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IN FOCUS

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Credit Rating Agencies: Regulation and Recent Developments

Credit rating agencies (CRAs) provide investors with evaluations of the creditworthiness of debt (i.e., how likely a debt is to be repaid in full) issued by a wide spectrum of entities, including corporations, sovereign nations, and municipalities. Their ratings are typically a letter hierarchical format (e.g., AAA as the safest, and progressively lower grades—AA+, AA, AA-, A+, A, A-, BBB, all the way down to D—representing greater risk). For regulatory and investment purposes, ratings are placed into one of two broad categories. *Investment grade* debt is rated BBB- or Baa3 (depending on the CRA) or higher. *Noninvestment grade* debt (also known as "high yield," or "junk" bonds) has a rating below these benchmarks and is generally associated with higher risk firms. This In Focus examines CRAs, their regulation, and recent developments.

Earlier Regulation

Adopted by the Securities and Exchange Commission (SEC) in 1975, the designation of a nationally recognized statistical rating organization (NRSRO) was originally used as a part of the agency's determination of capital charges on different grades of debt securities held by broker-dealers under the SEC's net capital rule (Rule 15c3-1 under the Securities Exchange Act of 1934). The rule is aimed at ensuring that broker-dealers maintain sufficient liquid assets to promptly satisfy their liabilities if needed.

When it began using ratings to enforce the net capital rule in 1975, the SEC staff, in consultation with agency commissioners, determined that the ratings of the three dominant agencies—Standard & Poor's (S&P), Moody's, and Fitch—were nationally used and are thus generally considered NRSROs with respect to SEC enforcement of the net capital rule. Between 1975 and 2000, the SEC added four more NRSROs to the original three. The SEC never defined the term NRSRO or specified how a CRA might become one. Its approach was essentially described as one of "we know it when we see it." Currently, there are nine NRSROs.

In 2006, Congress passed the Credit Rating Agency Reform Act (P.L. 109-291), which amended the Securities Exchange Act of 1934 to try to improve ratings quality for the protection of investors by fostering accountability, transparency, and competition in the credit rating industry. Among other things, P.L. 109-291 added Section 15E to the Securities Exchange Act, which established SEC oversight over those credit rating agencies that register as NRSROs. It also provided the SEC with examination authority and established a registration program for credit rating agencies seeking NRSRO designation, defined eligibility requirements, prescribed the minimum information applicants must provide in their application, and established a time frame and parameters for SEC review and approval of applications. NRSRO applicants and registered NRSROs are required to disclose information, including ratings performance, conflicts of interest, and the procedures used to determine ratings. Under the law, the SEC was also authorized to conduct annual deficiency and compliance examinations at NRSROs, which are not publicly identified.

The Financial Crisis and Dodd-Frank Regulation

In the run-up to the financial crisis of 2007-2009, the provision of investment-grade ratings by the three dominant CRAs—S&P, Moody's, and Fitch—for structured finance securities was widely seen as a critical part of the process of structuring the residential mortgage-backed securities (MBS) and collateralized debt obligations that held subprime housing mortgages. The issuance of private MBS reportedly grew from $126 billion in 2000 to $1.145 trillion in 2006.

Various reporting, including the 2011 *Financial Crisis Inquiry Report*, argued that the three leading CRAs fundamentally failed in their rating of these securities, exacerbating the market collapse. During the housing boom preceding the financial crisis, the CRAs often gave top-tier AAA ratings to many structured securities only to downgrade many of them later to levels often below investment grade. CRA ratings on corporate bonds reportedly did not encounter the same problems. Criticism of the CRAs, however, was not universal. A frequent defense of their failings was that their rating missteps could be traced in part to their view that rising housing prices would be sustained, a perspective also said to be held by a number of respected financial market observers at the time.

One reason put forward for the perceived overly favorable ratings in place heading into the crisis is that CRAs are typically paid by the issuers of the securities being rated by the agencies. This *issuer pays* model is often seen as a potential conflict of interest (Financial Crisis Inquiry Report, 2011). Rating-structured finance became a substantial revenue generator for the CRAs. For example, according to some reporting (Morgenson, *New York Times*, 2008), by the first quarter of 2007, such ratings constituted 53% of Moody's total revenue. In addition, "ratings shopping"—wherein structured finance issuers shopped for CRAs offering potentially more favorable ratings—may have played a role (Zhou and Kumar, 2012). Other possible causes of the allegedly inflated structured product ratings included:

- High concentration in the CRA industry (Financial Crisis Inquiry Report, 2011). According to recent SEC data, S&P, Moody's, and Fitch issued about 95% of outstanding ratings.

