy.

(2) Credit rating agencies, including nationally recognized statistical rating organizations, play a critical “gatekeeper” role in the debt market that is functionally similar to that of securities analysts, who evaluate the quality of securities in the equity market, and auditors, who review the financial statements of firms. Such role justifies a similar level of public oversight and accountability.

(3) Because credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial “gatekeepers” do, the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers.

(4) In certain activities, particularly in advising arrangers of structured financial products on potential ratings of such products, credit rating agencies face conflicts of interest that need to be carefully monitored and that therefore should be addressed explicitly in legislation in order to give clearer authority to the Securities and Exchange Commission.

(5) In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies.

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS.

(a) IN GENERAL.—Section 15E of the Securities Exchange Act of 1934 (15 U.S.C. 78o–7) is amended—

(1) in subsection (b)—

(A) in paragraph (1)(A), by striking “furnished” and inserting “filed” and by striking “furnishing” and inserting “filing”;

(B) in paragraph (1)(B), by striking “furnishing” and inserting “filing”; and

(C) in the first sentence of paragraph (2), by striking “furnish to” and inserting “file with”;

(2) in subsection (c)—

(A) in paragraph (2)—

(i) in the second sentence, by inserting “any other provision of this section, or” after “Notwithstanding”; and

(ii) by inserting after the period at the end the following: “Nothing in this paragraph may be construed to afford a defense against any action or proceeding brought by the Commission to enforce the antifraud provisions of the securities laws.”; and

(B) by adding at the end the following:

“(3) INTERNAL CONTROLS OVER PROCESSES FOR DETERMINING CREDIT RATINGS.—

“(A) IN GENERAL.—Each nationally recognized statistical rating organization shall establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the Commission may prescribe, by rule.

“(B) ATTESTATION REQUIREMENT.—The Commission shall prescribe rules requiring each nationally recognized statistical rating organization to submit to the Commission an annual internal controls report, which shall contain—

“(i) a description of the responsibility of the management of the nationally recognized statistical rating organization in establishing and maintaining an effective internal control structure under subparagraph (A);

“(ii) an assessment of the effectiveness of the internal control structure of the nationally recognized statistical rating organization; and

“(iii) the attestation of the chief executive officer, or equivalent individual, of the nationally recognized statistical rating organization.”;

(3) in subsection (d)—

(A) by inserting after “or revoke the registration of any nationally recognized statistical rating organization” the following: “, or with respect to any person who is associated with, who is seeking to become associated with, or, at the time of the alleged misconduct, who was associated or was seeking to become associated with a nationally recognized statistical rating organization, the Commission, by order, shall censure, place limitations on the activities or functions of such person, suspend for a period not exceeding 1 year, or bar such person from being associated with a nationally recognized statistical rating organization.”;

(B) by inserting “bar” after “placing of limitations, suspension.”;

(C) in paragraph (2), by striking “furnished to” and inserting “filed with”;

(D) in paragraph (2), by redesignating subparagraphs (A) and (B) as clauses (i) and (ii), respectively, and adjusting the clause margins accordingly;

(E) by redesignating paragraphs (1) through (5) as subparagraphs (A) through (E), respectively, and adjusting the subparagraph margins accordingly;

(F) in the matter preceding subparagraph (A), as so redesignated, by striking “The Commission” and inserting the following:

“(1) IN GENERAL.—The Commission”;

(G) in subparagraph (D), as so redesignated—

- (i) by striking “furnish” and inserting “file”; and
- (ii) by striking “or” at the end.

(H) in subparagraph (E), as so redesignated, by striking the period at the end and inserting a semicolon; and

(I) by adding at the end the following:

“(F) has failed reasonably to supervise, with a view to preventing a violation of the securities laws, an individual who commits such a violation, if the individual is subject to the supervision of that person.

“(2) SUSPENSION OR REVOCATION FOR PARTICULAR CLASS OF SECURITIES.—

“(A) IN GENERAL.—The Commission may temporarily suspend or permanently revoke the registration of a nationally recognized statistical rating organization with respect to a particular class or subclass of securities, if the Commission finds, on the record after notice and opportunity for hearing, that the nationally recognized statistical rating organization does not have adequate financial and managerial resources to consistently produce credit ratings with integrity.

“(B) CONSIDERATIONS.—In making any determination under subparagraph (A), the Commission shall consider—

“(i) whether the nationally recognized statistical rating organization has failed over a sustained period of time, as determined by the Commission, to produce ratings that are accurate for that class or subclass of securities; and

“(ii) such other factors as the Commission may determine.”;

(4) in subsection (h), by adding at the end the following:

“(3) SEPARATION OF RATINGS FROM SALES AND MARKETING.—

“(A) RULES REQUIRED.—The Commission shall issue rules to prevent the sales and marketing considerations of a nationally recognized statistical rating organization from influencing the production of ratings by the nationally recognized statistical rating organization.

