Comments of Lawrence J. White[*]

In response to the SEC's request for comments on its proposed rule, "Definition of Nationally Recognized Statistical Rating Organization," I respectfully offer the following comments:

## Overview

The intention of the SEC to provide a definition of its term "nationally recognized statistical rating organization" (NRSRO) is understandable. A definition and its associated criteria would help make the SEC's decision process with respect to its designation of NRSROs more transparent, and greater transparency is generally a worthwhile goal.

However, the specific criteria that the SEC has chosen are deeply flawed, since they focus largely on "inputs" to the rating process, rather than focusing on "outputs", and they favor incumbents over entrants. If promulgated as a final rule, these criteria would have the consequence of rigidifying the business model of bond-rating organizations in accordance with the SEC's criteria (and along the lines of the pattern of current incumbents), rather than in accordance with what may be efficient for the U.S. financial markets. Further, the SEC has not indicated whether (and how) it is prepared to apply its criteria to incumbent NRSROs on a periodic basis; but without such application, the Commission would be in the position of designating an enterprise as a NRSRO initially and then having no regular means of ensuring that the NRSRO, once designated, continues to meet the SEC's criteria.

Finally, and most important, by promulgating a final rule, the SEC would be solidifying the NRSRO category itself, which would be a major error in public policy. The NRSRO category and

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designation process has been, and would continue to be, an unnecessary barrier to entry into the bond rating business, thereby stifling competition and potential innovation.

In place of this effort to develop a definition, the SEC should instead abolish the NRSRO category entirely. The elimination of the NRSRO designation would allow the financial markets to reach their own conclusions as to which organizations are the most reliable raters of debt, which have the best track records in predicting insolvencies, which organizations are free of serious conflicts of interest, and what business models and methods are the most conducive to yielding good results. The SEC and other financial regulatory bodies would have to cease delegating their safety-and-soundness judgments to the NRSROs and instead make the necessary adjustments to their internal regulatory procedures, so as to maintain the safety-and-soundness standards that in the past led to the delegation of these judgments to the NRSROs.

The positive consequences of abolishing the NRSRO category would be a market-driven bond-rating industry, rather than a regulation-driven industry, with substantial benefits for the U.S. financial markets.

## Background

The SEC created the NRSRO category in 1975, for understandable reasons: The SEC wanted to establish capital requirements for broker-dealers and wanted to use bond ratings on the bonds in broker-dealers' portfolios to help in determining appropriate capital levels. The SEC's use of bond ratings in this context was an extension of practices by federal bank regulators that first began in the early 1930s and that spread to state insurance regulators' practices in subsequent decades.

To its credit, the SEC realized that the question of "whose ratings" had not been previously addressed adequately. Without a solution to the "whose ratings" question, there was the danger that an incompetent rating firm would, for example, award "AAA" ratings (or "CCC" ratings) indiscriminately to debt issues. Though the financial markets would quickly realize the worthlessness of this organization's ratings, those indiscriminate ratings might still be applicable for regulatory purposes.

To deal with this problem, as part of its net capital rule for broker-dealers (17 CFR 240.15c3-1), the SEC created the NRSRO category and immediately designated Moody's, Standard & Poor's (S&P), and Fitch as NRSROs. In the following years, the use of the NRSRO category spread widely: The SEC used the NRSRO category for other regulations, other financial regulatory bodies similarly adopted the NRSRO category when their regulations employed bond ratings as part of safety-and-soundness regulatory procedures, and the Congress included the NRSRO category when its legislation employed bond ratings. (This expansion in the use of the NRSRO category is documented on pp. 6-8 of the SEC's proposal.)

## The Problems

Though the NRSRO category solved the "whose ratings" problem, it created a new problem: The SEC became a major barrier to entry into the bond-rating business. The NRSRO designation has been an important one for bond raters, since it is only the NRSROs' ratings that are relevant for regulatory purposes and to which the financial markets must therefore pay attention. For example, bank regulators forbid banks and thrifts from holding below-investment-grade bonds their in their portfolios, and it is only the NRSROs' designations of "investment grade" (e.g., S&P's designation of BBB- or higher) that are relevant for these purposes.

But the SEC designated only two new NRSROs in the early 1980s, and two new NRSROs in the early 1990s. Mergers among the new NRSROs themselves and with Fitch caused the number and identity of NRSROs to return to the original three by the year 2000. Since then the SEC has designated two new NRSROs (one in early 2003, and another in early 2005), so that the current number is five.

It is certainly the case that significant economies of scale and the importance of bond raters' reputations would limit the number of bond-rating organizations in ways that would make "atomistic" competition unlikely. But the SEC's creation of the NRSRO category and its subsequent designation process has surely made entry into this business substantially more difficult than it otherwise would be.