- Despite high profits, the CRAs reportedly suffered from inadequate staffing, exercise of due diligence, use of internal controls, and a failure to properly update their rating models (Brookings, 2017).
- The CRAs encountered challenges from reportedly significant levels of mortgage fraud and lax mortgage underwriting protocols (Brookings, 2017).
- Unlike largely homogeneous and seasoned corporate bonds, the highly complex structured finance instruments had relatively little experience over multiple economic cycles and were heterogeneous individualized products (Levitan and Wachter, 2011).
- Potentially flawed assumptions in CRA predictive quantitative models (McNamara, 2012).
- The CRAs did not use data from more applicable historical periods in which housing prices were in decline (Levitan and Wachter, 2011).
- Various CRA quantitative models were opportunistically reverse engineered by some of the issuers of structured instruments seeking favorable ratings (Brookings, 2017).
- The CRAs were immune from legal liability for misstatements in registration statements under the Securities Act of 1933 (Partnoy 2010).

The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) was enacted, in part, to help ensure that another financial crisis did not occur and to "promote the financial stability of the United States by improving accountability and transparency in the financial system." Among other things, the act provided for an assortment of regulatory measures aimed at addressing factors widely perceived to have played a role in the CRAs alleged ratings inflation of structured securities.

The act contains provisions aimed to enhance SEC regulation of credit rating agencies. Among these, it established the SEC Office of Credit Ratings; imposed new reporting, disclosure, and examination requirements on NRSROs; required NRSROs to disclose their ratings methodology; required ratings analysts to pass qualifying exams and undergo continuing education; gave the SEC authority to deregister a NRSRO; and required that half or more (but not fewer than two) of the directors of an NRSRO's board, which approves NRSRO procedures and rating methodologies, be independent of the NRSRO.

In addition, in an attempt to help remedy the perceived issuer-payer model bias, the act directed the SEC to study alternative approaches to NRSRO compensation. After the study, the SEC was authorized to do rulemaking for a system that randomly assigned NRSROs to do initial credit ratings and then provide subsequent ratings monitoring for structured finance products. The 2012 SEC staff study found that the random assignment model could mitigate issuer-payer conflicts but also might fail to do so because issuers could continue "rating shopping" and hire other NRSROs to provide supplemental credit ratings. At the time, the SEC opted not to pursue rulemaking on the random assignment mechanism.

To help enhance CRA rating's accountability, the act also assigned liability to NRSROs through the provision of private rights of action while no longer shielding them from "expert liability" status, which imposes liability on accountants and other experts for material misstatements or omissions in corporate registration statements. Historically, CRAs were shielded from that expert liability due to the view that their ratings issued were opinions and entitled to protection under the First Amendment.

In 2010, when newly subject to the expert liability status, the three major CRAs opposed giving their consent to their ratings appearing in issuer prospectuses and registration statements for asset-backed securities such as MBS. This raised the prospect of a shutdown of the securitization market. The SEC responded with "no action" letters that effectively indefinitely rescinded the NRSROs' "expert liability" status for ratings of asset-backed securities.

The act also attempted to reduce reliance on credit ratings by directing federal agencies to remove specific references to NRSRO-assigned credit ratings in their regulations and guidance while also adopting alternative schemes. In the ensuing years, most agencies have reportedly done so. However, a Federal Reserve response to the economic and financial turmoil from the COVID-19 pandemic stood in contrast to the move away from ratings references in regulation. In early 2020, the Fed created several emergency corporate lending facilities. Under them, a corporate recipient was required to have investment grade debt rated by "major NRSROs." (See CRS Insight IN11327, *Federal Reserve: Emergency Lending in Response to COVID-19*, by Marc Labonte.)

Recent Market and Regulatory Developments

In recent months, CRAs upgraded hundreds of billions of dollars of domestic corporate debt, a partial reversal of their significant downgrades in March and April 2020 at the outset of the pandemic. Some analysts and investors had criticized those downgrades as excessively harsh, a charge that CRAs said lacked merit.

In November 2019, then-SEC Chair Jay Clayton said that NRSROs should be "continually" monitored and expressed interest in exploring whether there were "alternative payment models" that would better align the interests of the CRAs with investors. A more supportive view, however, came from a June 2021 report on CRA performance during the pandemic-induced economic instability of 2020. The study from the Committee on Capital Markets (a research organization composed of leaders from finance, business, law, accounting, and academia) concluded that in 2020, "the agencies responded to evolving market and economic conditions promptly and performed their role well as independent providers of forward-looking information."

On June 1, 2020, the SEC's Credit Ratings Subcommittee of the Fixed Income Market Structure Advisory Committee recommended some NRSRO reforms: (1) expanding NRSRO disclosure, (2) enhancing issuer—corporate and securitized—disclosures, and (3) adopting a scheme for bondholders to ratify issuer-selected NRSROs. Soon afterward, on July 21, 2021, the House Financial Services Committee held a hearing that examined NRSROs.

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