Statement of Lawrence J. White*
For the Committee on Banking, Housing, and Urban Affairs
United States Senate
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Hearing on "The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets"

I. Introduction

Thank you for the opportunity to testify before this Committee on this important topic.

Today the subprime residential mortgage market -- and credit markets that are related to the subprime market -- are experiencing substantial distress and losses and are likely to continue to do so. It is now clear -- and was clear to some observers at the time -- that during the past few years there were:

-- mortgage borrowers who shouldn't have been borrowing;

-- mortgage brokers who were giving poor advice to borrowers;

-- mortgage originators who should have maintained higher underwriting standards and shouldn't have been originating as many subprime mortgages;

-- mortgage-backed securities (MBS) packagers who shouldn't have been bundling and selling these MBS and other "structured-finance" derivative securities that were based on these MBS;

-- investors who shouldn't have been buying these securities; and

-- bond rating companies who shouldn't have been as initially optimistic about these securities and who were subsequently slow to recognize these securities' problems.

There is plenty of blame to go around.

The purpose of my testimony today, however, will not be to try to provide a "play-by-play" analysis of "who did what to whom." There are others who are better placed to do that than am I.

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Instead, I want to try to provide context and background: Why the bond rating industry is playing its current role in today's capital markets; how we got to where we are today; how recently enacted legislation may change the industry; and why, at least with respect to the bond rating industry, the Congress should refrain from the temptation of trying to fix the problems by passing new legislation.

There are at least two reasons for counseling restraint: First, preventing the kinds of mistakes that the bond rating firms made is difficult to do legislatively and runs great risks of stultifying the industry. The participants in the financial markets -- if given the opportunity -- are capable of shifting their business away from entities that cannot be trusted, which provides powerful incentives for correcting mistakes. Equally important, the bond rating industry is currently functioning under the auspices of a new law, which is only one year old, and new regulations, which are only three months old, that implement the provisions of that law. The new law, which was intended to encourage greater competition by reducing the regulatory entry barriers that had surrounded and protected this industry for over 30 years, should be given an opportunity to show its worth.

The remainder of this statement will expand on these views.

II. Some background

Until recently, the Security and Exchange Commission's (SEC) protective wall around the major bond rating companies was one of the best-kept secrets in Washington. Only after the Enron debacle of late 2001 and the Congressional hearings that followed did the SEC-created category "nationally recognized securities rating organization" (NRSRO) gain a little bit of recognition, and even today it still is far from a household term.

The SEC's regulation of the bond rating industry began in 1975, with perfectly good intentions. As bank and insurance regulators earlier had done for their regulated industries, the SEC wanted to use corporate bond ratings to help set minimum capital requirements for broker-dealers.

Before proceeding further, it is important to recognize these efforts for what they were and still are: The financial regulators were and still are delegating ("outsourcing") to third parties their regulatory judgments as to the suitability of bonds in their regulated institutions' portfolios. This is an important point to which I will return below.

The SEC realized in 1975 -- apparently, for the first time among regulators -- that specifying the use of ratings also required specifying *which* rating companies' ratings could be used. What would prevent a bogus rating company from awarding (for a suitable fee) "AAA" ratings to *any* corporation's bonds? Could the broker-dealers then use those "ratings" for regulatory purposes?

So, the SEC duly created a new regulatory category -- NRSRO -- and immediately "grandfathered" the three major incumbent bond raters -- Moody's, Standard & Poor's (S&P), and Fitch -- into the category.

In the following 17 years, through 1992, the SEC bestowed the NRSRO designation on only four new entrants -- but mergers among them and with Fitch had reduced the field to just the original three by the end of 2000. There were no new NRSRO designees by the SEC between 1992 and February 2003. Also, the procedures underlying SEC's designations (during the rare times when they occurred) were opaque: The criteria for defining NRSRO were never specified, and the designations were (and continued, through May 2007, to be) made quietly, with little explanation and no press release, through "no action" letters issued by the SEC staff to the new designee.

After 1975, other financial regulators adopted the SEC's NRSRO designations for their regulatory purposes (i.e., increased the extent of their delegation of suitability judgments), which greatly widened the impact of the SEC's NRSRO decisions.

III. Why has the NRSRO designation mattered?

Why did the NRSRO designation matter, and why does it still matter? Almost all regulated financial institutions -- banks, insurance companies, pension funds, etc. -- must heed the NRSROs' ratings in deciding which bonds they can hold in their portfolios. For example, banks cannot hold bonds that are below "investment grade" -- as designated by (and only by) NRSROs.

