LET'S HELP THE CREDIT RATING AGENCIES GET IT RIGHT: A SIMPLE WAY TO ALLEVIATE A FLAWED INDUSTRY MODEL

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Introduction

Credit ratings agencies have been a hot topic of discussion since the recent financial collapse. The rating agencies drastically overrated billions of dollars of securities that were at the heart of the meltdown.[1] Remember those infamous residential mortgage-backed securities ("RMBSs") and collateralized debt obligations ("CDOs")? With the credit rating agencies' AAA stamp of approval, those securities infiltrated and eventually suffocated thousands of banks and institutions, ultimately driving the world into its first economic recession in decades.[2]

The agencies were also criticized for earlier instances of alleged mis-rating. Consider the Enron and WorldCom bankruptcies in the early part of the decade. Amidst the drama surrounding Ken Lay, Jeffrey Schilling and the manipulated accounting techniques of Enron, the rating agencies maintained Enron's investment grade rating up until a mere five days before the company declared bankruptcy.[3] The agencies also failed to timely downgrade WorldCom's credit rating despite indications of a deteriorating

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[1] *See* Gary Gorton, *The Subprime Panic,* 15 EUR. FIN. MGMT. 10, 32 (2009); Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007-2008,* 23 J. ECON. PERSPECTIVES 77, 80 (2009); Viral V. Acharya & Matthew Richardson, *Causes of the Financial Crisis*, 21 CRITICAL REV. 195, 197 (2010).

[2] Lawrence J. White, *Markets: The Credit Rating Agencies*, 24 J. ECON. PERSPECTIVES 211, 212 (2010).

[3] *Id.* at 218; Richard A. Oppel, Jr., *Credit Rating Agencies Say Enron Dishonesty Misled Them*, N.Y. TIMES, Mar. 21, 2002, http://www.nytimes.com/2002/03/21/business/enron-s-many-strands-hearings-credit-agencies-say-enron-dishonesty-misled-them.html.

financial state.[4] The agencies' sluggish responses spurred governmental investigation and resulted in new regulation for the industry.[5]

What can be done to prevent such mistakes from happening again, particularly in the context of market-wide bubbles? To address an ultimate solution, it is necessary to assess the underlying problems and their causes. The rating agencies' missteps might be attributable to forces beyond their control or inevitable human error. After all, rating agencies are comprised of people, and people are not perfect. Alternatively, the mis-ratings of the 2008 financial crisis may have resulted from a high volume of increasingly complex, novel securities and an unprecedented housing bubble.[6]

The deeper truth, however, is that the industry suffers from two critical defects that potentially compromise the accuracy of ratings. First, the credit rating market is an oligopoly dominated by very few firms. Second, the major credit rating agencies are paid by the issuers whose securities they rate, creating a substantial conflict of interest. As evidenced by the recent financial collapse, credit rating agencies may be pressured to give higher ratings than are warranted in order to please the issuers that pay the bills.

The recognition of the oligopolistic nature of the industry and the conflict of interest is critical to an effective assessment of possible remedies. The agencies have been vilified and criticized,[7] with the response to their missteps being increased regulation in the form of oversight, transparency and internal compliance mechanisms.[8] These responses, however, have largely been met with

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[4] *See* White, *supra* note 2, at 218; Luisa Beltran, *WorldCom Files Largest Bankruptcy Ever*, CNNMONEY.COM, July 22, 2002, http://money.cnn.com/2002/07/19/news/worldcom_bankruptcy/. *See also* Christopher Whalen, *Standard and Poor's and the Ratings Game,* REUTERS, Aug. 8, 2011, http://blogs.reuters.com/christopher-whalen/2011/08/08/standard-poors-and-the-ratings-game/.

[5] Oppel, *supra* note 3.

[6] *See* Elliot Blair Smith, *"Race to Bottom" at Moody's, S&P Secured Subprime's Boom, Bust*, BLOOMBERG, Sept. 25, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ax3vfya_Vtdo [hereinafter *Race to Bottom*].

[7] *See id.*; Claire A. Hill, *Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?*, 71 U. PITT. L. REV. 585, 585 (2010).

[8] *See* Marie Leone, *Bush Signs Rating Agency Reform Act*, CFO.COM, Oct. 2, 2006, http://www.cfo.com/article.cfm/7991492; *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Impact on Credit Rating*

negative reactions from both industry players and scholars. The regulatory steps taken thus far are largely ineffective and possibly detrimental to the industry as a whole. What more can regulators do to ensure rating accuracy?

Various reform proposals have been suggested, including elimination of the government's significant influence over the industry or creation an entirely government-sponsored rating entity. It appears, however, that most of these reform proposals suffer from one or more serious defects or risks. That said, a perfect solution might not be feasible. At the end of the day, it is good enough for a proposal's benefits to outweigh its risks. With this reality in mind, this note advocates a simple reform.

The ultimate goal of reform should be to ensure credit rating accuracy. Specifically, the most important aspect of rating accuracy is the avoidance of unduly *high* ratings—as opposed to unduly *low* ratings—that catalyze market-wide bubbles and carry the potential to cause economic recessions. In this role, rating agencies should properly detect risky securities and label them as such via an accurately low credit rating. But this critical aspect of a rating agency's job is jeopardized because of the aforementioned conflict of interest that potentially leads to unduly high ratings. The harms resulting from the oligopolistic nature of the industry exacerbate the problem. To counter this risk, the agencies should be incentivized to give accurately low ratings to risky debt instruments. This note proposes to accomplish this goal by rewarding the rating agencies with a deduction when they accurately rate a security or entity that defaults.

When an agency gives a lower rating to a security that defaults, the agency has fulfilled the most important aspect of its job: correctly notifying the investing public of a risky asset. The agencies have done a public service. Rewarding the agencies by not taxing this public service comes at a cost well worth the benefit: a counter to the inherent industry flaws that entail the risk of unduly high ratings. Although it faces implementation questions, such a mechanism would likely result in more accurate ratings.

Part I of this note examines the oligopolistic state of the industry and why it is problematic. Part II turns to the conflict of interest and its materialization leading up to the financial crisis. Part

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Agencies, PRICEWATERHOUSECOOPERS, LLP (Sept. 2010), *available at* http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/closer-look-credit-rating-agencies.pdf.

III reviews legislation aimed at improving the industry within the last decade and the industry's response to such legislation. Part IV discusses four existing reform proposals that have not yet been implemented. Part V explains and defends this note's proposal.

I. The Credit Rating Oligopoly

Lawmakers and scholars alike have recognized the credit rating agency oligopoly.[9] The industry fits the traditional mold of an oligopoly in almost every respect. Traditional oligopoly traits—barriers to entry, few market participants, interdependence, price setting and high profitability—are clearly visible within the industry. Consequently, market participants and investors should be aware of risks commonly found within oligopolistic markets, including inefficiency, complacency, and suppressed innovation.

A. Barriers to Entry

Oligopolies are characterized by the existence of one or more significant barriers to entry into the market.[10] Barriers can come in many forms, including government intervention, substantial capital requirements, and economies of scale.[11] For credit rating agencies, barriers include reputational capital and cost spreading, in addition to government certification.

Government certification is the most obvious barrier to entry for credit rating agencies. The Securities and Exchange Commission ("SEC") certifies only select credit rating agencies as Nationally Recognized Statistical Rating Organizations ("NRSRO").[12] Created in 1975,[13] the label carries substantial legal weight because regulatory agencies incorporate the NRSRO designation into their

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[9] *See* White, *supra* note 2, at 216; Lawrence J. White, *The Credit Rating Industry: An Industrial Organizational Analysis,* 10–11 (Apr. 20, 2011), *available at* http://archive.nyu.edu/bitstream/2451/26205/2/1-2.pdf; Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers,* 60 (May 2006), *available at* http://ssrn.com/abstract=900257; Hill, *supra* note 7, at 587.

[10] ROY J. RUFFIN & PAUL R. GREGORY, PRINCIPLES OF MICROECONOMICS 222 (1983); EDWIN MANSFIELD, MICROECONOMICS 369 (9th ed. 1997).

[11] RUFFIN & GREGORY, *supra* note 10, at 221–22.

[12] *See Credit Rating Agencies—NRSROs*, SEC.GOV, http://www.sec.gov/answers/nrsro.htm (last visited April 5, 2012) [hereinafter SEC Info].

[13] White, *supra* note 2, at 213–14.

rule-making.[14] Regulated entities, such as institutional investors and broker dealers, are required to hold assets of a certain quality level, based on NRSRO ratings.[15] Thus, issuers' demand for and investors' reliance on NRSRO ratings is heightened by government intervention. Conversely, the demand for non-NRSRO ratings is drastically smaller because investors cannot rely on those ratings to satisfy regulatory requirements.[16] NRSRO ratings are also utilized in private contracts, bank pricing grids, pension parameters, and internal risk guidelines of institutional investors.[17]

Between 1975 and 2006, the SEC rejected the vast majority of agencies that applied for NRSRO status.[18] At the same time, it refused to reveal any formal admission criteria.[19] In the wake of the WorldCom and Enron debacles, however, Congress enacted the Credit Rating Agency Reform Act of 2006 ("CRARA"), which, among other things, demanded that the SEC cease acting as a stringent barrier into the NRSRO market.[20] The SEC has named five new NRSROs since the CRARA was passed,[21] but it still rejects applicants of the NRSRO designation if it finds adequate basis to do so.[22] Moreover, agencies are deterred from applying for NRSRO status due to high compliance costs, liability exposure and regulatory requirements that accompany the designation.[23] That said, the NRSRO designation is not the most significant barrier.[24]

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[14] *See* John C. Coffee, Jr., *Ratings Reform: The Good, The Bad, and The Ugly,* 1 HARV. BUS. L. REV. 231, 247 (2010).
[15] *Id.*
[16] *Id.*
[17] *Oversight of the Credit Rating Agencies Post Dodd-Frank*: *Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 112th Cong. 2 (2011) (testimony of James H. Gellert), [hereinafter Gellert Testimony].
[18] *See* Coffee, *supra* note 14, at 247. If the criteria for becoming an NRSRO were too relaxed, incompetent or fraudulent agencies could enter the market and arbitrarily give investment grade ratings. *See* White, *supra* note 9, at 26.
[19] *See* Coffee, *supra* note 14, at 247.
[20] White, *supra* note 2, at 222.
[21] *Id.*
[22] *See* U.S. SECURITIES AND EXCHANGE COMMISSION, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 10–14 (Jan. 2011), *available at* http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0111.pdf [hereinafter ANNUAL SEC REPORT]
[23] Gellert Testimony*, supra* note 17, at 4–5.
[24] Coffee, *supra* note 14, at 262–63.

