Credit Rating Agencies (CRAs) have experienced immense growth and influence in the modern financial landscape. The power exhibited by these CRAs caused great concern regarding their particular practices and compensation models. The United States’ federal government intervened by creating the Credit Rating Agency Reform Act of 2006 (CRARA) in an effort to protect investors and curb the potential misuses of such a unique power. This paper aims to explore the intervention of the federal government by analyzing the implementation of the CRARA of 2006, and to a lesser extent the Dodd-Frank Act of 2010, and understand how the implementation of Congressional acts affect the economic conditions and capitalistic mode that drives not only the United States, but most of the world.

In order to understand the effects of government intervention, the paper delves into the nuances of CRARA and how Congress delegated and divided regulatory power over the CRAs using the “Nationally Recognized Statistical Rating Organization” (NRSRO) status. By applying NRSRO status to CRAs that complied with Congressional mandates, the CRA industry was supposed to provide increase transparency, accountability, and competition among companies in the hopes of improving ratings quality. CRARA targeted CRAs and attempted to reform the ratings of securities, while the real dilemma lay in the financial institutions themselves. CRARA’s misdiagnosis of the problem resulted in less effective results that arguably contributed to the “Great Recession.” In lieu of failed policies like CRARA, financial institutions should be governed by more ethical standards to avoid recessions of this kind.

---

1 Bryan Tisdale is a member of the class of 2015 at the University of Chicago.
Credit Rating Agency History

Credit Rating Agencies (CRAs) have long been around and served as a means of evaluating the potential risk and rewards of securities. CRA ratings, through expressly stated opinions, allow for investors to make more informed decisions about their possible investments.

Despite being a very logical and efficient way of determining the value of the multitudes of securities, it was only in the 1980s that CRAs became indubitably entrenched in the financial markets, growing concurrently with the global capital. (Yasuyuki 2006)

Today Credit Rating Agencies have grown to have an incomparable influence on the global financial markets. In the words of Thomas Friedman, “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.”(White 2010) Select CRAs’ incomparable power is illustrated by the fact that 98% of ratings issued in 2007 were issued by only three agencies: Standard & Poor’s Ratings Services, Moody's Investors Service and the smaller Fitch Rating. (Gordon 2013) With unmatched influence in the financial industry, CRAs’ ratings were nearly universally utilized and determined the actions of most investors and financial institutions. Many times mutual funds, pension funds, and other funds were contractually limited to only buy and sell securities with the highest possible rating (AAA).

With CRAs’ seemingly ever-increasing power over the securities market, their compensation model became one of great concern. There exist two major compensation models within the CRA industry: subscriber paid and issuer-paid. Subscriber-paid occurs when CRAs are paid by subscribers to have the right to access the CRAs’ ratings and information. Issuer-paid occurs when the CRAs are paid by the institution which is selling the security that is to be rated. The issuer-paid compensation model contains an inherent conflict of interest and could potentially undermine the role of CRAs in determining the value of securities. In the wake of the financial catastrophes of the 2000s, CRAs’ undoubtedly large influence on the financial market caused obvious concern over their practices and compensation.

Congress’ response to the concern was the Credit Rating Agency Reform Act of 2006 (CRARA). CRARA was intended to protect investors by increasing the reliability of these credit rating agencies through their voluntary application to be designated a “Nationally Recognized Statistical Rating Organization.” (NRSRO) Congress’ hope was that a designation would give CRAs credibility in the market, allow for increased government oversight, increased competition, and result in more reliable ratings in the hopes of preventing unanticipated loss to the investor and facilitating increased fair and honest trade within the securities market.

The implementation of CRARA is a story of the introduction of government into a long-standing organization comprised of investors, CRAs and financial products that existed prior to government involvement. The rules and provisions attached to this government involvement are the substantive efforts
of the SEC to “protect investors and the public interest” (CRARA). The effectiveness of these rules and provisions are then analyzed and evaluated regarding the success, or failure, in reaching Congress’ goals.

**Credit Rating Agency Reform Act of 2006**

On September 29, 2006, the 109th Congress enacted the Credit Rating Agency Reform Act of 2006 (PUBLIC LAW 109–291). The act was established “to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.” (PUBLIC LAW 109–291) The goal is clearly defined, as is the strategy in which Congress intended on ascertaining that goal. Congress determined that greater oversight of the CRAs was needed in order to protect investors. Congress amended the Securities Exchange Act of 1934 in order to attain this level of oversight. In 1975, “Nationally Recognized Statistical Rating Organizations” (NRSRO) referred to credit rating agencies that were “nationally recognized” through the SEC’s granting of a “No Action Letter.” Congress expounded upon this term in CRARA. CRAs that complied with the SEC and its rules regarding sufficient transparency and accountability received the NRSRO designation. The NRSRO designation was also intended to increase competition by allowing more CRAs to be “nationally recognized,” providing legitimacy and exposure for the less-established CRA’s.

