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THE PARADOX OF CREDIT RATINGS

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The Paradox of Credit Ratings

Frank Partnoy¹

I. Introduction

Credit ratings pose an interesting paradox. On one hand, credit ratings are enormously valuable and important. Rating agencies have great market influence and even greater market capitalization. Credit rating changes are major news;² rating agencies play a major role in every sector of the fixed income market. Credit ratings purport to provide investors with valuable information they need to make informed decisions about purchasing or selling bonds, and credit rating agencies seem to have impressive reputations. The market value of credit ratings was confirmed on September 30, 2000, when Moody's Corp. became a free-standing publicly-traded entity. The market capitalization of Moody's as of June 2001 was more than \$5 billion.

On the other hand, there is overwhelming evidence that credit ratings are of scant informational value. Particularly since the mid-1970s, the informational value of credit ratings has plummeted. There have been multiple unexpected defaults and sudden credit downgrades in recent years, involving major issuers such as Orange County, Mercury Finance, Pacific Gas & Electric, and the governments and banks of several emerging markets countries. Numerous academic studies show that ratings changes lag the market and that the market anticipates ratings changes.³ The rejoinder to these studies – that ratings are correlated with actual default experience – is misplaced and inadequate, because ratings can be *both* correlated with default *and* have little informational value. Accordingly, such correlation proves nothing. Indeed, it would be surprising to find that ratings – regardless of their informational value – were *not* correlated with default. Any

¹ Professor, University of San Diego School of Law. I am grateful for comments from participants in a conference on The Role of Credit Reporting Systems in the International Economy, sponsored by the University of Maryland Center for International Economics, the New York University Stern School of Business, and the World Bank, and held at the World Bank in Washington, D.C., on March 1-2, 2001, and particularly to Professors Richard Levitch and Lawrence White, and to the University of San Diego School of Law for financial support.

² Professor Kenneth Lehn has argued credit ratings *must* have substantial informational content because of the hundreds of stories that appear in the financial press about bond rating changes issued by the major rating agencies. See Kenneth Lehn, *Letter to Jonathan G. Katz, Secretary, SEC*, Dec. 5, 1994, at 4 (available at SEC office headquarters, file no. S7-23-94; copy on file with author). This argument ignores the fact that credit ratings can have value other than informational value.

³ See, e.g., Galen Hite & Arthur Warga, *The Effect of Bond-Rating Changes on Bond Price Performance*, FINANCIAL ANALYSTS JOURNAL, May/June 1997, at 35-47.

rating agency with access to the financial press easily could create a track record of such correlation.

This paradox – continuing prosperity of credit rating agencies in the face of declining informational value of ratings – has generated extensive debate among commentators. Consider the following colorful quotation from Thomas Friedman; several scholars have cited this quotation as evidence of the power of credit rating agencies:

“There are two superpowers in the world today in my opinion. There’s the United States and there’s Moody’s Bond Rating Service. The United States can destroy you by dropping bombs, and Moody’s can destroy you by downgrading your bonds. And believe me, it’s not clear sometimes who’s more powerful.”⁴

Friedman’s quotation is intriguing, not because it accurately describes the status quo, but because it is so patently absurd. How could Standard & Poor’s be so powerful? Why should Moody’s be worth more than \$5 billion? That, at its core, is the paradox.

My claim – some have dubbed it a “complaint”⁵ – is that regulatory dependence on credit ratings explains the paradox.⁶ Numerous legal rules and regulations depend substantively on credit ratings, and particularly on the credit ratings of a small number of Nationally Recognized Statistical Ratings Organizations (NRSROs). Moreover, the barriers to entering the NRSRO market are prohibitive. The result is that credit ratings issued by NRSROs are valuable to financial market participants even if their informational content is no greater than that of public information already reflected in the market.

These regulations explain how credit ratings can have great market value but little informational value. Put simply, credit ratings are important because regulations say they

⁴ *Interview with Thomas L. Friedman*, THE NEWSHOUR WITH JIM LEHRER (PBS television broadcast, Feb. 13, 1996).

⁵ See Richard Sylla, *A Historical Primer on the Business of Credit Ratings*, 2001 working paper, at 25-26.

⁶ A few commentators have proffered alternative explanations, which are not necessarily inconsistent with my argument that regulatory dependence substantially explains the paradox. In the 1970s, L. Macdonald Wakeman explained the paradox based on the rating agencies’ ability to attest to the quality of an issue and monitor a bond’s risk so that management did not engage in behavior to benefit shareholders at the bondholders’ expense. (Martin Fridson recently has reiterated this view. See Martin S. Fridson, *Why Do Bond Rating Agencies Exist?*, Merrill Lynch: Extra Credit, Nov./Dec. 1999.) However, this agency cost rationale does not explain why bondholders could not write covenants to protect themselves, or why investors or other groups could not also provide such a monitoring function, or why – if the agencies’ true purpose was monitoring management to protect bondholders – this purpose was not highlighted by the agencies or by investors or even by management as an important or relevant role.

are. Credit ratings are valuable as keys to unlock the benefits (or avoid the costs) of various regulatory schemes. I use the term “regulatory licenses” to describe the valuable property rights granted to credit ratings by virtue of ratings-dependent regulation. Regulatory licenses based on NRSRO credit ratings have increased substantially since the mid-1970s, as regulators have relied more and more on credit ratings. To a lesser extent, such regulatory licenses existed as early as the 1930s.

If my claim is correct, ratings-dependent regulation is suboptimal and should be eliminated or, perhaps, replaced by credit spread-dependent regulation. Credit spreads are more accurate than credit ratings and reflect at minimum the information contained in credit ratings. This paper recommends that policymakers avoid creating additional regulatory licenses through new rules that depend substantively on credit ratings, and suggests credit spread-based regulation as an attractive alternative. In particular, this paper suggests that The New Basle Capital Accord, issued for comment on May 31, 2001, is flawed to the extent it incorporates risk weights that depend on credit ratings.

Part II briefly assesses the dominant reputation-based argument regarding credit rating agencies. Part III addresses historical evidence from the 1920s and 1930s supporting the regulatory license explanation. Part IV explains more recent evidence that regulatory licenses have increased since the mid-1970s. During each of these periods, credit ratings increased in importance notwithstanding abysmal performance by the rating agencies in predicting defaults.