The most powerful barrier to entry is the informal stranglehold the major agencies have on the industry through their amassed reputational capital.[25] Reputation is of crucial importance to the success of a credit rating agency; after all, its product hinges on its reputation for maintaining objective, accurate assessments of creditworthiness.[26] A positive reputation cannot be built overnight because it takes time to assess the accuracy and quality of an agency's ratings.[27] Additionally, the "two-rating norm"—the common practice of issuers to obtain ratings from both Standard and Poor's ("S&P") and Moody's Corporation ("Moody's")[28]—perpetuates S&P and Moody's as the go-to rating agencies, particularly in the realm of corporate bonds.[29] In the structured products realm, where Fitch Ratings ("Fitch") has distinguished itself, deals were rated by two or three agencies, almost exclusively among S&P, Moody's, and Fitch (the "Big Three").[30] From the issuer's perspective, the downside of not abiding by the norm (hurting a large debt issuance) outweighs its potential upside (avoiding the cost of an extra rating) because the fees charged by the agencies are a small fraction of the total value of the debt issuance.[31]

One final significant barrier is the economies of scale and sunk costs that benefit incumbent agencies. This barrier is particularly relevant within the realm of novel or structured products that require intensive analysis, such as RMBSs and CDOs. Large, incumbent agencies are better able to allocate various expenses, including analytical, administrative, legal, and marketing costs,

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[25] John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement,* 2009 COLUM. BUS. L. REV. 109, 179 (2009).
[26] ANNUAL SEC REPORT, *supra* note 22, at 12.
[27] *Id.* at 13. *See also Oversight of the Credit Rating Agencies Post Dodd-Frank*: *Hearings Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 112th Cong. 5 (2011) (testimony of Jules B. Kroll) [hereinafter *Kroll Testimony*] (citing to a Kroll Bond Ratings study, according to which sixty-seven of the top one hundred pension funds mandate the use of ratings by at least one of the top three rating agencies).
[28] Claire A. Hill, *Regulating the Rating Agencies*, 82:43 WASH. U. L. QUARTERLY 42, 61 (2004).
[29] Lynn Bai, *On Regulating Conflicts of Interest in the Credit Rating Industry*, 13 N.Y.U. J. LEGIS. & PUB. POL'Y 253, 304 (2010).
[30] *Id.* at 269.
[31] Hill, *supra* note 28, at 62.

across a wide range of ratings.[32] At the same time, those incumbent agencies are more likely to have large sunk costs that have produced methodologies and procedures, while newer agencies must produce the same tools from scratch.[33] As a result, the large NRSROs tend to have higher after-tax profit margins than the smaller NRSROs.[34]

B. Few Market Participants

Strong barriers to entry perpetuate the small number of firms that occupy the industry.[35] Among approximately 150 credit rating agencies worldwide,[36] only a handful carry the all-powerful NRSRO designation.[37] Between 2000 and 2006, there were no more than five registered NRSROs.[38] Only after congressionally directed easement of acceptance criteria did the SEC slowly raise that number to ten, where it stands today.[39] But the current number of registered NRSROs, already quite modest, is deceiving. Despite recent additions to the "NRSRO club," the market is effectively dominated by three firms: Moody's, S&P, and Fitch. The other seven NRSROs occupy small, distinct niches within the ratings market.[40]

The two most dominant NRSROs are Moody's and S&P, which account for about 79.6 percent of all outstanding ratings.[41] Each agency holds approximately 40 percent of the market.[42] Congress has recognized the two as a "duopoly" or "partner-monopoly."[43] Fitch holds approximately 17.6 percent of the market, making it the third largest agency.[44] In total, the Big Three account for an astounding 97 percent of all outstanding ratings.[45] The Herfindahl-Hirschman Index ("HHI")—a measure of market concentration and competition that is utilized by the SEC in their

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[32] ANNUAL SEC REPORT, *supra* note 22, at 12.
[33] *Id.*
[34] *Id.* at 9.
[35] MANSFIELD, *supra* note 10, at 351.
[36] White, *supra* note 2, at 216.
[37] SEC Info*,* supra note 12.
[38] White, *supra* note 2, at 222.
[39] *Id.*
[40] Coffee, *supra* note 14, at 248.
[41] ANNUAL SEC REPORT, *supra* note 22, at 5.
[42] *See* White, *supra* note 2, at 216.
[43] ANNUAL SEC REPORT, *supra* note 22, at 10–11.
[44] *Id.* at 5
[45] *Id.* at 7.

annual report of credit rating agencies—illuminates this statistic.[46] The HHI for the NRSRO market indicates that there are effectively 2.86 firms in the industry.[47] Thus, even with ten NRSROs, the industry operates as a three-firm gig. The Big Three comprise the true oligopoly.

C. Interdependence

The relatively few firms that occupy an oligopolistic market experience great interdependence between one another.[48] Actions by one market participant influence sales and profits of the other participants.[49] Thus, each participant makes policy and overarching business decisions with an eye to its fellow participants.[50] The credit rating oligopoly is no exception. Consider bankruptcies such as Enron and Lehman Brothers, where the major rating agencies maintained investment grade ratings right up until bankruptcy was declared.[51] Although possibly the result of exterior circumstances, it is logical that one agency's downgrade or upgrade—or inaction—affects how other agencies view their own rating. In this regard, one recent study indicates that the agencies "herd" with one another for high ratings.[52] According to the study, Moody's rating behavior closely tracked S&P's from 1994 to 2005 for upgrades, but not downgrades.[53]

Two other examples better illuminate the industry's interdependence. First, the industry's shift from the subscriber-pay model to the issuer-pay model clearly exemplifies reactionary activity.[54] Although the subscriber-pay model had been the bedrock

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[46] *Id.* at 6–7

[47] An HHI greater than 1000 indicates a moderately concentrated market, and an HHI greater than 1800 is considered a concentrated market; the HHI for the NRSRO market is 3,495, or the equivalent of there being 2.86 firms in the industry; notably, asset-backed securities have the second lowest HHI inverse (3.18 this year, but 2.71 and 2.82 for 2007 and 2008, respectively), behind only governmental securities—meaning that those securities were almost entirely rated by a few select firms, the Big Three. *Id.*

[48] MANSFIELD, *supra* note 10, at 351.

[49] *Id.*

[50] *Id.*

[51] White, *supra* note 2, at 218.

[52] Bai, *supra* note 29, at 270; Coffee, *supra* note 14, at 246.

[53] Bai, *supra* note 29, at 270.

[54] White, *supra* note 2, at 214.

of revenue generation since 1909, all of the major agencies switched to the issuer-pay model simultaneously in the early 1970s.[55] If the industry lacked interdependence, a few firms would likely have retained the subscriber-pay model, or made the shift to issuer-pay at a later time. The clearest example of interdependence, however, is also the most alarming. S&P and Moody's simultaneously adjusted their modeling techniques in 2004 to sell more top-rated mortgage backed securities; one week after Moody's implemented a new rating methodology to allow for higher ratings, S&P revised its own rating models, emphasizing the "threat of losing deals."[56] This reaction by S&P to adjust its rating methodology, clearly in a competitive attempt to keep up with Moody's, is a prime example of interdependence.

D. Price Setting and Profitability

Oligopolists tend to exercise some measure of price control[57] and earn above average profits.[58] Within the rating industry, there is no regulatory restriction on fees, so the agencies are free to charge what they like.[59] The market would otherwise determine an efficient price. But the demand side of the market is essentially required to purchase the agencies' ratings to satisfy agency rule-making, thereby limiting the market's ability to determine an efficient price.[60] Moreover, the incumbent agencies' reputations allow them to command a higher price.[61] The Senate and SEC have recognized that increased competition might lead to lower prices,[62] which suggests that the current structure suffers from higher prices than are necessary.

Perhaps the clearest evidence of the agencies' price-setting ability is the exceedingly high profits they have realized over recent

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[55] The possible reasons for the switch are many, including the development of the photocopy machine, which increased the risk of free-riding; regardless of the reason, virtually the entire industry made the shift, indicating that firms who failed to adapt would be left behind. *Id.* at 214–15.
[56] Smith, *supra* note 6.
[57] RUFFIN & GREGORY, *supra* note 10, at 218.
[58] EDWIN MANSFIELD, MICROECONOMICS 330 (1st ed. 1970).
[59] Hill, *supra* note 28, at 81.
[60] Hunt, *supra* note 25, at 143.
[61] ANNUAL SEC REPORT, *supra* note 22, at 12.
[62] *Id.* at 16.

years. In addition to tripling its revenue and net income from 2000 to 2004,[63] Moody's realized the highest profit margins in the S&P 500 five years in a row until 2007.[64] Although S&P is not publicly traded, their revenues are estimated to have tripled between 2002 and 2007.[65] More recently, the pretax profit margins for the two powerhouses exceeded 45 percent from 2008 through 2010.[66] The Big Three accounted for over 98 percent of earnings reported by all NRSROs.[67]

E. Consequences of Oligopoly

Because the rating industry fits the traditional mold of an oligopology—by exhibiting barriers to entry, few participants, interdependence, and large profitability—market participants should be wary of the negative consequences that accompany an oligopolistic market structure. Such consequences include inefficiency, complacency, and suppressed innovation.