By amending section 15E of the Securities Exchange Act of 1934, Congress provided basic guidelines on the information that should be provided by CRAs desiring the NRSRO designation. The SEC was granted the power to deem any information necessary for NRSRO status. The SEC was granted the independence to create and identify rules clarifying the information needed in the NRSRO application. The SEC was also granted the authority to oversee NRSRO’s from the time of their application onward, deciding whether a CRA should be designated and remain an NRSRO.

In regard to conflicts of interest, the SEC maintained the status quo insofar as a conflict of interest was ultimately handled within the organization itself and not mitigated by the SEC other than a few trivial provisions. These rules were to be monitored by the NRSRO’s themselves and were not a significant departure from the system that preceded CRARA.

Under the SEC’s facilitation, the intentions and strategy laid out by Congress in the Credit Rating Agency Reform Act of 2006—to protect investors and reform CRA’s in the public interest—were implemented using the rules and provisions imposed upon NRSRO applicants that both the SEC and Congress believed would achieve its goals.
**The Effects of Government Involvement**

**Uncertainty Absorption**

The average individual investors are often looked at as occupying the bottom rung of the system created between themselves, CRAs and financial institutions (Randall, 2010). In reality, investors sit atop the hierarchy because financial institutions and CRAs only exist due to the capital provided by investors. Financial institutions and CRAs have power over the investors by controlling the information provided to the investor. But investors ultimately wield controlling power because they are the basic source of survival for the financial industry. Akin to the media, information is provided to the CRAs, which in turn sift through and decide the relevancy and value of this information and then portray it to the investor who eventually makes a decision based on the information provided. This is a classic example of uncertainty absorption.

"Through the process of uncertainty absorption, the recipient of a communication is severely limited in his ability to judge its correctness…To the extent that he can interpret it, his interpretation must be based primarily on his confidence in the source and his knowledge of the biases to which the source is subject, rather than on a direct examination of the evidence.” (March et al. 1993)

One of the most progressive attempts at protecting investors is the SEC’s intent to break down the apparent organizational concept of uncertainty absorption. Prior to CRARA, there were great amounts of information known only to CRAs. This information included quantitative and qualitative data. CRAs’ quantitative methodologies for rating securities were highly confidential, for obvious business reasons. Qualitative assessments of securities and structured financial products were not accessible to investors interested in researching certain products. This allowed for assumptions to be made by the CRAs that were not checked or known by investors. This also allowed for much more collusion between financial institution and CRAs in respect to the inherent conflict of interest seen in their business models. Investors were left in the dark for very many reasons and SEC rules like mandating the publication of information worked to quell the unbalanced distribution of information. These rules were a valiant attempt to increase transparency in the system. From this effort investors were granted far more information than they previously had access to and were able to make more informed decisions about the actual securities as well as the CRAs producing the ratings for those securities. For Congress, transparency was achieved and the level of investor protection was increased.

When talking about the field of finance and the introduction of subprime mortgages by the financial institutions, many blame the CEOs. There existed limited structural secrecy and a general knowledge of these bad mortgages did travel all the way to the top (Barofsky 2012). Given that, up to that point, these risks had never manifested into real-life losses, CEOs of financial service corporations treated these calculated risks as not necessarily risks at all. What is important to note is that due to the high reward over what was thought to be the potential risk, the act of not accurately responding to the known risks was normalized within the entire
financial industry. Nearly every major financial institution was somehow engaged in these risky asset-backed security pools. This normalization of deviance was a phenomenon that should have been recognized by the CRAs. One of the major goals that Congress, and thereby the SEC, intended to do with CRARA was disrupt the uncertainty absorption that existed not within the financial institutions, but within the greater system that connected the financial institutions with the CRAs and the investors. The transparency that Congress sought was to be found in the breakdown of uncertainty absorption within the system created when financial institutions entice investors using CRA’s ratings.