Part V examines the risk of litigation faced by rating agencies. Many scholars argue that rating agencies should not and do not engage in reputation-depleting activity because of the risk of civil liability. In fact, the available evidence indicates that rating agencies’ expected civil liability is very low; rating agencies have not paid substantial damage awards in such litigation and by federal statute are immune from certain types of liability. Part VI concludes and offers some recommendations.

II. Credit Ratings and Reputation: The Dominant View

Many scholars dispute the regulatory license view of credit ratings, and instead assume the credit-rating industry is competitive and reputation-driven. This view seems to be the dominant one, and the following statements generally are representative:

“Indeed, the only reason that rating agencies are able to charge fees at all is because the public has enough confidence in the integrity of these ratings to find them of value in evaluating the riskiness of investments.”⁷

“Finally, credit rating agencies enhance the capital markets infrastructure by distilling a great deal of information into a single credit rating for a security. That rating reflects the informed judgment of the agency regarding the issuer's ability to

⁷ Jonathan R. Macey, *Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation*, 65 U. CHI. L. REV. 1487 (1998).

meet the terms of the obligation. Such information is frequently critical to potential investors and could not be acquired otherwise, except at substantial cost.”⁸

“In many markets, intermediaries play a certification role *without any regulatory intervention*. Standard and Poor’s (S&P) and Moody’s, for example, certify the credit risk of company debt.”⁹

“Information intermediaries, such as securities analysts or credit rating agencies, facilitate such conventions by decoding ambiguous signals.”¹⁰

“The very value of an agency’s ratings, like an accountant’s opinions, lies in their independent, reliable evaluation of a company’s financial data.”¹¹

“If the ‘regulatory license’ view is correct, it would deprive the rating agencies of much of their value, at least in well-functioning markets.”¹²

Scholars have employed such reputation-based arguments for centuries.¹³ Individuals acquire reputations over time based on their behavior; if an individual’s reputation improves, and other members of society begin to hold that individual in higher esteem, that individual acquires a stock of reputational capital, a reserve of good will, which other parties rely on in transacting with that individual. Reputational capital leads parties to include “trust” as a factor in their decision-making; trust enables parties to reduce the costs of reaching agreement.

Reputational capital and credit ratings are closely related. Rating agencies prosper based on their ability to acquire and retain reputational capital. Raters who invest in their investigative and decision-making processes (and who therefore generate accurate and

⁸ Susan M. Phillips & Alan N. Rechtschaffen, *International Banking Activities: The Role of the Federal Reserve Bank in Domestic Capital Markets*, 21 FORDHAM INT’L L.J. 1754, 1762-63 (1998).

⁹ Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 934 (1998) (emphasis added).

¹⁰ George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1110 (1995).

¹¹ Gregory Husisian, *What Standard of Care Should Govern the World’s Shortest Editorials?: Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 426 (1990).

¹² Roy C. Smith & Ingo Walter, *Rating Agencies: Is There An Agency Issue?*, 2001 working paper, at 33.

¹³ See, e.g., Adam Smith, LECTURES ON JUSTICE, POLICE, REVENUE, AND ARMS, EDWIN CANNAN, ED. 253-54 (Augustus M. Kelley, New York 1964).

valuable ratings) acquire reputational capital; individuals and institutions look to a rater's accumulated reputational capital in deciding whether to rely on the rater or, instead, to undertake independent investigation. Absent other factors, the consumer of a product will purchase a rating if the expected benefit of the rating minus the actual cost of the rating is both positive and greater than the expected benefit of an independent investigation minus the actual cost of such an investigation.

It is undeniable that the success and function of credit rating agencies depends to some extent on trust and credibility. Each credit rating agency depends for its livelihood on its reputation for objectivity and accuracy. If ratings are perceived to be substantially inaccurate, rating agencies will suffer a loss of reputation and there will be incentives for new entrants (although there may be barriers to entry, as well, a topic addressed in Parts III and IV). It also is undeniable that rating agencies publicly express the view that their business depends greatly on reputation. For example, according to Standard & Poor's, "Credibility is fragile. S&P operates with no governmental mandate, subpoena powers, or any other official authority. It simply has a right, as part of the media, to express its opinions in the form of letter symbols."¹⁴ The question remains whether the reputational story is the primary explanation of the credit rating industry, or whether another explanation dominates.

III. Early Credit Ratings Practices and 1930s Regulatory Licenses

One way to answer this question is to examine the credit rating industry during two critical periods of expansion of rating agency power and profit: the 1930s and the period since the mid-1970s. The available evidence indicates that reputational story of credit ratings likely was accurate during the early development of credit rating agencies. Throughout the 1920s, credit ratings were financed entirely from subscription fees, and rating agencies competed to acquire their respective reputations for independence, integrity, and reliability. In a market with low-cost barriers to entry, a rating agency issued inaccurate ratings at its peril. Every time an agency assigned a rating, that agency's name, integrity, and credibility were subject to inspection and critique by the entire investment community. Reputational considerations would have been especially acute in such an environment.

During the 1920s, the credit rating industry resembled a competitive market. Early rating agencies were small and only marginally profitable. By 1929, the agencies' scales were similar in kind. Each agency employed both ordinal (*e.g.*, A,B,C,D) and cardinal (*e.g.*, AAA, AA, A) ratings. Each agency used three subcategories for each broad rating category (*e.g.*, three levels of "As," three levels of "Bs"). It was possible to

¹⁴ See STANDARD & POOR'S DEBT RATING CRITERIA: INDUSTRIAL OVERVIEW 3 (1986).

match each agency's rating symbols one-for-one with each of the other agency's symbols.¹⁵

Moreover, although the agencies did not agree on every rating, ratings were loosely correlated and there was a certain amount of rating "inflation" evident in each of the agency's scales. The vast majority of ratings were in the A category. Very few bonds were rated C or lower. A representative sample chosen for one study was as follows:¹⁶

Distribution of Issues by Ratings, July 15, 1929

<u>Rating</u>	<u>Fitch</u>	<u>Moody</u>	<u>Poor</u>	<u>Standard</u>
A+	147	97	68	78
A	64	63	89	93
A-	80	99	110	104
B+	40	59	61	40
B	17	25	22	26
B-	4	2	7	16
C+	3			4
C				
C-				
D+				1
Unrated	8	18	6	1

Following the Crash of 1929, numerous ratings were abruptly lowered following the rating agencies' failure to anticipate the rapid decline in the prices of hundreds of bond issues, and the increases in defaults. For example, in 1929, all four rating agencies gave the Chicago, Rock Island & Pacific 4s-1988 their highest rating. From 1929 to 1933, the rating agencies gave the issue their second-highest rating. By 1934, the issue was in default.¹⁷

Notwithstanding the large number of abrupt ratings changes (mostly downgrades) in the early 1930s and the considerable lag between the time market prices incorporated negative information about bond issues and the time credit ratings incorporated such

¹⁵ The single exception to this one-for-one matching was Moody's, which did not use the D category of ratings at the time.