“(B) CONTENTS OF RULES.—The rules issued under subparagraph (A) shall provide for—

“(i) exceptions for small nationally recognized statistical rating organizations with respect to which the Commission determines that the separation of the production of ratings and sales and marketing activities is not appropriate; and

“(ii) suspension or revocation of the registration of a nationally recognized statistical rating organization, if the Commission finds, on the record, after notice and opportunity for a hearing, that—

“(I) the nationally recognized statistical rating organization has committed a violation of a rule issued under this subsection; and

“(II) the violation of a rule issued under this subsection affected a rating.

“(4) LOOK-BACK REQUIREMENT.—

“(A) REVIEW BY THE NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION.—Each nationally recognized statistical rating organization shall establish, maintain, and enforce policies and procedures reasonably designed to ensure that, in any case in which an employee of a person subject to a credit rating of the nationally recognized statistical rating organization or the issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating of the nationally recognized statistical rating organization was employed by the nationally recognized statistical rating organization and participated in any capacity in determining credit ratings for the person or the securities or money market instruments during the 1-year period preceding the date an action was taken with respect to the credit rating, the nationally recognized statistical rating organization shall—

“(i) conduct a review to determine whether any conflicts of interest of the employee influenced the credit rating; and

“(ii) take action to revise the rating if appropriate, in accordance with such rules as the Commission shall prescribe.

“(B) REVIEW BY COMMISSION.—

“(i) IN GENERAL.—The Commission shall conduct periodic reviews of the policies described in subparagraph (A) and the implementation of the policies at each nationally recognized statistical rating organization to ensure they are reasonably designed and implemented to most effectively eliminate conflicts of interest.

“(ii) TIMING OF REVIEWS.—The Commission shall review the code of ethics and conflict of interest policy of each nationally recognized statistical rating organization—

“(I) not less frequently than annually; and

“(II) whenever such policies are materially modified or amended.

“(5) REPORT TO COMMISSION ON CERTAIN EMPLOYMENT TRANSITIONS.—

“(A) REPORT REQUIRED.—Each nationally recognized statistical rating organization shall report to the Commission any case such organization knows or can reasonably be expected to know where a person associated with such organization within the previous 5 years obtains employment with any obligor, issuer, underwriter, or sponsor of a security or money market instrument for which the organization issued a credit rating during the 12-month period prior to such employment, if such employee—

“(i) was a senior officer of such organization;

“(ii) participated in any capacity in determining credit ratings for such obligor, issuer, underwriter, or sponsor; or

“(iii) supervised an employee described in clause (ii).

“(B) PUBLIC DISCLOSURE.—Upon receiving such a report, the Commission shall make such information publicly available.”;

(5) in subsection (j)—

(A) by striking “Each” and inserting the following:

“(1) IN GENERAL.—Each”; and

(B) by adding at the end the following:

“(2) LIMITATIONS.—

“(A) IN GENERAL.—Except as provided in subparagraph (B), an individual designated under paragraph (1) may not, while serving in the designated capacity—

“(i) perform credit ratings;

“(ii) participate in the development of ratings methodologies or models;

“(iii) perform marketing or sales functions; or

“(iv) participate in establishing compensation levels, other than for employees working for that individual.

“(B) EXCEPTION.—The Commission may exempt a small nationally recognized statistical rating organization from the limitations under this paragraph, if the Commission finds that compliance with such limitations would impose an unreasonable burden on the nationally recognized statistical rating organization.

“(3) OTHER DUTIES.—Each individual designated under paragraph (1) shall establish procedures for the receipt, retention, and treatment of—

“(A) complaints regarding credit ratings, models, methodologies, and compliance with the securities laws and the policies and procedures developed under this section; and

“(B) confidential, anonymous complaints by employees or users of credit ratings.

“(4) COMPENSATION.—The compensation of each compliance officer appointed under paragraph (1) shall not be linked to the financial performance of the nationally recognized statistical rating organization and shall be arranged so as to ensure the independence of the officer’s judgment.

“(5) ANNUAL REPORTS REQUIRED.—

“(A) ANNUAL REPORTS REQUIRED.—Each individual designated under paragraph (1) shall submit to the nationally recognized statistical rating organization an annual report on the compliance of the nationally recognized statistical rating organization with the securities laws and the policies and procedures of the nationally recognized statistical rating organization that includes—

“(i) a description of any material changes to the code of ethics and conflict of interest policies of the nationally recognized statistical rating organization; and

“(ii) a certification that the report is accurate and complete.

