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Statement of the Shadow Financial Regulatory Committee on

Regulation of Credit Rating Organizations

December 8, 2008

The U.S. Securities and Exchange Commission (SEC) and the European Commission are taking different approaches to regulating Credit Rating Organizations (CROs). The European proposal would oblige CROs to disclose models, methodologies and key assumptions underlying their ratings, make an internal assessment of the quality of their ratings, and publish an annual transparency report. The proposal would also force corporate governance changes on some CROs. They would have to register with the Committee of European Securities Regulators (CESR), but supervision of the CROs will occur in the EU jurisdiction in which the organization is registered. In the future all CROs must have at least three independent directors on their boards, whose remuneration will not be linked to the profitability of the business. At least one of these must be an expert in securitization. The EU transparency proposals would represent a step forward if properly enforced. But the proposal also threatens de facto Balkanization of world capital markets by potentially establishing different rating standards in different jurisdictions and impeding cross-border comparison of the creditworthiness of various issues.

In early summer, the SEC put forward three bold proposals to reform the role of credit rating organizations in the regulatory process. The SEC's first proposal sought to mitigate conflicts of interest, enhance disclosures and improve internal policies and business practices at CROs. The second proposal would have required the ratings organizations to differentiate the ratings on structured products from those on traditional bonds and loans. Most significantly, the third proposal would have nearly eliminated the role of ratings from SEC regulations. The laudable goal of these proposals was to enhance transparency, accountability and competition in the credit rating organization industry for the benefit of investors.

In contrast to these bold proposals, the actual rules adopted last week by the SEC were remarkably cautiously. While disclosure will be enhanced, the Commission did not adopt its proposal to mandate public disclosure of information that would have allowed independent experts to evaluate the ratings or take an independent view. The disclosure requirements were weakened to require that CROs disclose, with a lag, a random sample of 10% of their issuer-paid ratings and their histories for each class of issuer-paid ratings within six months of the rating. Ideally, one would like issuers to disclose sufficient information for other experts, perhaps using alternative techniques, to evaluate the creditworthiness of particular issues. In the absence of such disclosures competition is inhibited. The historical lack of competition has meant that there has been little innovation within the industry as suggested by their failure to incorporate forward-looking information from market prices, such as those of credit default swaps.

The SEC attempted to mitigate the conflict of interest between advising issuers and rating issues by requiring that any CRO that acted in an advisory capacity on a securitization could not also rate the securitization. The Shadow Committee questions whether this is enforceable in practice, given the industry custom of submitting alternative securitization structures to a CRO until the desired rating is achieved.

In not removing explicit reference to ratings from SEC rules and regulations, the SEC has missed an opportunity to diminish an important source of pressure for grade inflation in the ratings process. When ratings are associated with regulatory requirements, regulated firms have heightened incentives to push for higher grades for lower–quality instruments, even though the marketplace properly prices these instruments to provide higher yields. Purchasing such instruments artificially reduces their regulatory burden and increases their profits.

Issuers, who pay for the ratings, also have an incentive to press CROs for higher ratings. Moreover, over time, reliance on ratings may have undermined the expectation for asset managers to make an independent assessment of credit risk and weakened the governance of credit risk from the director level to line managers.

The Shadow Committee believes that the best approach to reform is to remove ratings from the regulatory process. If that is not done, then a minimal reform would be to mandate that the regulatory use of ratings be made conditional on the achievement by individual rating agencies of objective performance benchmarks. Rating agencies that systematically overestimate performance should be subject to penalty or suspension of Nationally Recognized Statistically Rating Organization status.

The failure to remove references to ratings in SEC regulations was also a missed opportunity for the SEC to provide intellectual leadership to other regulatory agencies. Ratings have begun to permeate a wide range of regulatory efforts as noted by the Shadow Committee in Statement 257 (February 11, 2008). For example, the FDIC partially ties its risk-based capital requirements to credit ratings and the standardized version of the Basel II risk capital standard is linked to credit ratings as well. Statement 257 noted the dangers of reliance upon regulatory mandates focused solely on government sanctioned certification rather than on a process of market competition and pricing.