¹⁶ See GILBERT HAROLD, BOND RATINGS AS AN INVESTMENT GUIDE: AN APPRAISAL OF THEIR EFFECTIVENESS 90 (1938).

¹⁷ HAROLD, BOND RATINGS AS AN INVESTMENT GUIDE, at 46.

information, credit ratings continued to be a respected and important institution in the bond market through the period. Indeed, rating agencies and credit ratings became much *more* important to both investors and issuers during this period. During the 1930s, demand for credit ratings increased, as investors became concerned about high bond default rates and credit risk.

Yet there is reason to doubt the agencies' ability to generate valuable information during this period. Rating agencies claimed their information was from unique sources, but much of it obviously was from publicly available investment news. The rating agencies did not dramatically change their methodologies during this period. Most bond issues during the 1930s were not rated until after they were distributed, a sign that credit ratings were viewed as valuable only in the secondary market, not in the primary market for new issues (where the agencies' information arguably should have been of much greater value).¹⁸

During the 1920s, institutions had used credit ratings in various and limited ways. Banks used credit ratings merely as a check on their own findings. Insurance companies placed less weight on ratings, and relied more on their own analysts. Industrial companies consultant ratings because of their "recognized publicity value."¹⁹

By the 1930s, credit ratings were assuming a much more important role. The relative liquidity of highly-rated bonds increased. There was extensive anecdotal evidence that credit rating changes increasingly led to bond price changes, and the leading academic studies during this period confirmed this evidence.²⁰

This increase in the importance of ratings during a time of poor rating agency performance is paradoxical. More puzzling still, the advances of credit rating agencies during the 1930s were short lived. By the 1940s, the agencies were contracting and the demand for credit rating was stagnant. The rating agencies were struggling when John Moody died in 1958.²¹ By the 1960s, the rating agencies employed only half-a-dozen analysts each, and generated revenues primarily from the sale of published research reports.²²

¹⁸ HAROLD, BOND RATINGS AS AN INVESTMENT GUIDE, at 21.

¹⁹ HAROLD, BOND RATINGS AS AN INVESTMENT GUIDE, at 22.

²⁰ See Gustav Osterhus, *Flaw-Tester for Bond Lists*, 29 AM. BANKERS ASSOC. J., Aug. 1931, at 67; see also Gilbert Harold, *Accuracy in Reading the Investment Spectrum*, 27 AM. BANKERS ASSOC. J., July 1934, at 32.

²¹ See Richard House, *Ratings Trouble*, INSTITUTIONAL INV., Oct. 1999, at 245.

²² *Id.*

In addition, there is no substantial evidence that the informational value of credit ratings increased during the period from the 1920s through the 1960s. Studies of credit ratings from the later portion of this period confirm the findings of the 1930s studies: credit ratings generated little or no informational value and merely reflected information already incorporated into market prices.²³

What, then, explains the ratings renaissance of the 1930s? My claim is that extensive regulatory licenses were created during this period (as regulators began incorporating credit ratings into substantive regulations), and that these licenses generated valuable property rights in credit ratings. These valuable regulatory licenses enabled rating agencies to flourish during the 1930s, notwithstanding the fact that the informational value of ratings had plummeted.

A close examination of the regulatory changes during the 1930s supports this regulatory license explanation. At the time, the Federal Reserve Board had virtually unlimited power to direct the character of member banks' bond holdings.²⁴ In 1930, the Federal Reserve began using bond ratings in their examination of the portfolios of member banks. Gustav Osterhus, of the Federal Reserve Bank of New York, devised a system for weighting a bank's entire portfolio based on credit ratings, so that the portfolio's "safety" or "desirability" could be expressed in a single number, referred to as a "desirability weighting."²⁵

In 1931, the United States Treasury Department, through the Comptroller of the Currency, adopted credit ratings as proper measures of the quality of the national banks' bond accounts. Specifically, the Comptroller ruled that bonds rated BBB (or an equivalent rating) or higher could be carried at cost, but bonds with lower ratings

²³ See George E. Pinches & J. Clay Singleton, *The Adjustment of Stock Prices to Bond Rating Changes*, 33 J. FIN. 29, 38 (1978). There were numerous studies of the effects of credit rating changes on market prices in the *Journal of Finance* during this period, in part because the performance of the rating agencies had been so abysmal. See, e.g., Frank K. Reilly & Michael D. Joehnk, *The Association Between Market-Dominated Risk Measures for Bonds and Bond Ratings*, 31 J. FIN. 1387 (1976); George E. Piches & Kent A. Mingo, *A Multivariate Analysis of Industrial Bond Ratings*, 28 J. FIN. 1 (1973).

²⁴ See *Conditions of Membership in the Federal Reserve System*, at 1 (mimeographed bulletin, Federal Reserve Board, Washington, 1933); *Membership of State Banks and Trust Companies, Regulation H*, at 5 (Federal Reserve Board, Washington, 1930).

²⁵ See Gustav Osterhus, *Flaw-Tester for Bond Lists*, 29 AM. BANKERS ASSOC. J., Aug. 1931, at 68ff.

(including defaulted bonds) required fractional write-offs.²⁶ This ruling received wide attention at the time, including a front-page article in *The Wall Street Journal*.²⁷

Other rules incorporating credit ratings soon followed. Many state banking superintendents adopted the Comptroller's plan during the following years.²⁸ State regulators began designating certain securities as "legal" investments for savings banks and trust funds. The result was that savings banks and trust funds were required to invest large sums in such qualified securities, known as "legals"; conversely, savings banks and trust funds were unable to buy securities they otherwise would have purchased, including highly-rated securities, because those securities were not designated as "legal."

Amendments to the federal Banking Act in 1935 provided that national banks could purchase only securities that fit the definition of "investment securities" as prescribed by the Comptroller of the Currency.²⁹ Similarly, Section 9 of the Federal Reserve Act provided that state member banks were subject to the same limitations.