“(B) SUBMISSION OF REPORTS TO THE COMMISSION.—Each nationally recognized statistical rating organization shall file the reports required under subparagraph (A) together with the financial report that is required to be submitted to the Commission under this section.”;

(6) in subsection (k), by striking “furnish to” and inserting “file with”;

(7) in subsection (l)(2)(A)(i), by striking “furnished” and inserting “filed”; and

(8) by striking subsection (p) and inserting the following:

“(p) REGULATION OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS.—

“(1) ESTABLISHMENT OF OFFICE OF CREDIT RATINGS.—

“(A) OFFICE ESTABLISHED.—The Commission shall establish within the Commission an Office of Credit Ratings (referred to in this subsection as the ‘Office’) to administer the rules of the Commission—

“(i) with respect to the practices of nationally recognized statistical rating organizations 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 nationally recognized statistical rating organizations; and

“(iii) to ensure that such ratings are not unduly influenced by conflicts of interest.

“(B) DIRECTOR OF THE OFFICE.—The head of the Office shall be the Director, who shall report to the Chairman.

“(2) STAFFING.—The Office established under this subsection shall be staffed sufficiently to carry out fully the requirements of this section. The staff shall include persons with knowledge of and expertise in corporate, municipal, and structured debt finance.

“(3) COMMISSION EXAMINATIONS.—

“(A) ANNUAL EXAMINATIONS REQUIRED.—The Office shall conduct an examination of each nationally recognized statistical rating organization at least annually.

“(B) CONDUCT OF EXAMINATIONS.—Each examination under subparagraph (A) shall include a review of—

“(i) whether the nationally recognized statistical rating organization conducts business in accordance with the policies, procedures, and rating methodologies of the nationally recognized statistical rating organization;

“(ii) the management of conflicts of interest by the nationally recognized statistical rating organization;

“(iii) implementation of ethics policies by the nationally recognized statistical rating organization;

“(iv) the internal supervisory controls of the nationally recognized statistical rating organization;

“(v) the governance of the nationally recognized statistical rating organization;

“(vi) the activities of the individual designated by the nationally recognized statistical rating organization under subsection (j)(1);

“(vii) the processing of complaints by the nationally recognized statistical rating organization; and

“(viii) the policies of the nationally recognized statistical rating organization governing the post-employment activities of former staff of the nationally recognized statistical rating organization.

“(C) INSPECTION REPORTS.—The Commission shall make available to the public, in an easily understandable format, an annual report summarizing—

“(i) the essential findings of all examinations conducted under subparagraph (A), as deemed appropriate by the Commission;

“(ii) the responses by the nationally recognized statistical rating organizations to any material regulatory deficiencies identified by the Commission under clause (i); and

“(iii) whether the nationally recognized statistical rating organizations have appropriately addressed the recommendations of the Commission contained in previous reports under this subparagraph.

“(4) RULEMAKING AUTHORITY.—The Commission shall—

“(A) establish, by rule, fines, and other penalties applicable to any nationally recognized statistical rating organization that violates the requirements of this section and the rules thereunder; and

“(B) issue such rules as may be necessary to carry out this section.

“(q) TRANSPARENCY OF RATINGS PERFORMANCE.—

“(1) RULEMAKING REQUIRED.—The Commission shall, by rule, require that each nationally recognized statistical rating organization publicly disclose information on the initial credit ratings determined by the nationally recognized statistical rating organization for each type of obligor, security, and money market instrument, and any subsequent changes to such credit ratings, for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different nationally recognized statistical rating organizations.

“(2) CONTENT.—The rules of the Commission under this subsection shall require, at a minimum, disclosures that—

“(A) are comparable among nationally recognized statistical rating organizations, to allow users of credit ratings to compare the performance of credit ratings across nationally recognized statistical rating organizations;

“(B) are clear and informative for investors having a wide range of sophistication who use or might use credit ratings;

“(C) include performance information over a range of years and for a variety of types of credit ratings, including for credit ratings withdrawn by the nationally recognized statistical rating organization;

“(D) are published and made freely available by the nationally recognized statistical rating organization, on an easily accessible portion of its website, and in writing, when requested;

“(E) are appropriate to the business model of a nationally recognized statistical rating organization; and

“(F) each nationally recognized statistical rating organization include an attestation with any credit rating it issues affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the instruments being rated, and

that such rating was an independent evaluation of the risks and merits of the instrument.