The SEC's NRSRO designation, combined with the financial regulators' liberal use of the designation for regulatory purposes, has thus provided the NRSRO incumbents with a captive audience: regulated financial institutions that must heed the NRSROs' ratings. In turn, since these financial institutions are major participants in the bond markets, the bond markets generally must heed the NRSROs' ratings -- even if some or most (or possibly all) of the participants disagree with the ratings.

Simultaneously, it is difficult (though not impossible, as the existence of a few smaller, non-NRSRO bond rating firms attests) for firms to enter and survive in the bond rating business without a NRSRO designation. Without the captive audience enjoyed by the NRSROs, survival for such firms is clearly more difficult.

The potential for bad economic outcomes under this restrictive and protective regulatory regime is clear. Not only are the standard consequences of inadequate competition -- excessively high prices and profits, and stodgy behavior -- to be expected. This regulatory arrangement also runs the risk of the squelching of new ideas and innovations in bond ratings and solvency assessments if the handful of incumbents somehow conclude that the innovations are not worthy of their notice.

This innovation question raises a larger issue: Under this regulatory regime, how could one tell if the bond rating firms meet a market test? With regulatory requirements that the NRSRO incumbents' ratings must be heeded, the capital markets have no choice but to heed them. The capital markets have no way of knowing or discovering whether there are better, more efficient and effective ways of assessing the creditworthiness of bond issuers -- or whether there are better, more efficient organizations that could conduct those assessments. The efficiency of those markets themselves is potentially affected.

It has often been argued by the incumbent NRSROs' representatives and allies that the incumbents have a good track record in the predictions that follow from their ratings; e.g., "AAA" bonds rarely default, "CCC" bonds default far more frequently, etc. Although this is correct, the same types of predictions could be gained from just observing the market spreads on various types of bonds, and one cannot (without more) tell if the incumbents' ratings might just be following and mimicking market spreads and not providing any truly new or valuable information to the capital markets.

Another, more sophisticated defense of the incumbent NRSROs rests on the perception that changes in the incumbents' ratings generally are followed by changes in market prices for the affected securities. These price changes, it is argued, indicate that the NRSROs ratings do provide valuable information to the capital markets. However, it is unclear whether the market reactions indicate that the change in the ratings has truly told the markets something new about a security's default probabilities, or whether instead the markets are simply reacting to the change in the "location" of the security's rating, which is now closer to (or farther away from), or has just crossed over, a crucial regulatory boundary -- e.g., the "investment grade" boundary that determines whether or not banks can hold a bond in their portfolios.

None of this discussion should be interpreted to mean that bond raters necessarily have no role to play in the capital markets. In principle, they can provide valuable information that will help investors learn who are the better (and worse) risks among borrowers and concomitantly also help the better borrowers "tell their story" more effectively. But the regulatory delegations by the financial regulators, combined with the entry barriers of the NRSRO system, have meant that there has been no market test as to whether the current NRSRO incumbents do actually play that role.

IV. Some recent history

In the aftermath of the Enron debacle, the financial press revealed that the major (NRSRO) bond raters had kept "investment grade" ratings on Enron's bonds until five days before Enron's bankruptcy filing. Subsequent Congressional hearings included attention to the SEC's restrictive NRSRO designation regime and its opaqueness, as well as to the incumbent NRSROs' business model of charging fees to the bond issuers (rather than to investors, as had been the business model prior to the 1970s) and the potential for conflicts of interest and abuse that could accompany it. The Sarbanes-Oxley legislation of 2002 mandated that the SEC issue a report on the NRSRO system, which it did in January 2003. And in April 2005 the SEC proposed regulations that would establish formal criteria for the designation of NRSROs. But the proposed regulations were never finalized, and the NRSRO regime remained intact.

Meanwhile, the SEC did designate a few more bond rating firms as NRSROs: Dominion Bond Rating Services, a Canadian firm, in February 2003; and A.M. Best, a specialist rater of insurance companies, in March 2005. More recently, in May 2007, two Japanese bond rating firms -- Japan Credit Rating Agency, Ltd., and Rating and Investment Information, Inc. -- were designated as NRSROs.