Then, on February 15, 1936, the Comptroller issued the following ruling:

"By virtue of the authority vested in the Comptroller of the Currency by . . . Paragraph Seventh of Section 5136 of the Revised Statutes, the following regulation is promulgated as to further limitations and restrictions on the purchase and sale of investment securities for the bank's own account, supplemental to the specific limitations and restrictions of the statute. . . . (3) The purchase of 'investment securities' in which the investment characteristics are distinctly and predominantly speculative, or 'investment securities' of a lower designated standard than those which are distinctly and predominantly speculative is prohibited.*

*The terms employed herein may be found in recognized rating manuals, and where there is doubt as to the eligibility of a security for purchase, such eligibility must be supported by not less than two rating manuals."³⁰

²⁶ Mimeographed ruling issued by J.W. Pole, then Comptroller of the Currency, not dated, although other references indicated that the ruling was made on September 11, 1931, *see* 133 THE COMMERCIAL AND FINANCIAL CHRONICLE 1672 (Sept. 12, 1931).

²⁷ *See* WALL ST. J., Sept. 12, 1931, at 1, 5.

²⁸ *See* HAROLD, BOND RATINGS AS AN INVESTMENT GUIDE, at 27-28 (citing adoptions of Montana, Mississippi, Alabama, Oregon, Ohio, and New York).

²⁹ Paragraph 7 of Section 5136 of the Revised Statutes of the U.S., as amended by Section 308 of the Banking Act of 1935

³⁰ Regulations governing the Purchase of Investment Securities, and Further Defining the Term "Investment Securities" as Used in Section 5136 of the Revised Statutes as Amended by the

This ruling created the most valuable regulatory licenses to date, and was a shot in the arm for the rating agencies. Of the approximately 2,000 listed and publicly-traded bond issues, more than 1,000 failed the Comptroller's definition of "investment securities."³¹ In one day, the Comptroller had slashed in half the universe of publicly-traded bonds banks could purchase. Market participants objected that the ruling would create a false sense of security that banks could safely buy and hold a bond, based on its credit rating, even though such ratings were based solely on past performance and were not necessarily accurate predictors of future performance.

Prior to these regulatory changes, many institutions – especially banks – had purchased bonds rated lower than BBB. After 1936, these regulations essentially prohibited banks, pension funds, insurance companies and other institutions from holding low-rated bonds altogether.

Not surprisingly, these regulations markedly increased the value of obtaining a good credit rating, specifically a minimum BBB rating, and it is no coincidence that credit ratings became more important and valuable following these changes in regulation. Moreover, before the adoption of these regulations, rating agencies had not rated bonds until *after* they were issued. The new regulations created incentives for bond issuers to obtain a rating *before* the bonds were issued. Bond issuers were forced to look to the rating agencies as sources of authority concerning their bond issues, regardless of what information the rating agencies generated. Not surprisingly, ratings became much more common during the following years. Within a few years after the 1936 Comptroller's ruling, the leading commentator on credit ratings wrote, "It is unanimously asserted by the rating agencies that the use of bond ratings today is greater than ever before and that the use of and reliance on the ratings is growing year by year."³²

It is unlikely that the increase in the importance of credit ratings during the 1930s was due primarily to new information the agencies were providing to investors. Instead, credit rating-dependent regulation created regulatory licenses, which generated profits for rating agencies notwithstanding their reputational constraints. The regulatory license view thus explains the paradox of credit ratings during this period. Rating agencies became more important and more profitable, not because they generated more valuable information, but because they began selling more valuable regulatory licenses.

IV. NRSROs and Expanding Regulatory Licenses Post-1973

A similar story can be told about the period since 1973. When Penn Central defaulted in 1970 on \$82 million of commercial paper, investors began demanding more

"Banking Act of 1935," Sec. II, issued by the United States Comptroller of the Currency, Washington, February 15, 1936).

³¹ HAROLD, BOND RATINGS AS AN INVESTMENT GUIDE, at 31.

³² HAROLD, BOND RATINGS AS AN INVESTMENT GUIDE, at 35; *see also id.* at v.

sophisticated levels of research, and the rating agencies – still relatively small and without substantial reputational capital, especially given their failure to anticipate this default – were not in a position to satisfy the demand.

Yet, sure enough, beginning in the mid-1970s, the credit rating industry began to become more influential and more profitable. The changes were dramatic. In 1980, there were 30 professionals working in the S&P Industrials group (even by 1986, there still were only 40); today, S&P and Moody's employ thousands of professionals.³³ In 1975, only 600 new bond issues were rated, increasing the number of outstanding rated corporate bonds to 5,500; today, S&P Moody's rate 20,000 public and private issuers in the U.S., \$5 trillion of securities in aggregate.³⁴ Perhaps the most important change in the credit rating agencies' approach since the mid-1970s has been their means of generating revenue. Today, issuers – not investors – pay fees to the rating agencies. Ninety-five percent of the agencies' annual revenue is from issuer fees, typically 2 to 3 basis points of a bond's face amount. Fees are higher for complex or structured deals.

What accounts for this recent growth in size and profitability? Is it possible that the increased value of ratings is due to increased informational value? The evidence indicates not. During this period, credit rating policy did not change substantially. Even rating scales are similar to those in use during the 1930s. Rating agency analysts track the credit quality of up to 35 companies each, and are paid significantly less than similarly-placed professionals on Wall Street. Both S&P and Moody's have high levels of staff turnover, modest salary levels and limited upward mobility; moreover, investment banks poach the best rating agency employees.³⁵ These factors limit the ability of rating agencies to generate valuable information.

³³ See S&P DEBT RATINGS CRITERIA, at v.

³⁴ See Pinches & Singleton, at 31.

³⁵ House, *Ratings Trouble*, at 245.

In addition, the process agencies use today to generate ratings does not obtain any obvious advantages over competing information providers and analysts. Credit rating agencies do not independently verify information supplied to them by issuers, and all rating agencies get the same data. Both Moody's and S&P make rating determinations in secret. The agencies never describe their terms or analysis precisely or say, for example, that a particular rating has a particular probability of default, and they stress that the ratings are qualitative and judgmental. This secretive, qualitative process is not the type of process one would expect if the agencies had survived based on their ability to accumulate reputational capital. On the other hand, such processes make it more likely that an agency would be able to survive in a non-competitive market; if the rating process had been public or quantitative (rather than qualitative), other market entrants easily could have duplicated the rating agencies' technology and methodology.

