Americans for Financial Reform
Accountability, Fairness, Security

Support Strong Credit Rating Agency Reform

Accountability and Transparency Rating Agencies Act (H.R. 3890)

Unreliable Ratings Allowed Risky Products to Permeate the Financial System

Unsound subprime mortgages and the securities based on those mortgages were the poison that contaminated the financial system, but it was the ability of these mortgage-backed securities to attract AAA ratings that allowed them to penetrate every corner of the markets. As events unfolded, it became increasingly clear that credit rating agencies, attracted by the lucrative fees to be earned rating structured products and virtually immune from accountability when their ratings fail, had given their seal of approval to securities whose risks they had not adequately investigated and did not fully comprehend. As one Standard & Poor's analyst famously proclaimed, "We rate every deal. It could be structured by cows and we would rate it."

House Bill Takes Multi-pronged Approach to Reform

The House bill seeks to address these shortcomings through a multi-pronged approach that simultaneously strengthens regulatory oversight, increases credit rating agency accountability, and reduces the financial system's vulnerability to faulty ratings. Credit rating agencies have been largely inoculated from liability for their misconduct through a combination of court deference toward arguments that ratings are protected speech under the First Amendment and actual statutory limits on liability. The House bill would remove these statutory limits on liability and make clear that knowing or reckless misconduct satisfies the pleading standards with regard to state of mind. In addition, the bill charges the Securities and Exchange Commission with conducting annual reviews of the rating agencies to evaluate such things as procedures followed in developing ratings and management of conflicts of interest, and it authorizes the agency to impose fines for violations. It also strengthens corporate governance practices at the rating agencies themselves, in particular by assigning responsibility for oversight of key functions to the board. Finally, the bill addresses the inequality between government and corporate bonds in that it requires all bonds to be rated on the risk of default. Currently, the rating agencies use a more conservative standard when rating US municipal bonds than they do when rating U.S. corporate or international issuers, which ends up costing taxpayers billions of dollars a year in extra interest and bond issuance costs.

- *AFR supports an amendment to further strengthen the bill by imposing a small fee on ratings engagements and dedicating the proceeds of that fee to ensure adequate funding for regulatory oversight.*
- *AFR also supports an amendment to enhance board oversight by requiring that a majority of board members be independent and that the definition of independence be tightened to ensure that these board members represent the interests of users of credit ratings.*

The House Bill Would Reduce Reliance on Ratings

In addition to increasing the reliability of credit ratings, it is also important to reduce the financial system's vulnerability when ratings prove unreliable. One way to reduce our reliance on ratings, and with it the system's vulnerability to inaccurate ratings, is to make both the ratings themselves and the securities rated more transparent. The House bill both would provide greater insight into the assumptions used in developing ratings, the sensitivity of the rating to those assumptions, and the nature and quality of the data relied on. This should better enable the users of ratings to assess the nature of risks being rated and the reliability of the rating. In addition, it would move to eliminate all legal references to credit ratings. While we support reducing reliance on ratings, eliminating all legal references to ratings without first determining whether more reliable measures of creditworthiness are available strikes us as reckless.

- *AFR supports an amendment to require regulators first to identify all areas where the laws and regulations refer to or rely on ratings, then to determine whether better or additional measures of creditworthiness are available, and finally to either replace or supplement the ratings as appropriate.*

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