“(r) CREDIT RATINGS METHODOLOGIES.—The Commission shall prescribe rules, for the protection of investors and in the public interest, with respect to the procedures and methodologies, including qualitative and quantitative data and models, used by nationally recognized statistical rating organizations that require each nationally recognized statistical rating organization—

“(1) to ensure that credit ratings are determined using procedures and methodologies, including qualitative and quantitative data and models, that are—

“(A) approved by the board of the nationally recognized statistical rating organization, a body performing a function similar to that of a board; and

“(B) in accordance with the policies and procedures of the nationally recognized statistical rating organization for the development and modification of credit rating procedures and methodologies;

“(2) to ensure that when material changes to credit rating procedures and methodologies (including changes to qualitative and quantitative data and models) are made, that—

“(A) the changes are applied consistently to all credit ratings to which the changed procedures and methodologies apply;

“(B) to the extent that changes are made to credit rating surveillance procedures and methodologies, the changes are applied to then-current credit ratings by the nationally recognized statistical rating organization within a reasonable time period determined by the Commission, by rule; and

“(C) the nationally recognized statistical rating organization publicly discloses the reason for the change; and

“(3) to notify users of credit ratings—

“(A) of the version of a procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating;

“(B) when a material change is made to a procedure or methodology, including to a qualitative model or quantitative inputs;

“(C) when a significant error is identified in a procedure or methodology, including a qualitative or quantitative model, that may result in credit rating actions; and

“(D) of the likelihood of a material change described in subparagraph (B) resulting in a change in current credit ratings.

“(s) TRANSPARENCY OF CREDIT RATING METHODOLOGIES AND INFORMATION REVIEWED.—

“(1) FORM FOR DISCLOSURES.—The Commission shall require, by rule, each nationally recognized statistical rating organization to prescribe a form to accompany the publication of each credit rating that discloses—

“(A) information relating to—

“(i) the assumptions underlying the credit rating procedures and methodologies;

“(ii) the data that was relied on to determine the credit rating; and

“(iii) if applicable, how the nationally recognized statistical rating organization used servicer or remittance reports, and with what frequency, to conduct surveillance of the credit rating; and

“(B) information that can be used by investors and other users of credit ratings to better understand credit ratings in each class of credit rating issued by the nationally recognized statistical rating organization.

“(2) FORMAT.—The form developed under paragraph (1) shall—

“(A) be easy to use and helpful for users of credit ratings to understand the information contained in the report;

“(B) require the nationally recognized statistical rating organization to provide the content described in paragraph (3)(B) in a manner that is directly comparable across types of securities; and

“(C) be made readily available to users of credit ratings, in electronic or paper form, as the Commission may, by rule, determine.

“(3) CONTENT OF FORM.—

“(A) QUALITATIVE CONTENT.—Each nationally recognized statistical rating organization shall disclose on the form developed under paragraph (1)—

“(i) the credit ratings produced by the nationally recognized statistical rating organization;

“(ii) the main assumptions and principles used in constructing procedures and methodologies, including qualitative methodologies and quantitative inputs and assumptions about the correlation of defaults across underlying assets used in rating structured products;

“(iii) the potential limitations of the credit ratings, and the types of risks excluded from the credit ratings that the nationally recognized statistical rating organization does not comment on, including liquidity, market, and other risks;

“(iv) information on the uncertainty of the credit rating, including—

“(I) information on the reliability, accuracy, and quality of the data relied on in determining the credit rating; and

“(II) a statement relating to the extent to which data essential to the determination of the credit rating were reliable or limited, including—

“(aa) any limits on the scope of historical data; and

“(bb) any limits in accessibility to certain documents or other types of information that would have better informed the credit rating;

“(v) whether and to what extent third party due diligence services have been used by the nationally recognized statistical rating organization, a description of the information that such third party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third party;

“(vi) a description of the data about any obligor, issuer, security, or money market instrument that were relied upon for the purpose of determining the credit rating;

“(vii) a statement containing an overall assessment of the quality of information available and considered in producing a rating for an obligor, security, or money market instrument, in relation to the quality of information available to the nationally recognized statistical rating organization in rating similar issuances;

“(viii) information relating to conflicts of interest of the nationally recognized statistical rating organization; and

“(ix) such additional information as the Commission may require.

“(B) QUANTITATIVE CONTENT.—Each nationally recognized statistical rating organization shall disclose on the form developed under this subsection—

“(i) an explanation or measure of the potential volatility of the credit rating, including—

“(I) any factors that might lead to a change in the credit ratings; and

“(II) the magnitude of the change that a user can expect under different market conditions;

“(ii) information on the content of the rating, including—

“(I) the historical performance of the rating; and

“(II) the expected probability of default and the expected loss in the event of default;

“(iii) information on the sensitivity of the rating to assumptions made by the nationally recognized statistical rating organization, including—

“(I) 5 assumptions made in the ratings process that, without accounting for any other factor, would have the greatest impact on a rating if the assumptions were proven false or inaccurate; and

“(II) an analysis, using specific examples, of how each of the 5 assumptions identified under subclause (I) impacts a rating;

“(iv) such additional information as may be required by the Commission.

“(4) DUE DILIGENCE SERVICES FOR ASSET-BACKED SECURITIES.—

“(A) FINDINGS.—The issuer or underwriter of any asset-backed security shall make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.