Notwithstanding these limitations on rating agencies, the increase in the economic value of ratings has been substantial. Moody's has operating margins of nearly 50 percent, more than triple those of other financial services firms, and Moody's financial ratios are more than double those of other firms.³⁶ Moody's market capitalization is more than 10 percent of Goldman Sachs's, even though Moody's assets are only 0.1 percent of Goldman's. Annual rating industry revenues in aggregate are in the range of a billion dollars.

These are big numbers not typically associated with a commodity business like information publication. It is incredible that all of this value stems from an increase in the informational content of ratings. Yet economically rational issuers will not pay more for a rating than the expected benefit of the rating. Therefore, the issuer must expect that the rating – and the informational content associated with the rating – will lower the issuer's cost of capital by at least the cost of the rating. Put another way, issuers must expect that they are able to save at least two to three basis points on an issue by having an agency rate it. What is the value issuers are willing to pay for, if it is not information?

One answer is that credit ratings are valuable because of an increase in regulatory licenses. Just as an increase in regulatory licenses explains the growth of rating agencies during the 1930s, so might such an increase explain the more recent expansion and increased profitability of the modern credit rating agency.

Again, according to the regulatory license view, ratings are valuable, not because they are accurate and credible, but because they are the key to reducing costs associated with regulation. In theory, rating agencies have good reason to avoid conflicts of interest and to protect the accuracy of their ratings, because they need to preserve their reputations. However, once the ratings of a small number of credit rating agencies are enshrined by regulators who incorporate credit ratings into substantive regulation, the markets become less vigilant about the agencies' reputations. Just as rating agencies will sell information until the marginal cost of acquiring and transferring information exceeds

³⁶

Moody's Corp. 10Q Statements.

the marginal benefit from issuer fees, rating agencies will sell regulatory licenses until the marginal cost of acquiring and transferring regulatory licenses exceeds the marginal benefit from issuer fees.

From 1940 to 1973, there was little growth in regulatory licenses. Regulatory dependence on credit ratings did not change much; there was no major new credit rating-dependent regulation. During the same time, as noted above, credit ratings did not become significantly more important or valuable.

The increase in regulatory dependence on credit ratings began in 1973 when, following the credit crises of the early 1970s, the SEC adopted Rule 15c3-1,³⁷ the first securities rule formally incorporated credit ratings, and thereby approved the use of certain credit rating agencies as NRSROs.³⁸ Rule 15c3-1 set forth certain broker-dealer “haircut” requirements, and required a different haircut for securities based on credit ratings assigned by NRSROs. More importantly, as the initial source of the term NRSRO, Rule 15c3-1 effectively froze the then-approved credit rating agencies (*e.g.*, S&P, Moody’s, Duff & Phelps, and Fitch) as acceptable for rating purposes, and severely limited the possibilities for new entrants. Since 1973, there have been credit-rating dependent rules and regulations promulgated under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and various banking, insurance, pension, and real estate regulations. NRSROs even have been cited in a few federal district court opinions.³⁹

A complete discussion of these rules and regulations is well beyond the scope of this paper.⁴⁰ Nevertheless, it is possible to get a picture of the growth of credit rating-based regulation over time by analyzing the increase in the number of published regulations and other related materials in each of several substantive areas.

³⁷ 17 C.F.R. § 240.15c3-1.

³⁸ See *Notice of Revision Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934*, Release No. 34-10,525, 1973 SEC LEXIS 2309 (Nov. 29, 1973) (“The Commission to a limited extent has also recognized the usefulness of the nationally recognized statistical rating organizations as a basis for establishing a dividing line for securities with a greater or lesser degree of market volatility.”). The term “NRSRO” is mentioned in Rule 15c3-1, but is not defined in any other regulation; other regulations simply refer to Rule 15c3-1. See, *e.g.*, 17 C.F.R. 270.2a-7 (Rule 2a-7, defining the term “as that term is used in Rule 15c3-1”).

³⁹ As of June 2001, the term NRSRO had been cited in only three federal cases, and in only tangential ways. See *UBS Asset Mgmt. v. Wood Gundy Corp.*, 914 F. Supp. 66 (1996) (using term in reference to allegation of misrepresentation in sale of securities); *Heiko v. FDIC*, 1995 U.S. Dist. LEXIS 3407 (Mar. 15, 1995) (using term in definition of “mortgage-related security”); *SEC v. Drexel Burnham Lambert Inc.*, 1989 U.S. Dist. LEXIS 10383 (1989) (using term to define “below investment grade fixed income security” in constructing remedy).

⁴⁰ For a more complete treatment, see Frank Partnoy, *The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U.L.Q. 619 (1999).

Interestingly, the United States Code – the body of federal statutes – contains relatively few references to NRSROs and credit ratings. The eight references to the term NRSRO in the United States Code are listed below.

Recent United States Code Provisions Depending on NRSRO-Ratings

Title 12, Banks and Banking

§ 24a – Requirements for national banks

§ 1831e – Activities of savings associations

§ 4519 – Authority to provide for review of enterprises by rating organizations

Title 15, Commerce and Trade

§ 78c(41) – Definition of the term “mortgage related security”

§ 78c(a)(41) – Mortgage-related security must be in one of top categories

Title 20, Education

§ 1132f-1 – Student Loan Marketing Association minimum rating requirements

Title 23, Highways

§ 181(11) – Definitions applicable to federal aid requirements

Title 47, Telecommunications

§ 1103(d)(2)(D)(i)(II) – Requirements for approval of loan guarantees

These recent statutory provisions make it clear that credit ratings are valuable in particular areas. However, these eight laws cannot be the source of any dominating regulatory dependence on NRSRO ratings. To some extent these statutes simply establish a framework for a set of regulations promulgated pursuant to the statutes.