The Woes of Centralization

As the government attempted to achieve the goals of Congress, there were many forces working against it, the most influential and damning of those forces being the government itself. The government’s own centralization proved to be a severe hindrance to achieving the goals it set out to accomplish.

Centralization is the act of consolidating power under a central control. Selznick describes centralization as having a dual nature regarding costs and benefits,

“In exchange for the benefits of order and coordination, initiative has been stifled and the power of decision indispensable element of democratic action lodged in far-off places, remote from the beneficial influences of local areas which become merely the objects of bureaucratic manipulation.” (Selznick 1948)

In the system of CRAs, financial institutions and investors, the connection between the financial institutions and the investors is facilitated by CRAs. As the financial industry grew ever larger and centralized in relation to the individual investor, the CRAs were there to fill that gap and prevent the investor from becoming “merely the object of bureaucratic manipulation.” The government’s intent was to intensify and direct the CRAs’ abilities to fill the gap between investors and the financial products they seek providing greater protection for the investor. The result of Congress’ actions resulted in the further centralization of the federal government which does not come without its woes.

“[Centralization] lays bare the peculiar hazard of this modern world: the danger implicit in vast size, the disaster consequent when power is exercised far from those who feel the effect of that power, remote and alien to their lives.” (Selznick 1948)

In regards to CRARA, there exist two extremely centralized institutions: the massive, multifarious institution that is finance and the already complex and ever-growing federal government. The U.S. federal government has been rapidly growing and centralizing since Roosevelt’s New Deal. In 2007, U.S. financial services had nearly doubled in size relative to GDP since 1980 (Philippon, 2010). This increase speaks to the
augmented influence and control of the financial industry within the global economy and thereby control over the investor. The government sought to protect the investors by further centralizing the CRA industry, which is a misdirected assertion of governmental power. It is evident that the finance industry’s own centralization has already outpaced governmental rule but the CRAs have not. Oversight and rule of the CRAs is thereby further alienating the investor from the particular investments they seek to make. CRAs then are employed to rate securities that are so complex and distant from mainstream knowledge of finance, and what seems to be the knowledge of CRA’s, that they eventually proved incapable of producing accurate ratings.

Despite the CRAs’ having never admitted to partaking in unethical conduct regarding their business models, the inherent conflict of interest present within CRAs is in fact a counterpoint to CRAs’ incompetence in their rating capabilities. An observer might say that the conflict of interest sways the CRAs’ incentive towards the financial markets rather than in the direction of the investors. Whether or not the CRAs produced false ratings because of the inherent conflict of interest within their business models or because they were unqualified to produce accurate ratings makes no difference and only speaks to the problem that centralization causes for the individual, widening the gap between those who exercise power and those affected by it. Even the inherent conflict of interest in CRAs’ business models is attributed to the rapid growth of the securities market and the availability of information due to technological advances, which caused CRAs to shift their models to an issuer-pay model. The issuer-pay model was not the original business model of CRAs.

“I think more importantly, probably though, was the increasing size and complexity of the markets themselves were demanding a model by which additional resources could be funded, more specialization, higher paid people, more of them. And so the decision to move from investor pay to issuer pay was coincident, both with information technology advances and complexity in capital markets and growth in capital markets.” ("Roundtable to Examine Oversight of Credit Rating Agencies" April 25, 2009)

Centralization of the finance industry caused much of CRAs’ problem of producing inaccurate ratings. More importantly, centralization of the national government is a force that has proved to cause much of the difficulty in the Act’s attempt at reforming CRAs and protecting investors. Due to the past crises, investors are wary of investment because of a lack of trust provided by the separation characteristic of centralization. This can actually be viewed as a good thing in that the precariousness of investors causes more due diligence on their own part, but it is certainly not desirable when attempting to restart the economy. Investors are only protected by their own efforts, not the government, which is its very goal. The government’s involvement in the attempt to oversee CRAs’ actions can then only be a deterrent to the CRAs’
effectiveness. “This fundamental evil of over-centralized government is accompanied by another: the inhibition of action through the proliferation of red tape.” (Selznick 1948) Red tape is the cause of many costs incurred by the NRSROs, “the first year quantifiable costs [to the CRA industry] related to the final rule will be $73,085,100.” (SEC 2009) These costs hurt all of the potential NRSROs, especially the smaller CRAs that the government hoped would register in order to induce competition. Therefore, the costs of oversight of NRSROs not only impairs the ability of CRAs to produce ratings but also the chances of increased competition, which is one of the primary goals the government set out to achieve in the Act. CRARA then, effectively wedges the government into an already flawed system hoping to make it more reliable by overseeing entities in which the problem and solutions do not originate nor lie in.