“(B) CERTIFICATION REQUIRED.—In any case in which third-party due diligence services are employed by a nationally recognized statistical rating organization, an issuer, or an underwriter, the person providing the due diligence services shall provide to any nationally recognized statistical rating organization that produces a rating to which

such services relate, written certification, as provided in subparagraph (C).

“(C) FORMAT AND CONTENT.—The Commission shall establish the appropriate format and content for the written certifications required under subparagraph (B), to ensure that providers of due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary for a nationally recognized statistical rating organization to provide an accurate rating.

“(D) DISCLOSURE OF CERTIFICATION.—The Commission shall adopt rules requiring a nationally recognized statistical rating organization, at the time at which the nationally recognized statistical rating organization produces a rating, to disclose the certification described in subparagraph (B) to the public in a manner that allows the public to determine the adequacy and level of due diligence services provided by a third party.

“(t) CORPORATE GOVERNANCE, ORGANIZATION, AND MANAGEMENT OF CONFLICTS OF INTEREST.—

“(1) BOARD OF DIRECTORS.—Each nationally recognized statistical rating organization shall have a board of directors.

“(2) INDEPENDENT DIRECTORS.—

“(A) IN GENERAL.—At least ½ of the board of directors, but not fewer than 2 of the members thereof, shall be independent of the nationally recognized statistical rating agency. A portion of the independent directors shall include users of ratings from a nationally recognized statistical rating organization.

“(B) INDEPENDENCE DETERMINATION.—In order to be considered independent for purposes of this subsection, a member of the board of directors of a nationally recognized statistical rating organization—

“(i) may not, other than in his or her capacity as a member of the board of directors or any committee thereof—

“(I) accept any consulting, advisory, or other compensatory fee from the nationally recognized statistical rating organization; or

“(II) be a person associated with the nationally recognized statistical rating organization or with any affiliated company thereof; and

“(ii) shall be disqualified from any deliberation involving a specific rating in which the independent board member has a financial interest in the outcome of the rating.

“(C) COMPENSATION AND TERM.—The compensation of the independent members of the board of directors of a nationally recognized statistical rating organization shall not be linked to the business performance of the nationally recognized statistical rating organization, and shall be arranged so as to ensure the independence of their judgment. The term of office of the independent directors shall be for a pre-agreed fixed period, not to exceed 5 years, and shall not be renewable.

“(3) DUTIES OF BOARD OF DIRECTORS.—In addition to the overall responsibilities of the board of directors, the board shall oversee—

“(A) the establishment, maintenance, and enforcement of policies and procedures for determining credit ratings;

“(B) the establishment, maintenance, and enforcement of policies and procedures to address, manage, and disclose any conflicts of interest;

“(C) the effectiveness of the internal control system with respect to policies and procedures for determining credit ratings; and

“(D) the compensation and promotion policies and practices of the nationally recognized statistical rating organization.

“(4) TREATMENT OF NRSRO SUBSIDIARIES.—If a nationally recognized statistical rating organization is a subsidiary of a parent entity, the board of the directors of the parent entity may satisfy the requirements of this subsection by assigning to a committee of such board of directors the duties under paragraph (3), if—

“(A) at least ½ of the members of the committee (including the chairperson of the committee) are independent, as defined in this section; and

“(B) at least 1 member of the committee is a user of ratings from a nationally recognized statistical rating organization.

“(5) EXCEPTION AUTHORITY.—If the Commission finds that compliance with the provisions of this subsection present an unreasonable burden on a small nationally recognized statistical rating organization, the Commission may permit the nationally recognized statistical rating organization to delegate such responsibilities to a committee that includes at least one individual who is a user of ratings of a nationally recognized statistical rating organization.”

(b) CONFORMING AMENDMENT.—Section 3(a)(62) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(62)) is amended by striking subparagraph (A) and redesignating subparagraphs (B) and (C) as subparagraphs (A) and (B), respectively.

SEC. 933. STATE OF MIND IN PRIVATE ACTIONS.

(a) ACCOUNTABILITY.—Section 15E(m) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–7(m)) is amended to read as follows:

“(m) ACCOUNTABILITY.—

“(1) IN GENERAL.—The enforcement and penalty provisions of this title shall apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws, and such statements shall not be deemed forward-looking statements for the purposes of section 21E.

“(2) RULEMAKING.—The Commission shall issue such rules as may be necessary to carry out this subsection.”

(b) STATE OF MIND.—Section 21D(b)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78u–4(b)(2)) is amended—

(1) by striking “In any” and inserting the following:

“(A) IN GENERAL.—Except as provided in subparagraph (B), in any”; and

(2) by adding at the end the following:

“(B) EXCEPTION.—In the case of an action for money damages brought against a credit rating agency or a controlling person under this title, it shall be sufficient, for purposes of pleading any required state of mind in relation to such action, that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed—

“(i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or

“(ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.”.