These regulations are found in the Code of Federal Regulations, where there are sixty recent provisions that rely explicitly on the NRSRO designation. These regulations primarily relate to the banking and securities industries. The breakdown of these regulations by Title is as follows:

Recent Code of Federal Regulations Depending on NRSRO-Ratings

Title 12, Banks and Banking	36
Title 17, Commodity and Securities Exchanges	22
Title 34, Education	1
Title 49, Transportation	1

A representative sample of these regulations is set forth below:

Securities Exchange Act Rule 15c3-1 (setting forth certain broker-dealer “haircut” requirements)

Securities Act Rule 134 (permitting issuers to disclose certain debt ratings in “tombstone” advertisements)

Investment Company Act of 1940, Rule 2a-7 (using NRSRO ratings to determine money market funds’ permissible investments; a rated security is an eligible investment if it has been rated in one of the two highest ratings for short-term debt by the required number of NRSROs)

Investment Company Act Rule 3a-7 (provision excluding certain structured financings from the Investment Company Act if they were rated in one of the two highest rating categories by at least one NRSRO)

Investment Company Act Rule 10f-3 (exemption permitting investment companies to purchase municipal bonds underwritten by an affiliate during the underwriting period if the bonds were rated investment grade by at least one NRSRO, or rated in one of the three highest ratings by at least one NRSRO if the municipality has been in existence for less than three years)

12 C.F.R. § 704.2, 704 App. A (Federal Reserve Board regulations, Reg. T, relying on NRSRO status)

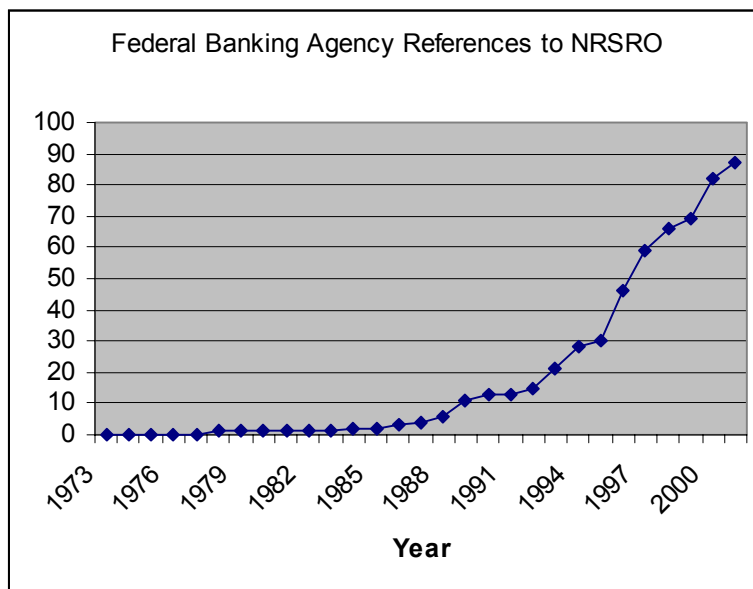
12 C.F.R. § 910.6 (Federal Housing Finance Board permission to modify regulation if an NRSRO determines that change a bond’s provisions will not result in a ratings downgrade)

24 C.F.R. § 266.100 (Housing and Urban Development Housing Finance Agency Requirements that potential Housing Finance Agencies be rated “top tier” by an NRSRO and maintain an overall “A” rating for their bonds)

As with the statutes, these regulations are the source of multiple regulatory licenses. State legislation and regulation in certain areas – particularly in insurance – also depends substantively on NRSRO ratings. These statutes and regulation show a steady increase in the willingness of legislators and regulators to make written provisions *explicitly* depend on credit ratings, although they are not the sole source of regulatory licenses.

The primary source of credit rating-dependent regulation is more indirect and implicit, and more difficult to quantify. This dependence stems primarily from the formal and informal reliance by particular regulatory agencies who – in their day-to-day business – issue letters, orders, releases, and rules that depend on NRSRO ratings.

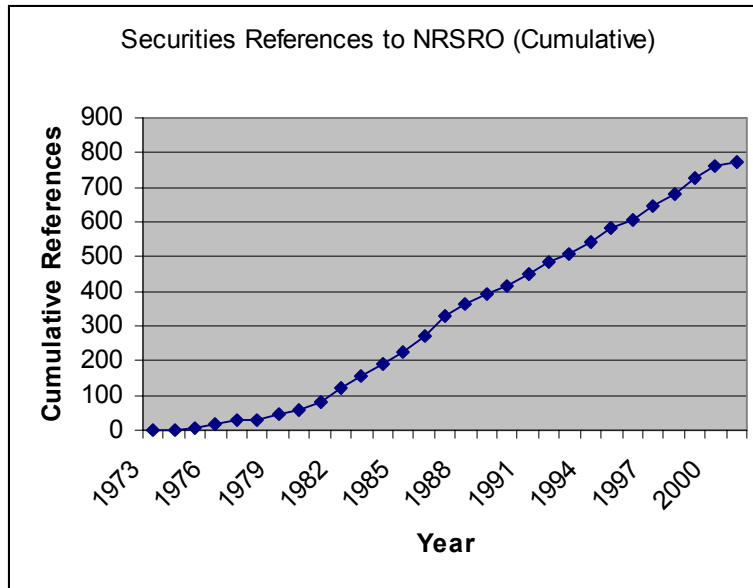
The evidence of the increase in this type of ratings-based regulation is largely anecdotal. For example, NRSRO-based rules have been crucial in recent banking regulation reform.⁴¹ One way to capture this anecdotal evidence more precisely is to calculate the annual references to particular ratings-based terms in databases compiling various agency decisions. These calculations show clearly there has been an enormous increase in NRSRO-based rules, regulations, and decisions since 1973.



Source: Lexis searches of Federal Banking Agency Database.

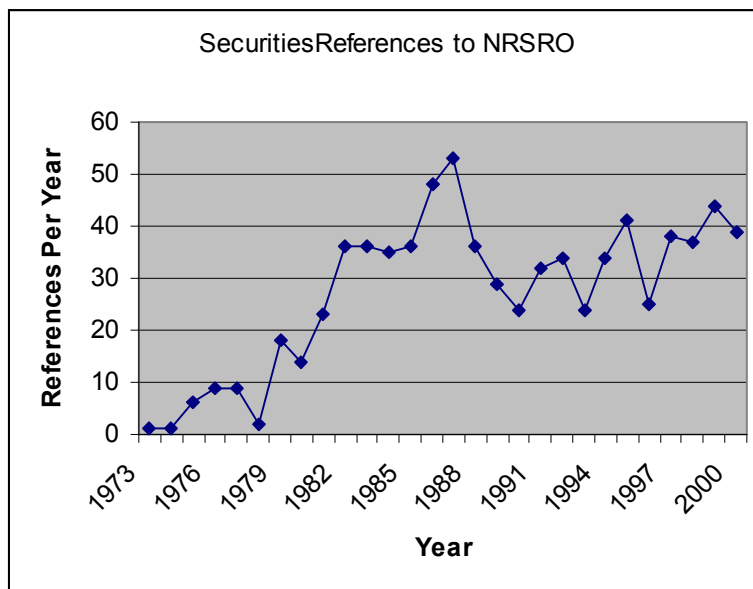
The same evidence exists for securities regulation. Each year, the Securities and Exchange Commission issues no-action letters and releases governing various aspects of the securities markets. These databases show similar growth in terms of references to credit-rating based rules, regulations, and decisions.