The SEC's designation process has meant that the financial markets have not been free to make their own judgments as to which organizations provide the best predictions with regard to bond defaults. The normal market processes of entry and exit have not been permitted to operate, since the combination of the NRSRO designation and the financial regulators' uses of NRSROs' bond ratings have forced the financial markets to pay attention to those bond raters that have been able to gain the SEC's NRSRO designation. If someone or some organization were to develop a superior method for predicting bond defaults, the financial markets might never have the opportunity to take advantage of this superior method. Conversely, the financial markets are forced to pay attention to NRSROs' ratings, even if market participants believe that those ratings are flawed. Equivalently, the incumbent NRSROs have not had to meet a market test since the inception of the NRSRO category and designation process in 1975.

It might be argued that the fact that the financial markets respond to NRSROs' changes in the ratings of debt instruments would indicate that the financial markets find the NRSROs' ratings to be useful predictors of the prospects of default. However, this conclusion is not warranted. Because financial regulators widely use the NRSROs' ratings for regulatory purposes, the financial markets may well be responding only to the consequences for regulatory actions of the change in rating.

For example, recall that banks and thrifts cannot hold bonds in their portfolios that are rated below-investment-grade (e.g., below S&P's BBB- rating). If a bond's rating were to fall below this level, the demand for the bond would consequently decrease, which would mean a lower price and a higher interest yield. Accordingly, suppose that S&P lowers a bond's rating from, say, A- to BBB+. The financial markets may well react to this announcement with a decrease in the price of that bond, not necessarily because the change in rating has told the markets anything that was not already known about the bond and its prospects, but instead because the change has moved the bond's rating that much closer to the BBB- "cliff" (beyond which banks and thrifts cannot hold the bond, etc.).

Further, the SEC has never established criteria for its NRSRO designation, and the designation process itself has been opaque, since it has occurred through SEC-issued "no action" letters.

<u>The proposed definition</u>

The SEC proposes to define the term "NRSRO" "as an entity (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (ii) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and (iii) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with these procedures." (SEC proposal, pp. 20-21)

With respect to the first component, the SEC proposes that "publicly available" ratings mean that the NRSRO's credit ratings "must be disseminated on a widespread basis at no cost." (SEC proposal, p. 23)

With respect to the second component, the SEC proposes that "generally accepted in the financial markets" mean that the NRSRO's ratings be linked "to the views of the predominant users of securities ratings." (SEC proposal, p. 28)

With respect to the third component, the SEC proposes that "systematic procedures", "manage conflicts of interest", "prevent misuse of nonpublic information", and "sufficient financial resources" would encompass: "(i) the experience and training of a firm's rating analysts"; "(ii) the average number of issues covered by analysts"; "(iii) the information sources reviewed and relied upon by the credit rating agency and how the integrity of information utilized in the ratings process is verified"; "(iv) the extent of contacts with the managements of issuers, including access to senior level management and other appropriate parties"; "(v) the organizational structure of the credit rating agency"; "(vi) how the credit rating agency identifies and manages or proscribes conflicts of interest affecting its ratings business"; "(vii) how the credit rating agency monitors and enforces compliance with its procedures designed to prohibit the misuse of material, nonpublic information"; "and (viii) the financial resources of the credit rating agency." (SEC proposal, pp. 32-33)

<u>The problems with the proposed definition</u>

The value that a credit rating organization provides to the financial markets is to help those markets deal with the uncertainties of the creditworthiness of borrowers. If the service is provided effectively, it helps potential lenders "pierce the fog" of asymmetric information so as to determine the gradations of the creditworthiness of borrowers, and it helps the more creditworthy of borrowers "stand out from the crowd" and make their greater creditworthiness known to prospective lenders. Since the event that concerns most lenders is the default by the borrower (and then the extent of loss, given default), default predictions are at the core of an effective credit rating service. This is the "output" that the financial markets care most about.

Unfortunately, the overall orientation of the proposed definition is to favor incumbent NRSROs and to use "inputs" rather than "outputs" as the criteria for defining a NRSRO.

With respect to the SEC's first component, the proposed requirement that the NRSRO's ratings "be disseminated on a widespread basis at no cost" mimics the business model of the incumbent NRSROs, which charge the issuers for their ratings. There are, of course, other business models, such as one in which the users of the rating (e.g., investors) pay for the information. Since the important feature should be the "output" efficacy of credit rating services, the SEC should not be dictating a specific business model for credit rating organizations. Further, the SEC does not indicate how quickly or by what method this dissemination should occur.

With respect to the SEC's second component, the proposed requirement that the NRSRO's ratings be "generally accepted in the financial markets" and linked "to the views of the predominant users of securities ratings" creates a "Catch 22" problem that favors the incumbent NRSROs, since it is the incumbent NRSROs' ratings that must currently be heeded by the financial markets (for the reasons discussed above). The NRSRO designation itself creates a barrier to entry -- a barrier to a start-up rating organization's ratings' gaining the attention of issuers and users in the financial markets.