Oligopolies tend to be inefficient because higher prices, derived from price-setting power rather than efficient market determination, result in decreased productivity.[68] For the rating agencies, decreased productivity might manifest in the form of methodology errors and inaccurate ratings. Leading up to the financial collapse, analysts at both Moody's and S&P discovered flaws in their rating methodologies that sometimes overrated securities.[69] In this vein, several commentators note that, if the rating

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[63] Partnoy, supra note 9, at 65.

[64] Yair Listokin & Benjamin Taibleson, *If You Misrate Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91, 92 (2010).

[65] *Ratings Agencies Face Glare of Meltdown Probe,* CBSNEWS.COM, Apr. 23, 2010, http://cbsnews.com/stories/2010/04/23/business/main6425009.shtml.

[66] Robert G. Wilmers, *Dodd-Frank: Financial Reform Didn't Fix Big Problems,* RICHMOND TIMES-DISPATCH, Oct. 23, 2011, *available at* http://www2.timesdispatch.com/news/commentary/2011/oct/23/dodd-frank-financial-reform-didnt-fix-big-problems-ar-1402739/.

[67] ANNUAL SEC REPORT, *supra* note 22, at 9.

[68] *See* MANSFIELD, *supra* note 58, at 330; *Oligopoly: Defining and Measuring Oligopoly*, ECONOMICSONLINE.CO.UK, http://economicsonline.co.uk/Business_economics/Oligopoly.html (last visited Apr. 5, 2012).

[69] Smith, *supra* note 6 (stating that Kai Gikes, an S&P quantitative analyst, discovered that the ratings systems occasionally overstated the quality of certain CDO securities in 2005); Gretchen Morgenson, *BB? AAA?*

industry fostered greater competition, the quality of ratings would likely increase.[70]

Moreover, members of oligopolies are often aware of their entrenchment in the market, resulting in increased complacency for lack of fear of removal.[71] Because the incumbent agencies know of their unique and powerful position, they might become less worried about their long-run reputation and succumb to short-term considerations.[72] Complacency for the agencies may have taken the form of mistakes in their rating models,[73] cutting corners for specific rating jobs[74] and, ultimately, the failure to accurately detect the true risk associated with RMBSs and CDOs.

Finally, oligopolistic markets can suppress innovation. The lag-time associated with ratings is one indicator that the industry might benefit from fresh rating methodology ideas. Similar to their treatment of WorldCom and Enron, the agencies maintained high ratings for AIG, Citigroup, Merrill Lynch, Fannie Mae, and Freddie Mac right up until their collapse.[75] In an ideal market, a wide variety of different modeling techniques would be utilized by various agencies, with the best ones surviving.[76] Instead, the Big Three have utilized very similar modeling techniques,[77] and the opportunity for new players with innovative ideas to enter the market is strained due to the oligopoly. Regulatory changes contribute to the problem by further entrenching the Big Three and impeding innovative credit assessment techniques and methods.[78] Finally, the SEC has recognized harmful network externalities within the industry that magnify this exact risk.[79] Network externalities exist when a

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Disclosure Tells Us More, N.Y. TIMES, Sep. 5, 2010, at BU1 (finding a Moody's analyst discovered a flaw in rating constant proportion debt obligation notes in early 2007).

[70] *See* Claire A. Hill, *Limits of Dodd-Frank's Rating Agency Reform*, 15 CHAP. L. REV. 133, 147 (2010); Hill, *supra* note 28, at 85; ANNUAL SEC REPORT, *supra* note 22, at 16; Coffee, *supra* note 14, at 240.

[71] White, *supra* note 2, at 221.

[72] *Id.*

[73] Morgenson, *supra* note 69.

[74] Hill, *supra* note 7, at 591 & 595.

[75] INSIDE JOB (Sony Pictures Classics 2010).

[76] Hunt, *supra* note 25, at 132–33.

[77] *Id.* at 133.

[78] White, *supra* note 2, at 223.

[79] ANNUAL SEC REPORT, *supra* note 22, at 13.

product's value increases the more it is used by consumers.[80] For the rating industry, issuers and banks may choose its rating agency based on the breadth of the agency's rating coverage and how many issuers utilize the agency's ratings.[81] In other words, issuers and banks will choose the Big Three. Thus, superior products may fail to win market share in the industry, notwithstanding their differentiated and beneficial features.[82]

II. The Inherent Conflict of Interest

A. The Conflict of Interest Explained

The oligopolistic nature of the industry is undoubtedly cause for concern, but the industry's most infamous feature is the conflict of interest that the large agencies face. This conflict primarily stems from the fact that the agencies are paid by the issuers and banks whose financial obligations they rate.[83] Issuers desire higher ratings because the interest rate they must pay on the securities they issue will be lower.[84] Likewise, banks acting as securitizers earn greater profit if a larger percentage of tranches attain higher ratings.[85] This is troublesome because the interests of investors and issuers diverge; investors desire accuracy and issuers desire favorable ratings. Thus, an agency may be torn between serving the public investors, who rely on accurate ratings to make informed financial decisions and to satisfy regulatory requirements, and serving the issuers and banks, which influence agency profit and market-share with their business.[86]

The potential conflict has not gone unnoticed. Nobel Prize winning economist Joseph Stiglitz noted that the agencies' incentive structure is "perverse" and analogous to "what college professors know as grade inflation."[87] Others have called the system a "form of

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[80] *Id.*
[81] *Id.* at 13–14.
[82] *Id.* at 14.
[83] Egan-Jones Ratings Company is the only NRSRO that utilizes the subscriber pay model. White, *supra* note 2, at 214.
[84] Yuval Bar-Or, *Rating Agencies Should Get a Death Sentence*, FORBES, Sept. 24, 2010, http://www.forbes.com/2010/09/24/dodd-frank-moodys-financial-advisor-network-credit-ratings.html.
[85] White, *supra* note 2, at 221.
[86] *Id.* at 215.
[87] Hill, *supra* note 7, at 593.

corruption,"[88] and a CFA survey indicated that most respondents believe the issuer-pay structure to be the most significant source of conflict for the agencies.[89] Moreover, in its report before passing the Dodd-Frank Consumer Protection and Financial Reform Act (the "Dodd-Frank Act"), the House of Representatives clearly recognized the inherent conflict of interest as a legitimate problem.[90] Validating critics' concerns is Egan-Jones Ratings Company ("Egan Jones"). As the only NRSRO that utilizes the subscriber-pay model, Egan Jones has experienced greater rating accuracy and timeliness than its issuer-pay counterparts.[91] But despite Egan Jones' successful utilization of the subscriber-pay model, elimination of the issuer-pay model for the rest of the industry is unfeasible for several reasons.[92]

Alarmingly, the oligopolistic state of the industry appears to exacerbate the conflict of interest. The agencies sometimes compete against one another within the oligopoly, but the benefits that usually accompany a competitive market are not realized because competition centers on satisfying customers (issuers and banks) instead of end users of ratings (investors). Although the industry's oligopolistic state largely confines competitive pressure to the Big Three, thereby reducing the ability of banks and issuers to rate-shop, it also prevents investor-friendly rating agencies from entering the market.[93] Moreover, because the incumbent agencies are entrenched, a modest amount of unduly high ratings will not affect their strong market positions.[94] Thus, the agencies are capable of satisfying short-run objectives without materially compromising long-run goals. This is consistent with a recent model indicating that, in a duopolistic market where investors are largely naïve and reputational costs low, equilibrium exists when both rating agencies inflate their ratings.[95] At least one commentator has determined that the conditions for

[88] *Id.* at 593–94.
[89] *Id.*
[90] H.R. REP. NO. 111-517, at Sec. 931(4) (2010) (Conf. Report) ("Credit rating agencies face conflicts of interest that need to be carefully monitored and that therefore should be addressed explicitly in legislation.").
[91] Valentina Bruno, Jess Cornaggia & Kimberly J. Cornaggia, *The Information Content of Credit Ratings: Compensation Structure Does Matter*, 31 (Nov. 21, 2011), *available at* http://www.egan-jones.com/studies.
[92] Bai, *supra* note 29, at 294.
[93] *See* Coffee, *supra* note 14, at 269.
[94] *Id.*
[95] Bai, *supra* note 29, at 268.

equilibrium under this model—a large fraction of naïve investors and low reputational costs—are satisfied.[96]

Still, several commentators doubt that a conflict of interest problem exists: they argue that an agency would not risk its reputation by producing inaccurate ratings because the agency's reputation for delivering high-quality, accurate ratings is its core competency; this is known as the reputational capital theory.[97] According to the theory, the risk of unduly high ratings is deterred by the fear of lost reputation.[98] Consistent with the theory, one former S&P managing director said that he never once witnessed a conflict of interest problem in the work place.[99]

But the reputational capital theory is flawed for several reasons. As mentioned above, the Big Three can sacrifice some reputational capital because they are entrenched within the oligopoly and barriers to entry are high.[100] Moreover, the major agencies exhibit "herding" behavior, where the ratings of one agency track those of another.[101] This means that a rating error will not result in unique reputational harm to a single agency, and instead might appear systemic.[102] Finally, reputation is unlikely to constrain rating agencies from issuing inaccurate ratings for novel financial products, such as CDOs and RMBSs.[103] Because rating agencies have not yet accumulated reputational capital for rating products they have never rated before, they risk nothing by issuing an inaccurate rating.[104] Whatever the reason, reputational capital failed to offset the pressure to satisfy issuers leading up to the financial collapse.