SEC. 934. REFERRING TIPS TO LAW ENFORCEMENT OR REGULATORY AUTHORITIES.

Section 15E of the Securities Exchange Act of 1934 (15 U.S.C. 78o-7), as amended by this subtitle, is amended by adding at the end the following:

“(u) DUTY TO REPORT TIPS ALLEGING MATERIAL VIOLATIONS OF LAW.—

“(1) DUTY TO REPORT.—Each nationally recognized statistical rating organization shall refer to the appropriate law enforcement or regulatory authorities any information that the nationally recognized statistical rating organization receives from a third party and finds credible that alleges that an issuer of securities rated by the nationally recognized statistical rating organization has committed or is committing a material violation of law that has not been adjudicated by a Federal or State court.

“(2) RULE OF CONSTRUCTION.—Nothing in paragraph (1) may be construed to require a nationally recognized statistical rating organization to verify the accuracy of the information described in paragraph (1).”.

SEC. 935. CONSIDERATION OF INFORMATION FROM SOURCES OTHER THAN THE ISSUER IN RATING DECISIONS.

Section 15E of the Securities Exchange Act of 1934 (15 U.S.C. 78o-7), as amended by this subtitle, is amended by adding at the end the following:

“(v) INFORMATION FROM SOURCES OTHER THAN THE ISSUER.—In producing a credit rating, a nationally recognized statistical rating organization shall consider information about an issuer that the nationally recognized statistical rating organization has, or receives from a source other than the issuer or underwriter, that the nationally recognized statistical rating organization finds credible and potentially significant to a rating decision.”.

SEC. 936. QUALIFICATION STANDARDS FOR CREDIT RATING ANALYSTS.

Not later than 1 year after the date of enactment of this Act, the Commission shall issue rules that are reasonably designed to ensure that any person employed by a nationally recognized statistical rating organization to perform credit ratings—

(1) meets standards of training, experience, and competence necessary to produce accurate ratings for the categories of issuers whose securities the person rates; and

(2) is tested for knowledge of the credit rating process.

SEC. 937. TIMING OF REGULATIONS.

Unless otherwise specifically provided in this subtitle, the Commission shall issue final regulations, as required by this subtitle and the amendments made by this subtitle, not later than 1 year after the date of enactment of this Act.

SEC. 938. UNIVERSAL RATINGS SYMBOLS.

(a) RULEMAKING.—The Commission shall require, by rule, each nationally recognized statistical rating organization to establish, maintain, and enforce written policies and procedures that—

(1) assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument;

(2) clearly define and disclose the meaning of any symbol used by the nationally recognized statistical rating organization to denote a credit rating; and

(3) apply any symbol described in paragraph (2) in a manner that is consistent for all types of securities and money market instruments for which the symbol is used.

(b) RULE OF CONSTRUCTION.—Nothing in this section shall prohibit a nationally recognized statistical rating organization from using distinct sets of symbols to denote credit ratings for different types of securities or money market instruments.

SEC. 939. REMOVAL OF STATUTORY REFERENCES TO CREDIT RATINGS.

(a) FEDERAL DEPOSIT INSURANCE ACT.—The Federal Deposit Insurance Act (12 U.S.C. 1811 et seq.) is amended—

(1) in section 7(b)(1)(E)(i), by striking “credit rating entities, and other private economic” and insert “private economic, credit,”;

(2) in section 28(d)—

(A) in the subsection heading, by striking “NOT OF INVESTMENT GRADE”;

(B) in paragraph (1), by striking “not of investment grade” and inserting “that does not meet standards of credit-worthiness as established by the Corporation”;

(C) in paragraph (2), by striking “not of investment grade”;

(D) by striking paragraph (3);

(E) by redesignating paragraph (4) as paragraph (3);

and

(F) in paragraph (3), as so redesignated—

(i) by striking subparagraph (A);

(ii) by redesignating subparagraphs (B) and (C) as subparagraphs (A) and (B), respectively; and

(iii) in subparagraph (B), as so redesignated, by striking “not of investment grade” and inserting “that does not meet standards of credit-worthiness as established by the Corporation”; and

(3) in section 28(e)—

(A) in the subsection heading, by striking “NOT OF INVESTMENT GRADE”;

(B) in paragraph (1), by striking “not of investment grade” and inserting “that does not meet standards of credit-worthiness as established by the Corporation”; and

(C) in paragraphs (2) and (3), by striking “not of investment grade” each place that it appears and inserting “that does not meet standards of credit-worthiness established by the Corporation”.

(b) FEDERAL HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1992.—Section 1319 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4519) is amended by striking “that is a nationally recognized statistical rating organization, as such term is defined in section 3(a) of the Securities Exchange Act of 1934,”.