With respect to the SEC's third component, the proposed criteria focus largely on "inputs" (e.g., the training of analysts, contacts with managements of issuers, etc.) rather than on "outputs" (efficacy in predicting defaults). Further, some of the criteria (e.g., contacts with management) are another form of dictating the business model (since it might be possible to use company reports, financial market data, and statistical analysis to predict defaults effectively, without ever directly talking with a company's senior management). Also, some of the criteria (e.g., average number of issues covered by analysts) run the risk of being used perversely. An increase in the average number of issues covered by analysts might be a sign that the rating organization is stretching its resources too thinly -- or it could be an indication of improved efficiency and innovation by the rating organization. Only an orientation toward <u>outputs</u> could properly distinguish between the two possibilities.

As an additional matter, the SEC's proposal is silent as to whether the NRSRO definition and criteria would be applied to incumbent NRSROs and, if so, how this application to incumbents would occur. Would all incumbents be initially subject to a formal review? Would there be subsequent periodic formal examinations of incumbent NRSROs? At what intervals? With what possible outcomes? But without such formal examinations of incumbents, the SEC's proposal creates (as has the SEC's designation until now) the possibility of a permanent NRSRO designation for a rating organization, despite persistent slipshod ratings subsequent to a designation.

Finally, as an over-arching matter, the final establishment of a definition and criteria for the NRSRO category would serve to solidify the NRSRO concept itself. This would be a serious public policy error, since the existence of the NRSRO category forces the SEC into the role of evaluator of bond-rating organizations and thus inherently creates an unnecessary barrier to entry and interferes with a market-determined process of success or failure for the organizations.

There is a superior policy route, to which I now turn.

<u>What should the SEC do? (A)</u>

The best policy for the SEC would be for the Commission to abandon its efforts to define the NRSRO term and then to abolish the NRSRO category entirely. This elimination of the NRSRO category would remove the SEC as a barrier to entry and would allow the participants in the financial markets themselves to make their own judgments among incumbents and entrants as to which rating methods and services provide the most value in helping the markets ascertain the creditworthiness of borrowers. The financial markets would further be able to make their own judgments as to which business models work best in the promotion of that goal and which offerors of credit rating services are reliable (or unreliable) because of actual or potential conflicts of interest. Rating organizations with new ideas as to how to predict bond defaults would not be inhibited by SEC designations (or their absence). Innovation could flourish.

The financial regulatory agencies would have to change their current regulatory procedures in the instances where they have delegated their safety-and-soundness judgments to the NRSROs' ratings. In essence, the regulatory agencies would have to formulate their own criteria and/or put the burden on the regulated entities to defend/justify their choices of bonds and investments.

Though the SEC has no power over the actions of other financial regulators, it could take the lead by revising its own regulations and procedures along these lines. Though there might initially be some extra cost and inconvenience, the eventual result -- a credit-rating industry that was more flexible, innovative, and responsive to the financial markets' needs -- would surely provide social benefits that would exceed these costs.

What should the SEC do? (B)

If abolishing the NRSRO category is considered too radical, then the SEC does have a second potential course of action, although this second route is far inferior to the elimination of the NRSRO category. This second route would require the SEC to establish criteria for a credit-rating organization to be designated as a NRSRO and a transparent process for the designation procedures.

However, for the reasons discussed above, the SEC's proposed definition and criteria are unsatisfactory and should be abandoned. Instead, the SEC must establish criteria that focus on "outputs" -- on the efficacy of a credit-rating organization in predicting defaults -- rather than focusing on inputs, as the proposed criteria do. The criteria should be neutral as between incumbents and entrants. The criteria should not dictate any specific business model. And the criteria should be applied initially and then periodically to incumbents, as well as to new designees, through a formal examination process (similar to the process that applies to banks) that should include the possibility of the removal of the NRSRO designation as the outcome of an unsatisfactory examination. Further, the designation, examination, and decision processes should be as transparent as possible.

Conclusion

The SEC is to be commended for its general efforts to come to grips with the dilemmas that it created when it established the NRSRO category 30 years ago. Its specific efforts to develop a definition of the term NRSRO, however, are deeply flawed.

The best policy route would be for the SEC to abandon its efforts to define the term and then to abolish the NRSRO category itself. The financial markets of the U.S. would greatly benefit from this sensible redirection of the SEC's efforts.

Thank you for your consideration of my comments.

Note:

Expansions of the reasoning underlying these comments can be found in my writings on the subject:

"The SEC's Other Problem," Regulation, Winter 2002-2003 (http://www.cato.org/pubs/regulation/regv25n4/v25n4-10.pdf).

"The Credit Rating Industry: An Industrial Organization Analysis," in R.M. Levich, C. Reinhart, and G. Majnoni, eds. Ratings, Rating Agencies and the Global Financial System, Kluwer, 2002 (http://www.wkap.nl/prod/b/1-4020-7016-0).

"Don't Like the 'Power' of the Bond Rating Firms? Basel 2 Will Only Make It Worse," in Bumps on the Road to Basel: An Anthology of Views on Basel 2, Centre for the Study of Financial Innovation, 2002 (http://www.csfi.fsnet.co.uk/).

"An Industrial Organization Analysis of the Credit Rating Industry," in M. Ong, ed., Credit Ratings: Methodologies, Rationale and Default Risk, Risk Books, 2002 (http://www.riskbooks.com/ix_crmradr.html).