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Statement of the Shadow Financial Regulatory Committee

On

SEC Standards for Designating Nationally-Recognized Credit Rating Organizations

December 9, 2002

During recent years the effectiveness of credit-rating firms has come under attack from bondholders and the Congress because of a failure to predict more accurately the financial decline and ultimate insolvency of Enron and other high-profile firms. As a consequence, Congress in the Sarbanes-Oxley Act of 2002 directed the Securities and Exchange Commission (SEC) to study the credit ratings industry to determine if changes can be made that will improve the "role and function of the credit rating industry in the operation of the securities markets." As part of this study the SEC is directed to examine "any barriers to entry into the business of acting as a credit rating agency,..." (sec. 702(a)(2)(D)). The SEC is now in the process of reviewing the standards it uses for designating credit rating firms to determine if changes in these standards can be made that would improve the operation and efficiency of this industry.

The SEC adopted standards for designating credit rating firms in 1975 when it began to rely on the use of credit ratings issued by nationally recognized statistical rating organizations (NRSROs) in its rule 15c3-1 (the "Net Capital Rule") for brokers and dealers as an indicator of a security's liquidity. Since that time the use of NRSRO ratings in federal and state securities laws and regulations has expanded dramatically, as has reliance on those ratings by investors and the marketplace for determining the creditworthiness of debt securities. However, the term "NRSRO" remains undefined in SEC regulations, whether under the Net Capital Rule or elsewhere (such as the purchase criteria for money market mutual funds under rule 2a-7 of the Investment Company Act), as has the process for obtaining NRSRO designation from the SEC.

Currently the SEC reviews the qualifications of applicant credit rating firms to determine if they meet the criteria for becoming an NRSRO. In making its determination the SEC considers a number of criteria, including whether the rating organization is "nationally recognized," or is recognized in the United States as an issuer of credible and reliable ratings by the predominant users of securities markets. In addition, the SEC considers the operational capacity and reliability of the applicant – specifically, the firm's organization structure and financial resources, the size and quality of its staff, its independence from the companies it rates, its rating procedures, and whether the firm has internal procedures to prevent the misuse of nonpublic information and whether those procedures are followed.

Since 1975 there has been very little entry into the credit rating industry. At that time the SEC "grandfathered" Moody's, S&P, and Fitch. Subsequently, it designated as NRSROs Duff & Phelps in 1982 and McCarthy, Crisanti & Maffei in 1983, and IBCA in 1991 and Thomson Bank Watch in 1992 as NRSROs for banks and financial institutions. The SEC has not granted NRSRO status to any new entity since, despite several applications. Today, due to a series of mergers and acquisitions by Fitch, there are only three bond rating firms in the United States: Moody's, Standard & Poors (S&P), and Fitch. Moody's is a freestanding company specializing in rating activities; S&P is owned by McGraw-Hill which provides a variety of financial services; and Fitch is owned by FIMALAC, a large French company.

The Shadow Financial Regulatory Committee (SFRC) believes that the SEC should revise its certification standards to permit other qualified firms to become NSROs. In particular, the SEC's "national recognition" criterion is too exclusionary and has little to do with the ability of a new rating firm or an established foreign rating firm to provide informative and reliable credit ratings. Indeed, a "national recognition" criterion is a Catch 22 – a firm cannot become an NRSRO unless it already is an NRSRO. The SEC should propose regulations that make explicit its criteria for designating and monitoring NRSROs and these criteria should have as their focus the ability of rating firms to provide credible and accurate credit ratings. A "national recognition" standard should not be part of these criteria.

Permitting more qualified rating firms to compete for the business of rating securities can be expected to lower the cost to issuers and investors. In addition, a more competitive rating industry should make rating firms more responsive to changes in the marketplace and over time should result in a more innovative credit rating industry.

While the SFRC considered the possibility of eliminating all impediments to entry into the credit rating industry, and in particular eliminating all SEC certification requirements for credit rating firms, the Committee believes that so long as the SEC (and other regulatory bodies) continue to rely on credit ratings as part of their safety-and-soundness regulatory apparatus, it will be necessary to have a process for certifying the quality of firms doing the rating. At some point, however, we may want to review this regulatory process.

Finally, critics of a more open credit rating industry argue that more competition may reduce the quality of credit ratings as credit rating firms compete to obtain additional business by providing more favorable ratings to issuers, especially since credit rating firms are typically paid by the issuers of the securities that they are rating. The Committee believes that this is unlikely. Firms that have been certified by the SEC will presumably have substantial "reputational capital" that they will not want to depreciate by diluting the quality of their ratings. Further, the SEC will still have the power to withdraw a credit rating firm's NRSRO designation if it determines that the firm no longer meets the certification requirements.