(c) INVESTMENT COMPANY ACT OF 1940.—Section 6(a)(5)(A)(iv)(I) Investment Company Act of 1940 (15 U.S.C. 80a-6(a)(5)(A)(iv)(I)) is amended by striking “is rated investment grade by not less than 1 nationally recognized statistical rating organization” and inserting “meets such standards of credit-worthiness as the Commission shall adopt”.

(d) REVISED STATUTES.—Section 5136A of title LXII of the Revised Statutes of the United States (12 U.S.C. 24a) is amended—

(1) in subsection (a)(2)(E), by striking “any applicable rating” and inserting “standards of credit-worthiness established by the Comptroller of the Currency”;

(2) in the heading for subsection (a)(3) by striking “RATING OR COMPARABLE REQUIREMENT” and inserting “REQUIREMENT”;

(3) subsection (a)(3), by amending subparagraph (A) to read as follows:

“(A) IN GENERAL.—A national bank meets the requirements of this paragraph if the bank is one of the 100 largest insured banks and has not fewer than 1 issue of outstanding debt that meets standards of credit-worthiness or other criteria as the Secretary of the Treasury and the Board of Governors of the Federal Reserve System may jointly establish.”.

(4) in the heading for subsection (f), by striking “MAINTAIN PUBLIC RATING OR” and inserting “MEET STANDARDS OF CREDIT-WORTHINESS”; and

(5) in subsection (f)(1), by striking “any applicable rating” and inserting “standards of credit-worthiness established by the Comptroller of the Currency”.

(e) SECURITIES EXCHANGE ACT OF 1934.—Section 3(a) Securities Exchange Act of 1934 (15 U.S.C. 78a(3)(a)) is amended—

(1) in paragraph (41), by striking “is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization” and inserting “meets standards of credit-worthiness as established by the Commission”; and

(2) in paragraph (53)(A), by striking “is rated in 1 of the 4 highest rating categories by at least 1 nationally recognized statistical rating organization” and inserting “meets standards of credit-worthiness as established by the Commission”.

(f) WORLD BANK DISCUSSIONS.—Section 3(a)(6) of the amendment in the nature of a substitute to the text of H.R. 4645, as ordered reported from the Committee on Banking, Finance and

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Urban Affairs on September 22, 1988, as enacted into law by section 555 of Public Law 100-461, (22 U.S.C. 286hh(a)(6)), is amended by striking “credit rating” and inserting “credit-worthiness”.

(g) EFFECTIVE DATE.—The amendments made by this section shall take effect 2 years after the date of enactment of this Act.

(h) STUDY AND REPORT.—

(1) IN GENERAL.—Commission shall undertake a study on the feasibility and desirability of—

(A) standardizing credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms;

(B) standardizing the market stress conditions under which ratings are evaluated;

(C) requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress; and

(D) standardizing credit rating terminology across asset classes, so that named ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity.

(2) REPORT.—Not later than 1 year after the date of enactment of this Act, the Commission shall submit to Congress a report containing the findings of the study under paragraph (1) and the recommendations, if any, of the Commission with respect to the study.

SEC. 939A. REVIEW OF RELIANCE ON RATINGS.

(a) AGENCY REVIEW.—Not later than 1 year after the date of the enactment of this subtitle, each Federal agency shall, to the extent applicable, review—

(1) any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and

(2) any references to or requirements in such regulations regarding credit ratings.

(b) MODIFICATIONS REQUIRED.—Each such agency shall modify any such regulations identified by the review conducted under subsection (a) to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations. In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness.

(c) REPORT.—Upon conclusion of the review required under subsection (a), each Federal agency shall transmit a report to Congress containing a description of any modification of any regulation such agency made pursuant to subsection (b).

SEC. 939B. ELIMINATION OF EXEMPTION FROM FAIR DISCLOSURE RULE.

Not later than 90 days after the date of enactment of this subtitle, the Securities Exchange Commission shall revise Regulation FD (17 C.F.R. 243.100) to remove from such regulation the

exemption for entities whose primary business is the issuance of credit ratings (17 C.F.R. 243.100(b)(2)(iii)).

SEC. 939C. SECURITIES AND EXCHANGE COMMISSION STUDY ON STRENGTHENING CREDIT RATING AGENCY INDEPENDENCE.

(a) **STUDY.**—The Commission shall conduct a study of—

(1) the independence of nationally recognized statistical rating organizations; and

(2) how the independence of nationally recognized statistical rating organizations affects the ratings issued by the nationally recognized statistical rating organizations.

(b) **SUBJECTS FOR EVALUATION.**—In conducting the study under subsection (a), the Commission shall evaluate—

(1) the management of conflicts of interest raised by a nationally recognized statistical rating organization providing other services, including risk management advisory services, ancillary assistance, or consulting services;

(2) the potential impact of rules prohibiting a nationally recognized statistical rating organization that provides a rating to an issuer from providing other services to the issuer; and

(3) any other issue relating to nationally recognized statistical rating organizations, as the Chairman of the Commission determines is appropriate.