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[96] About sixty-five percent of reportable trades in corporate bonds are "retail" trades less than $100,000 (largely naïve), and moderate inflation has no negative effect on an agency's performance statistics (low reputational costs). *Id.*

[97] Hunt, *supra* note 25, at 128-29.

[98] *Id.*

[99] Interview with William Chambers, Assoc. Professor of Prof'l Practice in Admin. Sciences, Bos. Univ., and Former Managing Dir., Standard & Poor's, in Bos., Mass. (Nov. 10, 2010).

[100] Coffee, *supra* note 14, at 269.

[101] *Id.* at 259.

[102] *Id.*

[103] Hunt, *supra* note 25, at 113.

[104] *Id.* at 114.

B. The Conflict of Interest Leading Up to the Financial Crisis

The conflict of interest was largely kept in check for three decades after the adoption of the issuer-pay model in the early 1970s.[105] It appears to have materialized in a dramatic way, however, with the titanic flow of structured products[106] leading up to the financial crisis. The Big Three competed against one another within the oligopoly in an attempt to satisfy issuers and retain market share of the lucrative structured products market. Looking at the then-current market environment, it makes sense that the agencies would give unduly high ratings. Three primary elements exacerbated the conflict and increased the risk of unduly high ratings: the extraordinary profitability in rating structured products, banks' ability to rate-shop, and rating consulting services offered by the agencies.

The rating agencies could earn up to three times more revenue from rating the new, complex CDOs than they could earn from traditional corporate bonds.[107] Couple this high profit potential with the banks' ability to "rate-shop," or take their business elsewhere if they were displeased with a rating, and the conflict was heightened. The two-rating norm, which might otherwise prevent rate-shopping, was not present within market for structured products, so the Big Three competed among themselves for business.[108] Moreover, the market for RMBSs and CDOs involved only a handful of investment banks with large volumes of securitized products.[109] The top six RMBS underwriters controlled 50 percent of the market, and the top twelve controlled 80 percent of the market.[110] This meant that an unfavorable rating for a single issuance entailed the risk of losing an extremely valuable customer.[111] Finally, the agencies

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[105] White, *supra* note 2, at 214.

[106] Gorton, *supra* note 1, at 27 (finding that the issuance of asset-backed CDOs tripled from 2005 to 2007, and they became increasingly comprised of subprime RMBS); Acharya & Richardson, *supra* note 1, at 200 (finding that securitization drastically increased from 2001 to 2007, with the amount of worldwide asset-backed securities increasing from $767 million in 2001 to $2.7 trillion in 2006).

[107] Smith, *supra* note 6; White, *supra* note 2, at 221.

[108] Bai, *supra* note 29, at 269.

[109] White, *supra* note 2, at 221.

[110] Coffee, *supra* note 14, at 238.

[111] White, *supra* note 2, at 221.

offered consulting services to issuers and banks, outlining how securities could be structured to garner high ratings.[112] In light of the substantial profitability resulting from the services,[113] agencies might give higher ratings to an issuer in an attempt to garner business from that issuer for consulting services.[114] These services also facilitated the ability of the already powerful banks to pressure the agencies,[115] while at the same time compelling the agencies to honor their consulting advice.[116] The services have been compared to Arthur Andersen's consulting activity during the Enron scandal.[117]

Ample evidence indicates that these elements resulted in the materialization of the conflict of interest. In its annual report on credit rating agencies immediately after the financial meltdown in 2008, the SEC expressly recognized the problem: "[i]ssues were identified in the management of conflicts of interest and improvements can be made."[118] The agencies admit that investment banks did indeed shop around for the best rating.[119] The agencies' focus on maintaining, or attaining, market-share of the lucrative structured products market at the expense of accuracy is evidenced by their actions and internal communications. For instance, when Moody's revised its rating models to allow higher ratings for mortgage backed securities in 2004, S&P followed suit, after an internal email emphasized the "threat of losing deals."[120] Moreover, an S&P analyst discovered a rating flaw that overrated CDO Squared securities in 2005.[121] When the prospect of tightening ratings criteria was brought up, a director of CDO ratings disagreed, saying "Don't kill the golden goose."[122] Looking back, one former S&P managing

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[112] *Id.* at 220–21.

[113] Moody's revenue from ancillary services was approximately $550 million in 2008, which comprised about thirty percent of the total revenue generated by the agency. *See* Moody's Corp., Annual Report (Form 10-K), at 92–93 (Mar. 2, 2009), *available at* http://ir.moodys.com/annuals.cfm.

[114] Bai, *supra* note 29, at 263.

[115] White, *supra* note 2, at 220-221.

[116] Partnoy, *supra* note 9, at 73.

[117] Bai, *supra* note 29, at 269.

[118] Hill, *supra* note 7, at 594.

[119] Blake Ellis, *How Credit Watchdogs Fueled the Financial Crisis,* CNNMONEY.COM, Apr. 24, 2010, http://www.money.cnn.com/2010/04/23/news/economy/credit_rating_agencies_hearing/.

[120] Smith, *supra* note 6.

[121] *Id.*

[122] *Id.*

director says that the practice amounted to a "market share war, where criteria were relaxed."[123]

In 2010, internal emails and testimonial evidence shed further light on the problem. A financial investigation commission hearing revealed the agencies' true focus. For instance, in his testimony before Congress, a former Moody's vice president claimed he felt pressured to accept deals, and his "unwillingness to say 'no' grew."[124] According to the vice president, "the independence of the group changed dramatically during [his] tenure," and "the message from management was" to "just say yes" to deals.[125] Consistent with the notion that the agencies were seeking market share at the expense of accurate ratings, one S&P employee wrote: "Let's hope we are all wealthy and retired by the time this house of cards falters."[126] Another wrote in an email: "This is frightening. It wreaks of greed, unregulated brokers and 'not so prudent' lenders."[127]

The communications, however, should not be taken out of context. Although ample evidence reveals a pressure to satisfy issuers and retain market-share, conscious and purposeful manipulation of ratings is not obvious. That is not to say that the conflict of interest did not materialize at all; rather, it probably materialized in the form of a reckless "can-do" attitude, where the agencies found ways to "legitimately" issue higher ratings.[128] As one former S&P managing director stated: "My mandate was to find a way. Find the way."[129] The agencies drank the "Kool-Aid" that the rest of the financial community was drinking and set their sights on achieving high ratings; in doing so, they quite possibly tricked themselves into thinking their ratings were accurate.[130] This reality would be consistent with the reputational capital theory. By adopting a "can-do" attitude and tricking themselves, the rating agencies may have believed their ratings were accurate and therefore not harmful to their long-term reputation. Nevertheless, the manifestation of the conflict in the form of a reckless "can-do" attitude warrants reform.

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[123] *Id.*
[124] Ellis, *supra* note 119.
[125] *Id.*
[126] *Id.*
[127] *Id.*
[128] Hill, *supra* note 7, at 586–87.
[129] Smith, *supra* note 6.
[130] Hill, *supra* note 7, at 597–98.

III. Legislative Action and Industry Responses

A. Legislative Framework

In light of the agencies' importance in maintaining a functional economy,[131] the government has passed legislation that attempts to eliminate the industry's harmful traits. The first major piece of legislation was the CRARA in 2006, which created Section 15E of the Securities Exchange Act of 1934—a regulatory framework by which NRSROs must adhere.[132] Its purpose was to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry."[133] Alluding to the oligopolistic nature of the market, the Senate noted that increased competition might result in increased ratings quality, more choices for investors, and lower costs.[134] Thus, the CRARA sets forth an objective registration framework and requires the SEC to admit any competent NRSRO.[135] It also grants the SEC authority to revoke registration of NRSROs that are not adequately financed or managed,[136] but it expressly denies the SEC the power to regulate the substance of the agencies' rating methodologies or procedures.[137] NRSROs are required to establish policies addressing conflicts of interest and disclose potential conflicts to the SEC.[138]

Pursuant to the CRARA, the SEC enacted rules that address conflicts of interest, encourage competition, and require detailed disclosures.[139] Notably, Rule 17g-5, as amended in 2009, addresses several conflicts of interest.[140] For instance, an NRSRO is forbidden from issuing a rating where it has advised or consulted the issuer or bank in the structure or design of the product.[141] An NRSRO is also

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[131] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 931(1), 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].
[132] Bai, *supra* note 29, at 256–57.
[133] ANNUAL SEC REPORT, *supra* note 22, at 16.
[134] *Id.*
[135] Coffee, *supra* note 14, at 248–49.
[136] Bai, *supra* note 29, at 258.
[137] Coffee, *supra* note 14, at 247.
[138] Bai, *supra* note 29, at 257.
[139] Coffee, *supra* note 14, at 247-48.
[140] For a detailed analysis of the conflicts that the rule addresses, see Bai, *supra* note 29, at 270–82.
[141] Coffee, *supra* note 14, at 250.

forbidden from issuing a rating for an issuer or bank with which it is affiliated.[142] Moreover, analysts are forbidden from negotiating fees with issuers whose products they rate[143] and from participating in the rating of a product that the analyst owns.[144] But although the rules significantly mitigate conflicts at the analyst level, critics say it fails to completely address conflicts at the agency level.[145] Moreover, some of the rules may disproportionately harm small or new NRSROs.[146]

More sweeping changes to the industry came from the Dodd-Frank Act,[147] which has been described as the most significant piece of financial legislation since the Securities Act of 1933.[148] Congress acknowledged the agencies' costly mistakes leading up to the financial crisis;[149] hence, an entire subtitle within the Dodd-Frank Act is entitled "Improvements to the Regulation of Credit Rating Agencies."[150] Recognizing the agencies' role as "gatekeepers" for the debt markets, Congress tabbed the agencies' activities "matters of national public interest" that justify "public oversight and accountability."[151] Notably, Congress explicitly recognized the conflict of interest that the agencies face.[152]

