<u>The Rating Game: It's Time for Real Competition</u>

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The news about the bond rating industry keeps getting worse. With their overly optimistic ratings implicated as a major cause of the subprime lending debacle, the three dominant raters – Moody's, Standard & Poor's, and Fitch – are desperately trying to salvage their reputations. Regulators are investigating and proposing new restrictions. Investors are filing lawsuits.

It's clear that the current rating business is broken. A major overhaul is needed. But the fix must break the stranglehold of regulation – not add to it -- and allow more competition.

How and why is the system broken? Where did regulation go wrong? The answers require a brief historical excursion.

John Moody sold the first publicly available bond ratings to investors in 1909. By the 1920s at least three other companies had followed his lead.

Starting in the 1930s, regulators increasingly *required* that banks, insurance companies, pension funds, and other financial institutions heed the ratings on the bonds in which they invested. For example, bank regulators mandated that banks could buy only "investment grade" bonds, as determined by "recognized rating manuals."

Although these requirements had a surface plausibility, they had deeper problems: Regulators were delegating -- outsourcing -- important safety judgments to a vaguely specified group of third parties (the bond raters); and the requirements meant that the raters had a large *guaranteed* audience.

In this tradition, in 1975 the Securities and Exchange Commission wanted broker-dealers to hold higher-rated bonds in their portfolios. Realizing that there were no formal criteria for *which*

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bond raters should be heeded, the SEC created a new category -- Nationally Recognized Statistical Rating Organization -- and immediately "grandfathered" Moody's, S&P, and Fitch as NRSROs.

Over the next 25 years, the SEC designated only four additional bond raters as NRSROs. All four eventually merged among themselves and with Fitch, so that by 2000 only the original three NRSROs remained. And during these decades all other financial regulators adopted the NRSRO category for their outsourced bond-related safety decisions.

The SEC had become a substantial barrier to entry into the bond rating business, since the major players in the bond markets were being forced to heed only those raters who were NRSROs. A guaranteed audience and protection from new competition was a recipe for complacency and lethargy by the incumbent three raters. Further, the SEC's procedures for anointing a new NRSRO were remarkably opaque.

All of this might have remained unnoticed if Enron had not gone bankrupt in late 2001. The press discovered that all three NRSROs firms had maintained investment grade ratings on Enron bonds until five days before the company's bankruptcy. Congressional hearings followed, and the Sarbanes-Oxley legislation required the SEC to issue a report on the NRSRO conundrum.

In addition to issuing a report that said little, the SEC designated a new NRSRO in early 2003 (Dominion Bond Rating Services) and another in early 2005 (A.M. Best). But little else changed.

Growing tired of waiting, Congress passed a new law, signed by President Bush in September 2006, that instructed the SEC to be less of a barrier to entry and to be far more transparent in its decisions. The SEC duly authorized four more NRSROs in 2007 and early 2008, bringing the total to nine -- just as the subprime lending crisis, and the three original NRSROs' contribution to it, became headline news.

One last piece of history: In the early 1970s the raters changed their business model, from John Moody's original "investor pays" model to the "issuer pays" model of today. Adding to the public's ire at the raters have been strong suspicions that the "issuer pays" model creates a conflict of interest for the raters.

So, what is to be done? The SEC on June 11 proposed regulations that would force more disclosure, try to limit conflicts, and institute new rating procedures. A week earlier the three major raters and the New York Attorney General agreed on more disclosure. And new regulatory legislation has been proposed in Congress.

But any hope that the Congress, the SEC, or the NYAG could achieve through regulation a better performance by the raters is a pipedream.

Instead, consider the source of the problem: a small group of complacent and stodgy raters, who were protected *by regulation* from competition for over 30 years, because financial regulators wanted to outsource safety decisions to an identifiably small group of raters.

The solution now becomes clear: Financial regulators must cease outsourcing those safety decisions and must bring them in-house. After all, the bond raters' judgments haven't been all that good lately. Even before the subprime debacle, there was the Enron fiasco, and still others before that. Also, the nominal "investment grade" demarcation (BBB, in S&P's system), which is an important "bright line" for many of those outsourced safety judgments, has actually been more of a fuzzy hairball, with drastically different default probabilities for different kinds of bonds, such as corporate bonds versus municipal bonds versus mortgage-based securities.

Once the outsourcing ceases, the SEC can abolish the NRSRO category. When they are not required to heed only a small set of anointed raters, bond market participants will make up their own minds as to which raters have the best track records with respect to predicting bankruptcies and bond defaults, which raters have conflicts that make them untrustworthy, etc. A more open field may well bring new forms of raters and ratings -- and possibly new business models, or perhaps even a reversion to John Moody's "investor pays" model.

This open field and open choice structure will be far superior to what we have now and to what the Congress might legislate. But will the raters in this new world of competition make mistakes? Of course. The processes of competition are rarely perfect -- and shouldn't be expected to achieve perfection. Indeed, to paraphrase Winston Churchill's comments on democracy, competition is the worst possible form of market structure -- except for all the rest.