(c) **REPORT.**—Not later than 3 years after the date of enactment of this Act, the Chairman of the Commission shall submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives a report on the results of the study conducted under subsection (a), including recommendations, if any, for improving the integrity of ratings issued by nationally recognized statistical rating organizations.

SEC. 939D. GOVERNMENT ACCOUNTABILITY OFFICE STUDY ON ALTERNATIVE BUSINESS MODELS.

(a) **STUDY.**—The Comptroller General of the United States shall conduct a study on alternative means for compensating nationally recognized statistical rating organizations in order to create incentives for nationally recognized statistical rating organizations to provide more accurate credit ratings, including any statutory changes that would be required to facilitate the use of an alternative means of compensation.

(b) **REPORT.**—Not later than 18 months after the date of enactment of this Act, the Comptroller General shall submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives a report on the results of the study conducted under subsection (a), including recommendations, if any, for providing incentives to credit rating agencies to improve the credit rating process.

SEC. 939E. GOVERNMENT ACCOUNTABILITY OFFICE STUDY ON THE CREATION OF AN INDEPENDENT PROFESSIONAL ANALYST ORGANIZATION.

(a) **STUDY.**—The Comptroller General of the United States shall conduct a study on the feasibility and merits of creating an independent professional organization for rating analysts employed by nationally recognized statistical rating organizations that would be responsible for—

(1) establishing independent standards for governing the profession of rating analysts;

(2) establishing a code of ethical conduct; and

(3) overseeing the profession of rating analysts.

(b) REPORT.—Not later than 1 year after the date of publication of the rules issued by the Commission pursuant to section 936, the Comptroller General shall submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives a report on the results of the study conducted under subsection (a).

SEC. 939F. STUDY AND RULEMAKING ON ASSIGNED CREDIT RATINGS.

(a) DEFINITION.—In this section, the term “structured finance product” means an asset-backed security, as defined in section 3(a)(77) of the Securities Exchange Act of 1934, as added by section 941, and any structured product based on an asset-backed security, as determined by the Commission, by rule.

(b) STUDY.—The Commission shall carry out a study of—

(1) the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models;

(2) the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns nationally recognized statistical rating organizations to determine the credit ratings of structured finance products, including—

(A) an assessment of potential mechanisms for determining fees for the nationally recognized statistical rating organizations;

(B) appropriate methods for paying fees to the nationally recognized statistical rating organizations;

(C) the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government; and

(D) any constitutional or other issues concerning the establishment of such a system;

(3) the range of metrics that could be used to determine the accuracy of credit ratings; and

(4) alternative means for compensating nationally recognized statistical rating organizations that would create incentives for accurate credit ratings.

(c) REPORT AND RECOMMENDATION.—Not later than 24 months after the date of enactment of this Act, the Commission shall submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives a report that contains—

(1) the findings of the study required under subsection (b); and

(2) any recommendations for regulatory or statutory changes that the Commission determines should be made to implement the findings of the study required under subsection (b).

(d) RULEMAKING.—

(1) RULEMAKING.—After submission of the report under subsection (c), the Commission shall, by rule, as the Commission determines is necessary or appropriate in the public interest or for the protection of investors, establish a system

for the assignment of nationally recognized statistical rating organizations to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product from selecting the nationally recognized statistical rating organization that will determine the initial credit ratings and monitor such credit ratings. In issuing any rule under this paragraph, the Commission shall give thorough consideration to the provisions of section 15E(w) of the Securities Exchange Act of 1934, as that provision would have been added by section 939D of H.R. 4173 (111th Congress), as passed by the Senate on May 20, 2010, and shall implement the system described in such section 939D unless the Commission determines that an alternative system would better serve the public interest and the protection of investors.

(2) **RULE OF CONSTRUCTION.**—Nothing in this subsection may be construed to limit or suspend any other rulemaking authority of the Commission.

SEC. 939G. EFFECT OF RULE 436(G).

Rule 436(g), promulgated by the Securities and Exchange Commission under the Securities Act of 1933, shall have no force or effect.

SEC. 939H. SENSE OF CONGRESS.

It is the sense of Congress that the Securities and Exchange Commission should exercise the rulemaking authority of the Commission under section 15E(h)(2)(B) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-7(h)(2)(B)) to prevent improper conflicts of interest arising from employees of nationally recognized statistical rating organizations providing services to issuers of securities that are unrelated to the issuance of credit ratings, including consulting, advisory, and other services.

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1001 Pennsylvania Ave., NW, Suite 500 South

Telephone: 202.289.4322

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