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Statement of the Shadow Financial Regulatory Committee

Reforming Credit Rating Organizations Under Dodd-Frank

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A controversial dimension of the financial crisis has been the role of credit ratings and the perverse incentives facing rating organizations. The misjudgments of the rating organizations about the credit quality of mortgage-backed securities are widely viewed as one of the contributing factors to the financial crisis. The reliance by asset managers upon the assessments of the rating organizations about these instruments led to substantial systemic risk and losses when the markets and the ratings firms downgraded their assessments of mortgages.

Regulators have been struggling with how to “reform” the credit rating organizations. The Dodd-Frank Act pushes in two different directions. First, it eliminates references to ratings in regulation. With this change rating agencies will have less impact on regulation, reducing potential conflicts of interest. Second, Dodd-Frank calls for studying the possibility of requiring uniformity in standards across rating organizations, asset classes, terminology and loss conditions and the possibility of adopting the “Franken Amendment” by which a government entity would select the rating organization for each instrument.

These two directions of the Dodd-Frank Act appear contradictory. The first reduces reliance upon ratings and emphasize the power of competition to improve the regulatory process, while the second replaces market forces with legislative mandates and close supervision by the regulators of the rating agencies. As regulators rely upon ratings

upon ratings to define their standards, greater uniformity in their meaning would seem sensible, but less important to the extent that regulators are pulling back on reliance on ratings. As regulators eliminate their reliance upon ratings, greater uniformity in their meaning is less necessary. If regulators want to move in the direction of common standards and definitions of ratings, the regulators should build upon the industry's experience and delegate the defining of the standards to industry, as it does in some other areas such as in the financial reporting and auditing spaces.

The Shadow Financial Regulatory Committee believes that rating organizations perform a useful service for investors, exploiting economies of scale in research and analysis to obtain potentially useful information. At the same time, the Committee continues to be sympathetic to reducing regulatory reliance upon ratings (see Shadow Committee statements, "Reliance on Third-Party Ratings," February 11, 2008 and "Regulation of Credit Rating Organizations," December 8, 2008). The challenge to regulators will be to find effective ways to describe credit quality without using credit ratings.

More broadly, the regulation of credit ratings and rating organizations is a challenging issue. For example, Dodd-Frank created potential liability for credit rating organizations in conjunction with the publication of ratings in prospectuses; previously, these ratings were characterized as "opinions" protected by the First Amendment. As a consequence, upon enactment of Dodd-Frank the rating agencies barred the use of their ratings in asset-backed securities offering documents to avoid being subject to liability. The asset-backed securities market froze until the SEC issued a waiver of the requirement that the rating be included in an offering prospectus. This illustrates how the effectiveness and value of regulation is limited by market forces.