⁴¹ See Federal Reserve Regulation H (Mar. 14, 2000) (interim rule establishing NRSRO-based criteria for financial subsidiaries of banks).



Source: Lexis searches of Securities No-Action Letters and Releases Database.

When this data is viewed on a year-by-year basis, it also is apparent that the number of NRSRO references increases during periods of difficulty in financial markets, when regulation and regulatory decisions are likely to be more important or frequent. In particular, note the increase in references surrounding the market “crash” of 1987 and the decline in references during the relative calm of the early 1990s.



Source: Lexis search of Securities No-Action Letters and Releases Database.

One final set of evidence regarding the importance of rating-dependent regulation relates to the growth in ratings-driven transactions. In a previous paper,⁴² I discussed three recent financial market developments – inaccuracies in credit spread estimation, increases in ratings-driven transactions, and the growth of credit derivatives – which are not consistent with the notion that credit rating agencies have survived based on their ability to accumulate and retain reputational capital. I mention them here simply as additional shortcomings to the view that rating agencies have prospered based on their reputation for quality. Each development highlights serious flaws in the rating process, and raises questions about the informational content of ratings. Inaccuracies in credit spread estimation show that credit ratings do not accurately capture credit risk over time. Increases in ratings-driven transactions show that market participants are engaging in transactions to obtain more favorable ratings based on factors other than improved credit quality. The growth of credit derivatives shows how financial market innovation has generated regulatory arbitrage opportunities which both undercut and exploit credit ratings. These market developments make sense only if the regulatory license view carries some weight.

In sum, the evidence demonstrates that the regulatory dependence on credit ratings has increased since 1973. By employing ratings as a tool of regulation, regulators have fundamentally changed the nature of the product rating agencies sell, as issuers pay rating fees to purchase, not only credibility with the investor community, but also a license from regulators. The web of regulation added from 1973 until today has given the rating agencies a valuable and powerful franchise in selling regulatory licenses. Those lucky few rating agencies now have a product to sell regardless of whether they maintain credibility with the investor community.

V. Rating Agencies and Litigation

Some scholars have argued that even if the regulatory license view is correct, rating agencies nevertheless are constrained by potential civil liability. As the argument goes, even if rating agencies are benefiting from rating-dependent regulation, they still must factor in the expected costs of litigation, including both the cost of defending lawsuits and any damage awards or settlements. Rating agencies will not undertake activities with substantial expected litigation costs (unless, presumably, these activities also generated substantial benefits). The assumption throughout this argument is that the rating agencies face a substantial risk of civil liability. For example, Professors Smith & Walter cite “the extremely litigious environment in the United States and the ability to bring civil actions in U.S. courts in the event of problems incurred elsewhere in the world.”⁴³

These assumptions are incorrect. Perhaps most importantly, credit rating agencies are *immune from liability* for misstatements in a registration statement under Section 11

⁴² See Frank Partnoy, Siskel & Ebert, ***.

⁴³ Smith & Walter, at 35.

of the Securities Act of 1933. Securities Act Rule 436 explicitly provides that NRSRO are exempt from liability as an expert under Section 11.⁴⁴ Simply put, rating agencies are protected by law from the risks of “gatekeeper” liability faced by other financial intermediaries.

Moreover, courts have not indicated a willingness to impose liability on rating agencies for other alleged federal and state violations. Although court decisions from the early 1920s were consistent in the view that rating agencies had been able to accumulate and retain reputational capital rating agencies, there is no evidence that rating agencies face substantial litigation risk in the U.S. Early cases relied on ratings as evidence of the propriety of bond purchases in assessing whether fiduciaries had satisfied their duties, but did not impose liability on rating agencies. For example, an 1897 court in *In re Bartol*, addressing a challenge of a trustee’s purchase of an electric railway bond, referred to *Poor’s Manual* of 1890 in holding that “[i]t must be conceded under the evidence, that the trustees used all the care that a person of ordinary care and prudence would use in determining upon an investment of his personal funds.”⁴⁵ Likewise, in *In re Detre’s Estate*, a 1922 court relied on a Moody’s rating in finding that a trust properly purchased certain bonds: “In *Moody’s Manual* for 1914, these . . . bonds are rated: Security, very high; Salability, good; net rating, A.”⁴⁶ And in *In re Winburn’s Will*, a 1931 court relied on the ratings given by Moody’s, holding that “[t]here is a distinction between seasoned securities of this character here involved and investments in speculative securities.”⁴⁷

Recent cases are no different. The mere fact that rating agencies have been sued (on grounds other than Section 11, including state common law claims) is not evidence that the rating agencies’ expected litigation costs are high. Of course, it is true that rating agencies have been sued following a number of defaults. These suits have included class action litigation related to the Washington Public Power Supply System default in 1983, claims related to the Executive Life bankruptcy in 1991, a suit by the Jefferson County, Colorado, School District against Moody’s in 1995, and claims by Orange County, California, based on professional negligence, against S&P in 1996.⁴⁸

The only common element to these cases is that the rating agencies win. The suits typically are dismissed or settled on favorable terms to the rating agencies. For example,

⁴⁴ See also Item 10(c) of Regulation S-K.

⁴⁵ 182 Pa. 407, 38 A. 527 (1897).

⁴⁶ 273 Pa. 341, 117 A. 54 (1922).

⁴⁷ 249 N.Y. Supp. 758, 762 (1931).

⁴⁸ See Cantor & Packer, *The Credit Rating Industry*, at 4; Francis A. Bottini, Jr. *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*, 30 SAN DIEGO L. REV. 579, 584-95 (1993); *County of Orange v. McGraw-Hill Cos.*, No. SA 94-22272 JR (June 11, 1996).