In 2005 legislation to effect a major lessening of the entry barriers of the NRSRO system was introduced in the House of Representatives. The legislation was approved by the House in the summer of 2006. The Senate accepted most of the House's provisions but made some significant modifications and passed its version in September 2006. The House acceded to the Senate's version, and President Bush signed the Credit Rating Agency Reform Act of 2006 on September 29, 2007.

The legislation does not eliminate the NRSRO system, but it does aim to reduce the barriers to entry that the SEC had erected, as well increasing transparency. The Act allows any firm that has been issuing ratings for three years to apply to the SEC to be registered as a NRSRO (the incumbent NRSROs must also apply), and it requires the SEC to establish a relatively timely and transparent process for approving or rejecting applications. The "good character" requirements for an NRSRO organization (incumbents as well as applicants) are relatively modest. The Act makes clear that the SEC is not supposed to favor any specific business model for NRSROs. Overall, the clear intent of the Act is to open entry and encourage greater competition in the bond rating industry.

The SEC promulgated final regulations that implemented the Act's provisions in June 2007. The final regulations maintain the general spirit and substance of the Act.

The Act does not go as far as I would like. I would strongly prefer the simple elimination of the NRSRO designation and the concomitant withdrawal of the regulatory delegations of safety judgments that have given so much power to the SEC's NRSRO decisions. The participants in the financial markets could then freely decide which bond rating organizations (if any) are worthy of their trust and dealings, while financial regulators and their regulated institutions could devise more direct ways of determining the appropriateness of bonds for those institutions' portfolios. Also, I fear that some of the "good character" provisions of the Act might be used in the future to create new barriers to entry.

Nevertheless, the Act provides a welcome shift in public policy toward a more competitive rating industry.

V. The current situation

As I noted in the Introduction, the subprime mortgage debacle represents multiple failures at multiple levels. This hearing is about the bond raters' role.

I have no special knowledge as to why the bond raters were overly optimistic with respect to the repayment prospects of the subprime mortgage borrowers during the past few years. It is clear that they were not the only parties who were overly optimistic, nor was the mortgage market the only place where excessive optimism prevailed. Risk generally was being undervalued in credit markets.

However, to the extent that participants in the residential mortgage markets -- including the bond rating firms -- were counting on the persistence of low interest rates and the continuation of double digit increases in housing prices, so that even weak or speculative mortgage borrowers could "always" sell their houses at a profit or refinance into a low interest mortgage to avoid defaults, then these participants were being hopelessly and unrealistically optimistic.

Further, the bond raters' excessive optimism played a special enabling role. Their excessively optimistic ratings on some MBS and related structured finance derivative securities (such as collateralized debt obligations, or CDOs) that were based on subprime mortgages meant that these securities carried lower interest rates, which in turn meant that the underlying mortgages carried lower interest rates -- which allowed more subprime borrowers to qualify for mortgages. With less favorable ratings, fewer subprime mortgages would have been originated, and fewer defaults would have subsequently occurred.

Separate from this excessive optimism has been the bond raters' delays afterward in downgrading these securities as borrower defaults mounted. These delays could not affect the original defaults; once the mortgages were originated, the subsequent performance of those mortgages could not be affected by any post-origination delays in downgrades of these securities. The delays only affected (to the extent that market repricings had not already fully anticipated the changes) who would bear the losses on these securities.

Here, the story as to why the bond raters have been slow to downgrade is clearer. To a large extent -- with only one new element -- it is a repeat of the reasons for their delay in the Enron and other, earlier downgrades.

First, the bond rating firms have a conscious policy of not trying to adjust their ratings with respect to short-run changes in financial circumstances; instead, they try to "rate through the cycle". Regardless of the general wisdom of such a philosophy, it does mean that when the short-run changes are not part of a cycle but instead are the beginning of a longer-run trend, the bond raters will be slow to recognize that trend and thus slow to adjust their ratings.

Second, the two leading bond rating firms -- Moody's and S&P -- have not been unaware of the adverse consequences of their downgrades for the downgraded securities and for the securities' issuers. The downgrade will likely make the raising of capital more difficult and expensive. Further, some bond covenants contain ratings-dependent "triggers" that can force redemptions (this is true of some structured-finance bonds, as well as corporate bonds), further exacerbating the problems of a company that may already be stressed. This consciousness of the consequences has tended to make them more cautious and conservative with respect to downgrades.