On the surface, Dodd-Frank's impact on rating agencies appears beneficial, with increased regulation designed to protect investors. Most notably, Dodd-Frank requires the removal of several references to NRSRO ratings from rules in an attempt to decrease investors' reliance on ratings.[153] The rating agencies are held to a greater level of accountability through increased liability exposure.[154] The agencies are also required to maintain and document an internal structure for ratings and file annual internal control reports.[155]

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[142] Bai, *supra* note 29, at 277.
[143] Coffee, *supra* note 14, at 250.
[144] Bai, *supra* note 29, at 272.
[145] *Id.* at 259.
[146] Kroll Testimony, *supra* note 27, at 3.
[147] Dodd-Frank Act, *supra* note 131, §§ 931–946.
[148] American Bar Association, *Regulatory Developments*, 66 BUS. LAW. 665, 665 (2011).
[149] Dodd-Frank Act, *supra* note 131, § 931.
[150] *Id*. at §§ 931–946.
[151] *Id*. at § 931.
[152] *Id.*
[153] *Regulatory Developments*, *supra* note 148, at 687.
[154] *Id* at 680–81.
[155] *Id.*

Conflicts of interest are further mitigated at the analyst level through employment transition restrictions[156] and the separation of marketing considerations from rating methods.[157] The agencies must also abide by increased disclosure requirements, including the disclosure of quantitative, qualitative, and third-party content.[158] Finally, the SEC is required to establish an Office of Credit Ratings to monitor and regulate the agencies.[159]

Notwithstanding its intent, the Dodd-Frank Act appears to fall short in several ways. Opponents argue that the Act's regulations are largely ineffective, perpetuate the oligopolistic nature of the industry, and fail to adequately address the conflict of interest; the Act focuses on inputs, or processes, rather than outputs, or results, so the agencies can find ways to satisfy the new regulations without actually improving ratings quality.[160] Moreover, although the SEC is granted additional oversight authority, the SEC's ability to effectively oversee and assist the agencies is questionable.[161] At this point, the Office of Credit Ratings is completely unfunded.[162] The Act also perpetuates the oligopoly and its resulting harms, such as complacency and suppressed innovation: although it appears to address the faulty practices of the Big Three, it in fact fortifies their entrenched positions by promulgating rules that the Big Three can most easily satisfy.[163] Additionally, the Act threatens to suppress innovation by rigidifying the industry through regulations that the

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[156] *Id.* at 682 ("NRSROs will be required to report to the SEC (and the SEC will be required to disclose to the public) when an individual who had been an employee of the NRSRO within the previous five years becomes employed by an obligor, issuer, underwriter, or sponsor of a security or money market instrument that was rated by the NRSRO during the twelve months before the employee transitioned to his or her new position . . . .").
[157] *Id.*
[158] The issuer or underwriter of any asset-backed security will be required to make publicly available the findings and conclusions of any third-party due diligence report it obtains. *Id.* at 684–85.
[159] *Id.* at 683.
[160] Hill, *supra* note 70, at 145.
[161] Hill, *supra* note 7, at 603.
[162] *See Letter to Members of Congress Calling for an Increase in Funding to the SEC and CFTC in Order to Implement Financial Reform*, COALITION NEWS, Jan. 6, 2011, http://ourfinancialsecurity.org/2011/01/letter-to-members-of-congress-calling-for-an-increase-in-funding-to-the-sec-and-cftc-in-order-to-implement-financial-reform/.
[163] *See* Gellert Testimony, *supra* note 17, at 2.

SEC will devise and raising the costs of becoming an NRSRO, thereby decreasing the likelihood of new entrants with new ideas.[164] Finally, and perhaps most importantly, the issuer-pay business model remains.

B. Oversight and Examinations Committee Hearing

On July 27, 2011, the Oversight and Examinations Committee met to discuss the inconsistencies of the Dodd-Frank Act—namely that it attempted to decrease investor reliance on the agencies while at the same time entrenching the Big Three and perpetuating the oligopoly.[165] The Committee scheduled several witnesses—various experts in the ratings industry—to testify regarding their thoughts on Dodd-Frank's impact.[166] Among those who testified were S&P President Deven Sharma, Moody's Global Managing Director Michael Rowan, CEO of Kroll Bond Rating Agency ("Kroll") Jules Kroll, and CEO of Rapid Ratings James Gellert.[167]

Perhaps unsurprisingly, the representatives from Moody's and S&P seemed to have little qualms with Dodd-Frank, instead testifying about the vast actions they have taken in accordance with the Act.[168] In fact, the agencies vehemently praised Dodd-Frank. Deven Sharma of S&P stated that "the regulatory changes [of Dodd-Frank] have reinforced and strengthened the integrity of the ratings process through increased oversight, greater transparency and accountability, and improved quality in analyst training."[169] Similarly, Michael Rowan of Moody's testified that his agency has

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[164] White, *supra* note 2, at 223.

[165] Press Release, The Committee on Financial Services, Oversight Subcommittee Hearing Focuses on Credit Rating Agencies (July 6, 2011), *available at* http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=253710.

[166] *Id.*

[167] *Id.*

[168] *See Oversight of the Credit Rating Agencies Post Dodd-Frank*: *Hearings Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 112th Cong. (2011) (testimony of Deven Sharma) [hereinafter Sharma Testimony]; *Oversight of the Credit Rating Agencies Post Dodd-Frank*: *Hearings Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 112th Cong. (2011) (testimony of Michael Rowan) [hereinafter Rowan Testimony].

[169] Sharma Testimony, *supra* note 168, at 1.

"embraced the need for change because we believe that a modernized oversight regime will help increase confidence in credit ratings and the rating process, as well as instill greater discipline in the industry as a whole."[170] These responses come as little surprise if the Big Three are indeed further entrenched by Dodd-Frank.

The responses from agencies other than the Big Three, however, paint a much different picture. Jules Kroll of Kroll, a smaller NRSRO, claimed Dodd-Frank, as well as the CRARA, compound barriers to entry and induce an anti-competitive environment, particularly in light of the resulting regulations.[171] New regulations will be expensive, time consuming and particularly burdensome for smaller NRSROs.[172] For instance, the Ten Percent Rule[173] is likely to impede the success of smaller NRSROs and further deter new players from entering the market.[174] Moreover, the separation of sales and marketing personnel from ratings analysis might limit otherwise valuable information that would help increase the accuracy of ratings.[175] Finally, Dodd-Frank's standardized and mechanical rating disclosure form brings with it numerous unwanted side-effects, including a homogenized work-product, a more mechanical, less flexible rating process, and additional cost and time requirements for the SEC and agencies.[176]

Potential NRSRO candidates are not content, either. James Gellert of Rapid Ratings, a non-NRSRO credit rating agency, expressed his discontent with the Dodd-Frank Act and outlined reasons why his firm has not applied to become an NRSRO.[177] Although Gellert noted two beneficial attributes of Dodd-Frank—the removal of NRSRO references and the look-back requirements[178]—

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[170] Rowan Testimony, *supra* note 168, at 2.
[171] Kroll Testimony, *supra* note 27, at 4.
[172] *Id.* at 3.
[173] Rule 17g-5 promulgated by the SEC pursuant to the CRARA prohibits an NRSRO from issuing or maintaining a rating to a person that provides the NRSRO with more than 10% of its revenue. *Id.*
[174] *Id.*
[175] *Id.* at 4.
[176] *Id.* at 4–5.
[177] Gellert Testimony, *supra* note 17, at 4–5.
[178] *Id.* at 6; *Regulatory Developments*, *supra* note 148, at 682 ("NRSROs will be required to put in place procedures reasonably designed to ensure that, if any employee of an issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating had previously been employed by the NRSRO and participated in determining a credit rating of

the CEO found considerably more undesirable consequences for potential NRSRO candidates.[179] These include increased liability exposure, increased operating costs, and complex internal process requirements.[180] Most importantly, new disclosure regulations are viewed as a legitimate threat to the firm's intellectual property.[181] Gellert asserted that the uncertainty of the "ultimate landscape for operating as an NRSRO" and the threat to the firm's "critical Intellectual Property and revenue model" are "massive disincentives" to become an NRSRO.[182]

In sum, legislation has failed to completely address the oligopoly and issuer-pay conflict. The CRARA and Dodd-Frank Act may actually perpetuate the harms of oligopoly by strengthening the Big Three's grip on the market, substantially increasing barriers to entry, and rigidifying the industry with strict, input-based regulations. Despite the increased regulatory tools entrusted with the SEC, the controversial compensation model—and therefore the primary conflict of interest—remains embedded in the industry. Where should lawmakers go from here?

IV. Existing Reform Proposals

Various reform proposals call for more than just increased regulation. Most ideas address one or both of the primary industry flaws. A few proposals have made their way into legislation, like increased liability exposure, decreased regulatory criteria for NRSRO designation, and the removal of NRSRO references from regulations. Possibly out of fear of radical change or strong lobbying by the incumbent rating agencies, true game-changing reform proposals have largely been ignored or rejected. This section briefly examines recent proposals that have the potential for remedying the two-headed illness within the industry. The two most dramatic proposals, the removal of the requirement for NRSRO certification and outsourcing the ratings job to the government, are polar opposite in nature. Two other novel proposals, the "disclose or disgorge" and

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that entity during the one-year period before the rating action, the NRSRO will conduct reviews to determine whether conflicts of interest influenced the rating, and will revise the rating as appropriate.").

[179] Gellert Testimony, *supra* note 17, at 6.

[180] *Id.*

[181] *Id.* at 8.

[182] *Id.* at 4–5.

incentive compensation approaches, significantly modify the agencies' business models and purport to alleviate potential conflicts of interest.