### Competition

Increased Competition among CRAs was one of the foremost goals of CRARA (SEC 2009). After the bill was passed, the government believed there to be 30 CRAs intending to register for NRSRO status. According to the SEC’s Office of Credit Ratings website at the date of this writing there are only 10 registered NRSROs. “The 12 months that ended in June 2011, the SEC found the big three still issued 97% of all credit ratings, down from 98% in 2007.” (Gordon 2013) These facts speak to the notion that the potential costs incurred by the individual CRA seeking NRSRO designation, due to the new centralization of the CRA industry, were too great for many CRAs. The provisions for registration were so costly that it "prevented at least one potential competitor from winning approval and have dissuaded others from even applying,” the law set "odd barriers that are very favorable to the incumbents” and made it “exceptionally difficult for a younger player to qualify.” (Gordon 2013)

Another problem compounding on CRAs was the virtually acute necessity to achieve NRSRO designation. As CRARA took effect, even though outright government sponsorship of CRAs was not given, the NRSRO designation suddenly carried with it far more legitimacy. CRAs now had to have the designation to be relevant. CRAs were faced with the problem of not being able to afford a designation that they needed to obtain in order to stay in business. The effect of the policy exalted those CRAs with already great influence in the market while causing the initially less influential CRAs to find it harder to succeed. Those CRAs that already had notoriety were given more because of their new NRSRO status. CRAs that enjoyed the benefit of having their ratings communicated on a grander scale than the lesser known and less successful CRAs now had that communication amplified because of the increased legitimacy of created by becoming a NRSRO. Remunerative reward for the lesser known agencies was also dramatically stifled because, with the lack of notoriety, there was little chance that their ratings were going to be bought. Due to the government’s legitimization of CRAs, by designating them NRSROs, the policy exhibited the sociological concept of the Matthew Effect, derived from the Biblical book of Matthew and first coined by Robert K. Merton: “For unto every one that hath shall be given, and he shall have abundance: but from him that hath not shall be taken
even that which he hath.” (Matthew 25:29, King James Version). Merton explains simply that notoriety begets notoriety. This is exemplified by the NRSRO status and the fact that designation of these more powerful CRAs as NRSROs popularized them as well as substantially legitimized them as “credible” rating organizations. This was an obviously unintended consequence of the Act and is actually the exact opposite of what the government intended to do, which was increase competition in the hope of making CRAs more reliable and thereby protecting investors.

**CRARA’s Role in the “Great Recession”**

Many hypothesize that due to the inaccurate ratings of asset-backed securities that had a large hand in the sub-prime mortgage crisis, the Credit Rating Agency Reform Act must have been a failure. There is some truth to the hypothesis that CRARA was a failure. But in regard to CRARA’s actual goal of protecting investors, the implementation was not a complete failure when defined by the terms Congress itself used to determine how investors could be protected.

Transparency, accountability and increased competition were supposed to be the means through which investor protection was to be achieved. Registration and oversight of NRSROs increased transparency. By obstructing the uncertainty absorption present in the investor-CRA-financial industry system, more information was certainly accessible to investors and provided for some level of protection. Increased competition is a means that was never engendered by this policy; therefore investor protection was not at the level hoped for by policymakers. The NRSRO registration process was unfavorable to the newer, less-established agencies due to costs which impaired the younger agencies from being able to participate in the market. Competition was insignificantly different after CRARA’s inception for two reasons. Government centralization and the inherent deterrents and costs of controlling CRAs had a part in the unaltering level of competition. In addition, the Matthew Effect exhibited its tendency for more successful entities to prosper while the smaller entities remain unable to cope with the changes caused by CRARA resulting in an even smaller market share than initially held.

The last means by which Congress intended to better protect investors was through accountability. Actions taken to strengthen accountability were negligible. In the original act and the final rules implemented by the SEC there never was a policy that made CRAs accountable for their actions other than the loss of the NRSRO designation. CRAs are prompted to comply with the conflict of interest rules set by the SEC only by threat of the repeal of the NRSRO designation. As it was said earlier, this repeal of the NRSRO designation is somewhat insignificant to the large organizations that already have a disproportionate amount of market share that would likely not be lost in the case of a designation change. “The egotistical motives of self-preservation and of self-satisfaction are dominating forces,” therefore a stronger, more “material incentive” is needed, like that of prison time or the threat of government shutdown of the business (Barnard, 1954). With other professions such as a medical doctor, the doctor is liable for the expert advice provided.
CRARA did nothing significant to allot any large amount of risk to the CRAs. CRAs virtually had no “skin in the game,” which would have provided the CRA’s with a “powerful incentive” to produce quality ratings, ratings that are dramatically influential to the entire financial system (Bailout 2012).