Third, the downgrades are a recognition that their earlier ratings were wrong -- and wrong in an adverse way. Few individuals, or organizations, enjoy admitting that they were wrong. This too must also cause delay.

Fourth, and this is a new element in the current situation, the bond raters have had to deal with (for them) a new kind of risk. For their traditional ratings of corporate, municipal, and sovereign bonds, and even for rating simple MBS, they have focused solely on credit (or default) risk: the possibility that the borrower will fail to repay its obligations in full and in a timely manner.

In rating collateralized debt obligations (CDOs), however, where the underlying collateral was MBS and other securities, an extra feature could affect the ability of the CDOs to be paid off in full and in a timely manner: liquidity risk, which is the risk that the markets for the underlying collateral will become illiquid (perhaps because of fears and uncertainties among market participants as to underlying repayment possibilities), leading to unusually wide spreads between bid and ask prices for those underlying securities. Those wider spreads, in turn, could trigger forced liquidations of the asset pools underlying the CDOs and lead to unexpected losses to the investors in the CDO securities, even if the underlying collateral were ultimately to perform with respect to credit risk along the lines that had been predicted.

I believe that the bond raters were slow to recognize this additional element of risk, which further contributed to their delays in downgrading.

VI. What Is to Be Done?

With large losses in the residential subprime mortgage and related markets -- some estimates have been in the vicinity of $100 billion -- and large numbers of households facing defaults and foreclosures, the temptations for legislative and regulatory remedies are great. Since this is a hearing on the bond rating firms, I will confine my comments to their domain: I strongly urge the Congress *not* to undertake any legislative action that would attempt to correct any perceived shortcomings of the bond rating firms. I base this plea on two grounds:

First, it is difficult, if not impossible, to legislate remedies that could somehow command the bond raters to do a better job. One could imagine legislation that would mandate certain business models -- say, forcing the industry back to its pre-1970s model of selling ratings to investors, because of concerns about potential conflicts of interest -- or that would mandate certain standards of required expertise as inputs into the rating process. But such legislation risks doing far more harm than good, by rigidifying the industry and reducing flexibility and diversity.

If given the opportunity, the participants in the financial markets will learn about persistent mistakes and will take their business elsewhere, thereby providing strong incentives for improved performance without the need for legislation.

Second, as was discussed above, the Credit Rating Agency Reform Act of 2006 was signed just a year ago, and the final implementing regulations were promulgated only three months ago. Including the two firms that were newly designated in May 2007, just before the final regulations were promulgated, there are now seven NRSROs. The SEC's more timely and transparent procedures under the Act should yield at least a few more.

The financial markets -- and equally important, financial regulators -- should be given an opportunity to adjust to the new circumstances of a more competitive ratings market, with more choices, more business models, and more ideas. It will be important to see whether and how the financial regulators adjust their regulatory delegations in this new and potentially different environment.

In sum, the new Act should be given the opportunity to show its potential for beneficially changing the bond rating industry.

VII. Conclusion

The subprime mortgage debacle and its related consequences are an unfortunate reality today. The losses are likely to be substantial, and they will be borne widely. Many parties can share some of the blame. The major bond rating firms, who were clearly excessively optimistic with respect to the repayment prospects of subprime mortgage borrowers over the past few years, surely share in some of that blame.

If given the opportunity, however, the financial markets will find ways of fixing problems so that they are less likely to occur in the future. The Credit Rating Agency Reform Act of 2006, passed only a year ago, provides that opportunity. It replaces the former repressive, protective regulatory regime that surrounded the bond rating industry with a more open and transparent framework that is likely to yield more competition, more alternatives, and more ideas. That new framework deserves a chance to succeed.

Some recent published writings on the bond rating industry by Lawrence J. White

"The Credit Rating Industry: An Industrial Organization Analysis," in Richard M. Levich, Carmen Reinhart, and Giovanni Majnoni, eds., Ratings, Rating Agencies, and the Global Financial System. Boston: Kluwer, 2002, pp. 41-63.

"The SEC's Other Problem," Regulation, 25 (Winter 2002-2003), pp. 38-42.

"Good Intentions Gone Awry: A Policy Analysis of the SEC's Regulation of the Bond Rating Industry," Policy Brief #2006-PB-05, Networks Financial Institute, Indiana State University, 2006.

"A New Law for the Bond Rating Industry," Regulation, 30 (Spring 2007), pp. 48-52.