One proposal is the removal of the NRSRO designation altogether.[183] The removal would eliminate all regulatory reliance on credit ratings and the legal power currently afforded to the agencies.[184] Stated differently, the free market would determine the demand for credit ratings, and the inflated government-driven demand for ratings would be no more.[185] The idea brings with it a plethora of potential benefits, including increased competition to drive down price, enhanced rating quality and greater innovation.[186] But the plan faces serious implementation questions and other risks. On its face, the proposal would require a dramatic overhaul of the entire bank regulatory system,[187] and regulatory agencies would be taking on a difficult task in assessing safety and soundness on a more individualized basis.[188] Financial institutions would struggle with "do-it-yourself" credit analysis for complex or novel securities.[189] Perhaps more alarming is the possibility that the two primary industry flaws might worsen. Rate-shopping could worsen due to increased competition in the free markets, amplifying the pressure to satisfy issuers.[190] Moreover, the Big Three might become more entrenched due to their reputational oligopoly.[191] Overall, the proposal's risks, coupled with the dramatic overhaul required for implementation, make the proposal less attractive.

Another proposal is to place the industry entirely in the hands of the government; ratings can be viewed as a public good, in

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[183] *Oversight of the Credit Rating Agencies Post Dodd-Frank*: *Hearings Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 112th Cong. 7 (2011) (testimony of Lawrence White).

[184] But how would regulators determine safety of a financial institution's portfolio? Proponents of the proposal say that regulators would place the burden of proving safety and soundness on the regulated entity; larger entities might conduct creditworthiness assessments themselves, while smaller entities could outsource the job to credit rating agencies, and show that the agencies' ratings are reliable. *Id.* at 5.

[185] *Id.*

[186] White, *supra* note 2, at 224.

[187] Listokin & Taibleson, *supra* note 64, at 104.

[188] Hill, *supra* note 7, at 604.

[189] Coffee, *supra* note 14, at 233.

[190] Hill, *supra* note 7, at 605.

[191] Hill, *supra* note 28, at 86.

that they entail high fixed costs but extremely low marginal costs since the information can be shared seamlessly across a multitude of parties.[192] Thus, the government could directly control the ratings job either by creating a government-sponsored rating entity or by publically funding private entities.[193] If completely government funded, the rating process would no longer suffer from the conflict of interest that would otherwise result from the issuer-pay model,[194] and costly compliance and oversight measures would be drastically reduced. These upsides are appealing, especially given the significant role that the conflict of interest played in the recent financial collapse, but the idea of publically funding the entire industry has significant flaws. Which taxpayers will fund the subsidization? If the general public provides the money, only a select few (lenders and borrowers) benefit at the expense of the entire populous.[195] More problematically, recipients of public funding will be incentivized to continue to receive funding, perhaps at the expense of accurate ratings.[196] Moreover, the industry in its current state, albeit an oligopoly, experiences some level of market-driven supply and demand. A government-sheltered ratings market might be unable to determine the appropriate amount of information to produce and at what cost. Finally, would a government sponsored rating industry be capable or incentivized to keep pace with the innovative financial industry?[197]

A more recent reform proposal, the "disclose or disgorge" proposal, requires the agencies to disclose the quality of their work when making ratings. Specifically, agencies would be required to disclose to the public a rating that is of "low-quality," or else disgorge profits it derived from making that rating.[198] If an agency is less confident with the accuracy of a rating, it must disclose that the rating is of low-quality.[199] But would investors truly heed the warning of a "low-quality" rating on a security or instrument? If not,

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[192] Listokin & Taibleson, *supra* note 64, at 102.
[193] *Id.* at 102–3.
[194] *Id.* at 102.
[195] *Id.*
[196] *Id.* at 103 ("Non-conformist ratings may be squelched, since these ratings are likely to attract more negative attention for failure than conventional ratings.").
[197] *Id.* at 102.
[198] Hunt, *supra* note 25, at 182.
[199] *Id.*

the method is almost entirely ineffective, as a "low-quality" notice would provide no material protection for investors. Even if the warning is heeded, the instrument might be punished and treated as if it had a lower rating than it actually does; reduced demand might lead to an unduly high interest rate paid by issuers. Moreover, the idea of imposing penalties on the agencies seems like a step in the wrong direction because penalties act as additional barriers and deter potential NRSROs. Indeed, even though the proposal outlines a mechanism to determine the "quality" of ratings, one can certainly question its ability to do so accurately.

Finally, a slightly less radical approach to reform involves altering the way the agencies are compensated. One such option is to compensate the agencies with the debt they rate.[200] Utilizing this approach, the amount of debt the agency receives as compensation would depend on the debt's rating; the higher the rating, the less debt the agency receives as compensation, and vice versa.[201] The substantial benefit is that the agency has a financial incentive to avoid overrating.[202] However, although the conflict of interest is directly addressed, the proposal suffers from a few possible defects. Ultimately, the rating agencies have an even greater incentive to manipulate ratings because their compensation is directly tied to the rated securities. The agencies can manipulate the value of the debt they hold by re-rating the product at a later stage; thus, to be effective, the agencies must be paid over time, which raises additional implementation and cash-flow concerns.[203] Moreover, there is the risk of private collusion between the agencies and issuers, where the agencies merely compensate issuers for the loss they will incur in giving an unduly high rating.[204] Finally, the agencies themselves might be functionally harmed by severe cash-flow concerns. At the very least, transitioning into this mechanism would mean the agencies would take a large pay-cut for a few years until

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[200] Listokin & Taibleson, *supra* note 64, at 104.

[201] In other words, an agency would collect less debt as its fee if the debt receives a high rating (because the debt is worth more), and collect a larger amount of debt as its fee if the debt receives a low rating (because the debt is presumably worth less). *Id.*

[202] If it overrates a security, it will receive less debt than it would have received if it had rated it accurately, and it will collect less than its true charged fee. *Id.* at 105.

[203] *Id.*

[204] Hill, *supra* note 7, at 606.

the first round of rated debt matures. In this regard, incentive to enter the NRSRO market would be diminished, and the oligopoly is reinforced.

V. A Simple Proposal to Incentivize Accuracy

Reform should mitigate the potential harms resulting from both the conflict of interest and the oligopolistic state of the industry. Consistent with the sentiment expressed by Jules Kroll and James Gellert, this note proposes to partially break the oligopoly by relaxing rules promulgated under the CRARA and Dodd-Frank for smaller NRSROs. The crux of this note's proposal, however, aims to counter the conflict of interest by incentivizing accurate ratings through a tax deduction. Such a mechanism would also reduce the harmful effects of oligopoly and counter the risk of rate-shopping that might accompany increased competition.

A. Lower Barriers for Small or New NRSROs

In order to promote competition and innovative business development, regulators should alter their rules to place fewer burdens on small and potential NRSROs. Based on testimony from Jules Kroll and James Gellert, current smaller NRSROs, unlike the Big Three, are disproportionately burdened by the new regulations promulgated under Dodd-Frank and the CRARA. Moreover, potential NRSROs are reluctant or unable to become NRSROs because of the various costs and risks that accompany the designation. The SEC should allow, among other things, small or new NRSROs to get their feet under them by relaxing certain rules for these entities.

Changes to the rules promulgated under Dodd-Frank and the CRARA should include the following: relaxed disclosure standards for new or smaller NRSROs; a more flexible Ten Percent Rule; and a narrow definition of "marketing" for purposes of mitigating conflicts of interest. First, small or new entrants should not be required to disclose in detail the "assumptions underlying the credit rating procedures and methodologies," or detailed quantitative or qualitative information.[205] This type of detailed disclosure would entail the risk of reverse engineering and jeopardize the firm's

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[205] Gellert Testimony, *supra* note 17, at 9.

intellectual property.[206] This risk has already deterred one agency, Rapid Ratings, from seeking NRSRO status.[207] Second, the Ten Percent Rule should not apply to small or new firms that experience lower revenue and therefore are more susceptible to reaching the ten percent mark.[208] Potentially prohibiting an agency from taking a large deal, the rule prevents smaller agencies from becoming substantial players in the NRSRO market. Third, marketing should not be construed so broadly as to impede valuable informational exchanges.[209] A narrow interpretation of this rule would likely catch most instances of potential conflict, while not obstructing exchanges of information that increase rating accuracy.

Although competition entails a plethora of benefits, it is also important to recognize the unique risk that a competitive environment brings to the rating industry. Heightened rate-shopping and pressure to satisfy issuers might accompany increased competition,[210] as demonstrated by the rise of Fitch before the financial collapse.[211] The risk, however, is directly mitigated by this note's primary proposal, the deduction incentive scheme. By implementing both parts of this note's proposal, the industry will realize the benefits of increased competition and avoid the risk of increased pressure to satisfy issuers.

B. Incentivizing Accuracy Through the Tax System

The crux of this note's proposal directly counters the issuer-pay conflict of interest, incentivizes innovation to detect risky securities, and encourages non-NRSROs to apply for NRSRO status. Although the ultimate goal is accurate ratings, effective reform should primarily aim to avoid a repeat of the systemic overrating of risky securities that led to the financial collapse. It is this risk of systemic overrating, as opposed to underrating, that jeopardizes overall economic stability. Thus, it is most important for reform to promote the accuracy of ratings attached to risky securities. If an agency accurately gives a risky security a low rating, thereby alerting investors, it has satisfied its duty to investors and, in a way, done a

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[206] *Id.*
[207] *Id.* at 5.
[208] Kroll Testimony, *supra* note 27, at 3.
[209] *Id.* at 4.
[210] Coffee, *supra* note 14, at 240.
[211] *Id.* at 239.

public service. Therefore, in light of the inherent pressure to overrate, the government should promote such activity with proper incentives.