Orange County's \$2 billion suit against S&P nettled a paltry settlement of \$140,000, roughly 0.007% of the claimed damages.⁴⁹ The record of plaintiffs bringing cases against rating agencies has been abysmal because the rating agencies have defended successfully with two arguments: (1) credit ratings are speech, which is privileged in the U.S., and (2) credit ratings are extensively disclaimed and are not a recommendation to buy, sell, or hold securities. Judges seem willing to accept these arguments. Accordingly, the fact that rating agencies are sued is not evidence that they face substantial litigation risk, especially in the United States, where financial intermediaries are sued frequently as a matter of course. The rating agencies have not been alone as defendants, and their co-defendants have fared much worse; investment banking defendants settled Orange County's litigation for hundreds of millions of dollars in aggregate.

Antitrust lawsuits against rating agencies have fared no better. The Department of Justice investigated Moody's for unfair competition, based on Moody's practice of issuing unsolicited or "hostile" ratings, regardless of whether the borrower has requested that it be rated, but ultimately decided not to prosecute those claims.⁵⁰ Civil antitrust claims – such as those brought by the Jefferson County School District in 1995 and Information Resources, Inc. in 1996 – have suffered similar fates.

That is not to say that all judges are impressed with the rating agencies' expertise. In one prominent federal appellate decision in 1999, Judge Diane Wood dismissed a claim against McGraw-Hill (S&P's parent) by an investor, Maurice Quinn, who had purchased \$1.29 million of A-rated collateralized mortgage obligations, which were downgraded to CCC and defaulted soon thereafter.⁵¹ The investor sued for negligent misrepresentation and breach of contract. Judge Wood (in an opinion joined by judges Richard Posner and Harlington Wood, Jr.) upheld the dismissal of the claim, on the ground that it was unreasonable for the investor to rely on an S&P credit rating. The closing words of her opinion are worth citing in their entirety, if only for the disdain they show S&P:

"While it is unfortunate that Quinn lost money, and we take him at his word that he would not have bought the bonds without the S&P 'A' rating, any reliance he may have placed on that rating to reassure himself about the underlying soundness of the bonds was not reasonable."⁵²

The irony is clear: at the same time virtually every financial regulator in the United States is relying substantively on credit ratings, a few smart judges in Chicago are saying such reliance *by an investor* is unreasonable.

⁴⁹ See Partnoy, *Siskel and Ebert*, at 690-703.

⁵⁰ See, e.g., Suzanne Woolley, *et al.*, *Now It's Moody's Turn for a Review*, BUS. WEEK, April 8, 1996, at 116.

⁵¹ See *Quinn v. McGraw-Hill*, 168 F.3d 331 (7th Cir. 1999).

⁵² *Id.* at 336.

VI. Proposals and Conclusion

One implication of regulatory license view is the following simple proposal: eliminate the regulatory dependence on credit ratings. The primary objection to eliminating regulatory dependence on credit ratings is the perceived need for substantive financial market regulation. Without a substitute for credit ratings in particular regulation, creating a free market in ratings would require eliminating vast swaths of the regulatory regime as it relates to financial services companies.

Some commentators might support such deregulation. For those who do not, credit ratings must be replaced with some alternative basis for substantive regulation. Here it is: in place of credit ratings, simply use credit spreads. Credit spreads already incorporate the information contained in credit ratings. They are at least as accurate as credit ratings. And because credit spreads are determined by the market as a whole, not by any individual entity or entities, a credit spread-based system would not create regulatory licenses for any approved agency.

Credit spreads can be measured in an objective way at the time of purchase and periodically thereafter. Financial market participants generally agree on the methodology used to calculate credit spreads. Any differences in methodology could be resolved by a requirement that bondholders obtain a valuation from more than party, or that the valuation be reasonable. Average or median spread could be calculated over time, to avoid immediate forced sales due to temporary price movements.

Credit spreads can be measured at the time of purchase, although such measurement would be less reliable than in the secondary market. Regulators and investors considering the regulation of bond purchases could take into account pre-issuance estimates of credit spreads (*i.e.*, “price talk”), much in the same way investors now rely on pre-issuance estimates of credit ratings, which are not issued until the bonds are issued (when credit spreads first are available at the same time).

One obvious application of this proposal is the risk weights from The New Basel Capital Accord, Jan. 2001, which are set forth below.

Proposed Basle Risk Weights (Credit Ratings)

		AAA to <u>AA-</u>	A+ to <u>A-</u>	BBB+ to <u>BBB-</u>	BB+ to <u>B-</u>	Below <u>B-</u>
Risk Weights	Sovereigns	0%	20%	50%	100%	150%
	Banks	20%	50%	100%	100%	150%
	Banks (short-term)	20%	20%	20%	50%	150%
	Corporates	20%	50%	100%	100%	150%

Commentators have addressed numerous criticisms of The New Basel Capital Accord, and this paper does not take a position as to those criticisms. Rather, the point here is that to the extent the Basel Committee decides to employ categorical risk weights, it would be better if those weights depended on credit spreads than on credit ratings. Such a change to the proposed Accord would be a straightforward exercise. The following table is suggestive:

Alternative to Proposed Basle Risk Weights (Credit Spreads)

		T-minus to <u>T+75bp</u>	T+75bp to <u>T+150bp</u>	T+150bp to <u>T+250bp</u>	T+250bp to <u>T+500bp</u>	<u>>T+500bp</u>
Risk Wts	Sovereigns	0%	20%	50%	100%	150%
	Banks	20%	50%	100%	100%	150%
	Banks (short-term)	20%	20%	20%	50%	150%
	Corporates	20%	50%	100%	100%	150%

These credit spread categories are for illustrative purposes only, and this paper is agnostic as to the level of credit spreads in each category. As noted above, if there are concerns about the volatility of credit spreads (compared to credit ratings), regulators could use an average or median spread over time. If there are concerns about liquidity and the ability to determine credit spreads in illiquid markets, regulators could include provisions for multiple valuations, with an obligation for regulated entities providing values to provide a “fair valuation.” The credit spread approach is straightforward and easy to implement. At minimum, regulators should experiment with incorporating credit spreads in some portion of NRSRO-based regulation.

Manuel Conthe began the March 2001 conference on credit ratings with a reference to J.P. Morgan’s aphorism that it is not money, but rather character, that leads to success in the financial markets. This paper has attempted to demonstrate that the view of credit rating agencies prospering based on their good character – a reputation for generating credible and accurate information – is not supported by history or economic analysis. Instead, the rating agencies have thrived, profited, and become exceedingly powerful by selling regulatory licenses, the right to be in compliance with various rules and regulations. With respect to credit ratings at least, it seems that it is money rather than character that has led to success.