Policy Evaluation

Fundamentally, CRARA is a misdiagnosis of the problem. Relating CRAs to a police force, which can be construed as the view of Congress, CRAs should protect investors. At the time of CRARA’s enactment, Congress seemed to believe that by reforming this “police force” of rating agencies, investors would be better protected. While they may make mistakes, the problem, however, is not the police force. The problem is the toxic financial products being traded freely within the finance industry. One does not blame the police for a town riddled with irresponsible citizens; rather, one should blame the citizens.

Better, more ethical and sound business practices should be enforced. If the finance industry remains ethical and logical in their dealings, the CRAs may never have the monetary incentive to act on a conflict of interest. They may never have the difficulty of rating ultra-complex and toxic securities that are so far removed from the original investor than maybe crises like those of the early 2000s could be prevented. However, when approaching the problem of reforming the CRAs (the police) the solution was understandable. The strategy through which Congress intended to protect investors is logical and straightforward: transparency, accountability and the abolishing of the conflict of interest problem. The means of attaining and implementing that strategy, however, were flawed.

Teachings of a Failed Policy

CRARA illustrated that more information and more accountability of the CRAs was necessary for the public interest. The application of accountability entices the issuance of more information. The liability of CRAs decreases concurrently with the more information they publish. It stands to reason that if CRAs publish all of their information they have no liability, but by not withholding information CRAs don’t make any money. It is a paradox that CRAs must wrestle with and the federal government must preserve in order to not completely ruin the CRA industry. In some respect, accountability for CRAs is a much simpler endeavor than applying accountability to a police force. The CRA is not in charge of apprehending the issuers of these extremely risky securities. Ensuring accountability of the CRAs only requires of them to accurately warn the investor of their potential risk. Once again, applying the police analogy, CRAs must perform the equivalent of a police department only warning citizens of the dangerous neighborhoods without having the job of ridding the streets of illicit behavior.

An early attempt by the government to apply accountability to the financial world was the Sarbanes-Oxley Act of 2002. It read as “an act to protect investors by improving the accuracy and reliability of corporate disclosures.” (PUBLIC LAW 107–204, 2002) Aimed at upper-management of corporations,
liability was applied to Chief Financial Officers and Chief Executive Officers in the hope of ensuring accuracy of accounting facts and figures.

After CRARA, The Dodd-Frank Act of 2010 made the final move to apply accountability to the CRAs. The act changed the ratings the CRAs produced from merely opinions that fell under the protection of the 1st Amendment to an Expert status which makes inaccurate ratings liable to lawsuit. While this act made CRAs more accountable for their ratings, it provided the ratings with a large stamp of government approval that did not actually ensure a certain quality of ratings, but only that inaccurate ratings could have legal implications.

The federal government had the wisdom to not interfere with the methodologies of the CRAs in order to preserve individual CRA market insights and intellectual property. However, through its oversight the government proved to be a burden to the swift and accurate flow of information that was supposed to be provided by the CRAs. The government’s plan to improve investor protection was counterproductive. The free-flow and publication of information improves the investor’s ability to fend for himself. Applying a certain liability to the producers of information maintains that the information is truthful and therefore advantageous to the investors’ cause.

The government can learn from the failures experienced in the implementation of CRARA and other financial regulatory acts. Government involvement is not always the necessary tool to guarantee investor protection. It is obvious from CRARA that the growth of government can bring with it downsfalls. More importantly than what government can learn is what the individual investor can learn. The lesson to the investor is that the government’s involvement in financial matters should never cause one to believe that they are better off or more protected because of it. Exemplified by CRARA and other financial regulatory acts, it is not definitive that the quality of ratings produced by CRAs is any better or worse than prior to the government’s involvement. Ultimately, it is still up to the investor to perform the necessary due diligence on the securities they intend to trade whether it be with the help of CRA’s or not.
Bibliography


Gordon, Greg (August 7, 2013). "Industry wrote provision that undercuts credit-rating overhaul". McClatchy Newspapers. (Retrieved 4 September 2013.)


Securities Exchange Act of 1934