In an effort to promote this goal, the rating agencies should receive a deduction for accurately rating a security that defaults. This would provide the agencies with a direct financial incentive to accurately rate risky products.[212] By rating risky products accurately low, the agencies stand to gain a tax-break if the product in fact proves to be risky, as evidenced by default. Obviously not all low-rated products default, but the agencies stand to substantially benefit from the significant portion that do default.[213] At the same time, such a mechanism would act as a disincentive to give unduly high ratings. The opportunity cost of issuing an unduly high rating is significantly increased. For instance, if an agency is tempted to give an unduly high rating, perhaps to attain or retain an issuer, it must weigh that benefit against the cost of foregoing a possible deduction. In other words, issuing an unduly high rating comes with an entirely new cost.

The deduction mechanism also mitigates the harms of oligopoly, including complacency and suppressed innovation. The agencies will be more careful to avoid modeling errors and cutting corners.[214] Instead, they are more likely to develop innovative methodology and modeling techniques that better detect risky securities. Thus, the ratings market might begin to feature a wide variety of rating techniques, where the best techniques survive and

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[212] Moody's revenue from investor services was approximately $1.4 billion, or 70 percent of all revenue. *See* Moody's Corp., Annual Report (Form 10-K), at 42–44 (Mar. 2011), *available at* http://ir.moodys.com/annuals.cfm [hereinafter Moody's Annual Report].

[213] At S&P, global corporate default rates for 2010 were as follows: 22.27 percent rated C/CCC defaulted, 2.07 percent rated B- defaulted, 0.69 percent rated B defaulted, and 0.00 percent rated B+ defaulted. *2010 Annual Global Corporate Default Study and Rating Transitions,* Mar. 30, 2011, Table 9, *available at* http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245302234237 [hereinafter *Corporate Default Rates*]. Structured finance default rates in 2010 were as follows: 34.30 percent rated C/CC, 16.62 percent rated CCC, and 3.29 percent rated B. *Global Structured Finance Default Study—1978-2010,* Mar. 28, 2011, Appendix Table 1, *available at* http://www.standardandpoors.com/prot/ratings/articles/en/us/?articleType=HTML&assetID=1245301718990 [hereinafter *Structured Finance Default Rates*].

[214] *See* Hill, *supra* note 7, at 591, 595.

evolve.[215] Moreover, the deduction acts as a subsidy to the industry. Such a subsidy encourages new entrants to enter the market, and perhaps allows smaller NRSROs greater ability to build capital and resources in their attempt to capture market share. Small NRSROs will be better able to absorb the large compliance costs of increased regulation[216] and compete with the Big Three. Notably, the subsidy only rewards "good" agencies that accurately rate risky debt, as opposed to "bad" agencies that give unduly high ratings.

On its face, the basic framework of the proposal is simple, but three primary components should be addressed. First, the amount of the deduction should equal the fee collected in connection with rating the security or entity. That is, income from rating activity that works to alert the public of risky debt will be tax-free. Second, a threshold line would be drawn within the rating spectrum to determine which ratings qualify for the deduction. For example, imagine the threshold were drawn at the investment-grade mark.[217] Only securities rated below investment grade, and not those securities rated above investment grade, would be eligible for the deduction. Third, eligible securities that default would trigger a deduction if the security was rated below investment grade *prior to default*. To be eligible for a deduction, the security's rating would need to be accurate for an appropriate amount of time before default occurs (probably a period of months). A rating agency should not receive a deduction for downgrading an entity or security merely days before default, as was the case with Enron, WorldCom, Lehman Brothers, and several other distressed companies.[218]

The practical effect of this mechanism is to incentivize agencies to give accurate low ratings, which counters the pressure to satisfy paying customers with high ratings. If an agency gives a risky debt product a high rating above the threshold line, and the product eventually defaults, the agency cannot claim the deduction. This means that giving an unduly high rating comes with a price. But despite its potential upside, the proposal is confronted with many issues, including questions regarding its core structure, implementation concerns, and risks to the mechanism's efficacy. These issues are addressed below.

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[215] *See* Hunt, *supra* note 25, at 132–33.
[216] Gellert Testimony, *supra* note 17, at 5.
[217] In reality, the line would probably need to be drawn lower than the investment-grade mark, due to the self-fulfilling prophecy described below.
[218] White, *supra* note 2, at 218.

C. Similar Alternatives to the Core Structure

As it stands, the proposal only rewards ratings for accurately rating risky securities. Why not reward the agencies for rating any and *all* securities accurately? An agency could be rewarded a deduction for every rating that proves to be accurate, not just the risky ones. Unfortunately, this idea suffers from a seemingly incurable issue: is it possible to determine rating accuracy for each and every product? It seems that the only measure of accuracy on a rating-by-rating basis is whether the security defaults. An instrument rated AAA that does not default is accurate, and an instrument rated C that defaults is accurate. But what about all of the securities rated between AAA and C? For instance, if a product is rated BB and defaults, was the rating accurate or inaccurate? Without the ability to determine if the rating is accurate, a reward cannot be given.

One possibility is to divide the rating spectrum into two parts by a threshold line. Just as this note proposes, securities in the bottom part that default would receive a deduction. Additionally, securities in the top part that do not default would also receive a deduction. The latter part of this mechanism, however, is unfeasible. Because the vast majority of securities ultimately do not default,[219] the agencies would be incentivized to place all of the securities in the top part, thereby compounding the overrating problem. Only those securities with a 51 percent chance of default—of which there are very few[220]—would be placed in the lower threshold. Thus, it seems impossible to reward the agencies for accurately rating safe products that do not default. Fortunately, accurately rating risky securities is of primary concern, as it should be.

Another option is to impose a penalty for inaccurate ratings, either in combination with or in lieu of a reward for accurate ratings. Again, if the only rating-by-rating measure of accuracy is default, a threshold line would be drawn. The agencies would be penalized—perhaps by disgorgement of profits[221]—for securities in the top threshold that default. Such a penalty structure, however, would be detrimental. Penalties would discourage the rating of complex securities that the agencies are less comfortable rating. Niches of the rating industry that experience higher default rates would be unfairly

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[219] *See Corporate Default Rates*, *supra* note 213, at Table. 9; *Structured Finance Default Rates*, *supra* note 213, at Appendix Table 1.
[220] *See id.*
[221] Hunt, *supra* note 25, at 182.

burdened. Moreover, the oligopoly would be fortified. Existing smaller NRSROs might be less capable of absorbing such penalties and therefore disproportionately burdened. Potential new entrants, already expressing concern with increased compliance costs,[222] would surely be further deterred from applying for NRSRO status. A few highly rated securities inevitably default,[223] so annual penalties for the agencies would be inevitable. Ultimately, the threat of retaliation for inaccurate ratings might undermine the progress already made in the ratings industry.[224] A penalty system would not be beneficial.

D. Implementation Concerns

The proposal faces four implementation issues that must be addressed. First, at what point should the threshold line that defines which securities qualify for deductions be placed? Because it already directly regulates the agencies,[225] the SEC would most likely be the authority to determine this threshold line. Theoretically, the threshold line could be drawn anywhere below the highest rating, but it would need to be drawn close to the investment grade mark[226] or lower to effectively deter overrating. In actuality, it is probably necessary to set the threshold line lower than investment grade in order to avoid the self-fulfilling prophecy problem. If drawn at investment grade, rating agencies might downgrade a security below investment grade knowing that the downgrade would mean liquidation of the security by institutions, increasing the likelihood of default.[227] A threshold line below investment grade would avoid this concern because rating shifts that occur below investment grade do not necessarily trigger required liquidation.

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[222] Gellert Testimony, *supra* note 17, at 5.

[223] *See Structured Finance Default Rates, supra* note 213, at Appendix Table 3 & Appendix Table 4.

[224] Sharma Testimony, *supra* note 168, at 10.

[225] *See* Dodd-Frank Act, *supra* note 131, §§ 931–946.

[226] The lowest investment grade ratings for S&P, Moody's, and Fitch respectively are, BBB-, Baa3, and BBB-. *What is a Bond Rating,* WM FIN. STRATEGIES, http://www.munibondadvisor.com/rating.htm (last visited Apr. 5, 2012).

[227] *See The Importance of Being Investment Grade,* EXPECTED LOSS, http://expectedloss.blogspot.com/2010/10/importance-of-being-investment-grade.html (last visited Apr. 5, 2012).

Wherever the threshold line is drawn, it should be unknown to the agencies during the period in which it applies. If the threshold line is known to the agencies, ratings will likely be concentrated around the threshold line. Agencies might intentionally place securities immediately below the threshold line, so as to reap the potential deduction while still pleasing issuers. Similarly, those securities receiving a rating right above the line might be bumped down so as to qualify for the deduction.[228] In response to this issue, the SEC could keep the line unknown until the end of the year. Consequently, there would be no set, predetermined line that the agencies might otherwise concentrate ratings around. The line might even be determined on a completely arbitrary basis, perhaps by lottery. The SEC would need to be careful in setting the line year after year, ensuring a fair determination process that is not influenced by the rating agencies.

The second issue is the necessity of a discernable definition of "default" for purposes of triggering a deduction. Sometimes a default is easily discernable, like when the debtor declares bankruptcy or otherwise willingly admits to being in default. But this is not always the case. A debtor and creditor might disagree about whether the debtor is actually in default, resulting in litigation and perhaps settlement. Thus, the SEC would need to establish guidelines that clearly indicate what "default" means. One possibility is to follow the International Swaps and Derivatives Association's ("ISDA") determination of default, which is utilized to determine defaults for Credit Default Swaps ("CDS").[229] Default might be based on ISDA's definition of payment default, or "Failure to Pay," which occurs when an entity fails to make a payment when and where due.[230] If this metric works for the vast CDS market,[231] it should certainly work within the framework of this proposal.

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[228] *See* Bai, *supra* note 29, at 268 ("[A] moderate inflation by one rating notch for large issuer clients has no negative effect on the rating agency's performance statistics that are required to be disclosed under the current regulations.").

[229] *See* Vinod Kothari, *ISDA Credit Event Definition*, http://credit-deriv.com/isdadefinitions.htm (last visited Mar. 8, 2012).

[230] *Id.*

[231] As of December 31, 2010, the net notional CDS amount was $2.3 trillion. *Market Statistics,* ISDA CDS MARKETPLACE, http://www.isdacdsmarketplace.com/market_statistics (last visited Mar. 8, 2012).

The third concern deals with timing. Agencies often adjust their ratings in the form of downgrades or upgrades.[232] As discussed, the agencies have sometimes been sluggish in downgrading ratings in the past.[233] They should not be rewarded for downgrading debt right before a company defaults, which gives investors and financial institutions too little time to protect themselves. This is why a time-limit restriction is necessary. For instance, the agency must have issued and maintained a low rating (below the threshold level determined by the SEC) for the security or entity at least six months before default occurs. This amplifies the issue of what constitutes "default," but if "default" can be defined in an easily discernable manner, this timing issue should not be a problem. The SEC would need to determine an appropriate time restriction.

Finally, why implement this proposal through the tax system and the Internal Revenue Service ("IRS")? The tax system facilitates proportionality and simplicity. A deduction provides a subsidy that is directly proportional to the fee collected for accurately rating a risky security. The message to the agencies becomes: "You won't be taxed for activity that protects the investing community." Furthermore, realizing the deduction would simply mean completing a line item or form that accompanies the agency's tax return to the IRS. In this regard, it would be less burdensome on smaller NRSROs with smaller internal compliance departments. Of course, a deduction is not the only way to effectuate the proposal's goal. Conversely, the SEC, which is presumably in a better position to deal with rating agencies, could simply write the agencies checks for the appropriate amount. Moreover, avoiding the tax system eliminates other concerns inherent in using a deduction, such as inconsistent tax rates between agencies[234] and unusable deductions.[235]

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[232] *See Upgrades and Downgrades,* YAHOO FIN., http://finance.yahoo.com/news/category-upgrades-and-downgrades/ (last visited Mar. 8, 2012).

[233] White, *supra* note 2, at 218.

[234] Marginal tax rates for corporations making over $75,000 are between 34 and 39 percent. *Corporate and Individual Tax Data*, SMALL BUS. TAXES & MGMT, http://www.smbiz.com/sbrl001.html (last visited Mar. 8, 2012).

[235] The Big Three should be able to utilize the deductions because all three had significantly positive pre-tax earnings in 2011. *See* Moody's Annual Report, *supra* note 212, at 61; McGraw-Hill Companies, Annual Report (Form 10-K), at 41 (Mar. 2011), *available at* http://www.mcgraw-hill.com/about/annual_report/ar2010.pdf); *About Fitch Ratings,* FIMALAC.COM, http://www.fimalac.com/Fitch-ratings-GB.html (last visited Mar. 8, 2012). Even if they cannot be utilized in a given year due to

E. Risks of the Proposal

At first glance, two primary risks jeopardize the efficacy of the proposal: systemic underrating and private collusion between banks and issuers.[236] Agencies might intentionally underrate a considerable amount of the securities, in an attempt to reap as many deductions as possible. Additionally, issuers and banks might privately collude with the agencies and compensate them for the cost of a foregone deduction in exchange for an unduly high rating. These concerns, however, are largely immaterial for several reasons.

The agencies are unlikely to engage in intentional underrating because they could potentially lose market-share. As discussed, issuers and banks tend to rate-shop, so inaccurate low ratings might result in lost business.[237] If an agency persistently gives low ratings that prove inaccurate, issuers and banks will surely abandon that agency. Ideally, the deduction will only act as a counter-balance to the "can-do" attitude that leads to unduly high ratings. The agencies will be more cognizant of risky debt instruments than before—perhaps in the form of innovative modeling techniques and rating methodologies—but are prevented from systemically underrating by the inescapable need to retain market share.

To put the matter differently, the agencies' behaviors depend on the interplay of two opposing forces: potential deductions (rate products lower) and pleasing issuers (rate products higher). Ideally, the two forces would be identical and directly offset one another, resulting in complete objectivity. In reality, one force will probably be more influential than the other. Even so, the deduction mechanism is beneficial whether or not it outweighs the pressure to satisfy issuers.

On one hand, the desire to please issuers might outweigh the direct financial benefit of a possible deduction. Even in this scenario, however, the deduction operates as a potential benefit that must be foregone in lieu of a high rating. Although the benefit of giving a

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negative pre-tax income, the deductions could add to net operating loss carry-forwards, enabling the agency to realize those deductions in future years. *How to Figure an NOL,* INTERNAL REVENUE SERV., http://www.irs.gov/publications/p536/ar02.html#en_US_2011_publink1000177329 (last visited Mar. 8, 2012).

[236] *See* Listokin & Taibleson, *supra* note 64, at 107.

[237] Ellis, *supra* note 119.

high rating to bolster market-share might outweigh the deduction benefit in most cases, the two forces might be close enough in other rating decisions to induce some accurately low ratings. Moreover, even if the desire to maintain market share outweighs the deduction benefit in every single case, the cost of giving those unduly high ratings has undoubtedly risen. Other incentive mechanisms, both current and future, might combine with the deduction to make the opportunity cost[238] of issuing an unduly high rating too high. Finally, "good" rating agencies (that do not succumb to the conflict of interest) are financially rewarded. Conversely, "bad" rating agencies (that give unduly high ratings) miss out on those financial benefits. In this way, the "good" agencies are subsidized and given a market advantage, enabling them to better compete.

On the other hand, the incentive to underrate might outweigh the desire to please issuers. In such a case, at least a few securities will receive an inaccurately low rating. As already mentioned, consistent underrating is unlikely because banks and issuers can take their business elsewhere.[239] Still, if agencies are able to fool the issuers and banks, they might take advantage of inaccurately low ratings. Even if this is the case, however, it is better to have more inaccurate low ratings than inaccurate high ratings. The immediate downside to lower ratings—higher cost for an entity to issue debt—is far outweighed by the inherent risks of systemic overrating.[240] Moreover, the agencies are unlikely to get away with systematic underrating, as transparency and SEC oversight would surely illuminate any dramatic shift in rating distribution. But even if a small portion of debt is inaccurately rated low, slipping by both the issuers and the regulatory authorities, this is a small price to pay to ensure against unduly high ratings, a market-wide bubble, and an economic recession. The risk of underrating, which has not been complained of by any scholar or industry expert of note, is immaterial compared to the proven risk of overrating currently faced by the rating agencies.

The second primary risk of the proposal is private collusion between the agencies and issuers.[241] The issuers might simply pay a higher price to the agencies to make up for the deduction they would

[238] In other words, the agency must forego the potential benefit of one thing in order to have another.
[239] White, *supra* note 2, at 221.
[240] Bar-Or, *supra* note 84.
[241] Listokin & Taibleson, *supra* note 64, at 107.

otherwise receive, in exchange for an unduly high rating. This is a legitimate concern. From the issuer's perspective, the value of a high rating is surely larger than this additional cost.[242] If such a scenario, the accuracy of ratings would not change; instead, the cost of ratings would go up by an amount slightly larger than the value of a potential deduction.

This concern is mitigated for a few reasons. Some issuers might not pay the additional cost of attaining a high rating. Even if collusion is desired, transparency and oversight by the SEC would make this compensation activity more difficult to execute. Furthermore, if such collusion occurs at the issuance stage, the agencies can still adjust ratings at a later date. Rating agencies will not be locked into a contractual agreement to maintain a high rating, as that would be illegal. Finally, even if private collusion takes place, the cost of attaining an unduly high rating is increased. Those "bad" issuers who wish to attain unduly high ratings must pay a higher price to attain such, while "good" issuers benefit from lower prices.

Conclusion

The credit rating industry is plagued with two burdensome traits. Smaller rating agencies recognize that the oligopolistic nature of the industry is being perpetuated by increased regulation that entrenches the Big Three. Industry experts and scholars chastise the issuer-pay business model for creating a seemingly insurmountable conflict of interest that continues to jeopardize the safety and soundness of the financial community. And while several reform proposals have been invoked and discussed, none appear to be catching much wind amongst lawmakers.

This note asks lawmakers to consider the aforementioned deduction incentive approach, which strengthens rating accuracy and mitigates the harms of oligopoly. At its heart, the approach counters the pressure to give unduly high ratings, which results from the desire to please issuers and retain market share. Instead of finding ways to give unduly high ratings, the agencies might adopt a different type of "can-do" attitude with a focus on detecting and accurately rating low-quality debt. If effected, the proposal would spur innovative rating techniques and more responsive rating-adjustments, operate to curb the threat of complacency, and increase competition within the industry. Potential NRSROs will have greater

[242] Hill, *supra* note 28, at 62.

incentive to apply for NRSRO designation, and existing smaller NRSROs will reap subsidies to better keep pace with the Big Three. "Good" rating agencies will be subsidized to level the playing field with "bad" rating agencies that benefit from pleasing issuers. At a minimum, the proposal is a step in the right direction by raising the cost of giving unduly high ratings; coupled with current and future regulatory tools, the cost might eventually be enough to completely offset the pressure to satisfy issuers.

At the end of the day, the agencies' role of alerting the public of risky debt is of central importance. In this role, the rating agencies provide a form of public service, which therefore justifies tax-free income when successfully accomplished. This note's proposal aims to promote such service. Is the potential benefit worth the price in tax dollars? If it means the avoidance of another global economic meltdown, the answer is undoubtedly "yes."