The Rating Agencies and the Franken Amendment: Key Questions and Answers

“’We’ve got to deal with the conflicts. If I hire S&P or Moody’s to be my consultant and show me how I can do this and that to get an investment-grade rating or [an] even higher rating, they obviously have a conflict of interest there.’”

“That’s right. I think the compensation model… where the issuer pays for the rating is really at the heart of the conflict problem…”

—Exchange between Sen. Richard Shelby (R-AL) and SEC chair-designate Mary Schapiro at her confirmation hearing, Jan. 15, 2009

Q. Why is rating-agency reform crucial?
A. The major credit rating agencies, Moody’s, Standard & Poor’s, and Fitch, bear a heavy burden of responsibility for the financial meltdown and the resulting – and ongoing – economic tragedy. It was their seal of approval, in the form of Triple-A and other investment-grade ratings, that enabled Wall Street to develop a multi-trillion dollar global market for bonds that cried out to be labeled as junk.

Q. What is the Franken Amendment?
A. It calls on the Securities and Exchange Commission to create a ratings oversight board, with investor representatives in the majority. The board would choose a rating agency to conduct the initial evaluation of each new issue of asset-backed bonds or other structured-finance products. Assignments would be based on objective measures of rating accuracy over time. Securities issuers would not be allowed to play a role in the assignment process.

Q. Why is this amendment necessary?
A. The core problem, as a succession of public officials of both major parties have noted, is one of glaring, built-in conflict of interest. Why did these firms gloss over the huge risks of mortgage-backed bonds and collateralized debt obligations? Because that was the way to attract business from the securities issuers who paid them, picked them, and, all too often, had their help structuring securities to achieve the desired rating. In 2004 and 2005, Standard & Poor’s and Moody’s lowered standards again and again as each sought to avoid the perception that it might be less generous. “I knew it was wrong at the time,” S&P director Richard Gugliada testified later, adding that “it was either that or skip the business.”
The House and Senate financial-reform bills include a number of other provisions involving the rating agencies. Both call for stronger SEC oversight, more ratings transparency, and greater evenhandedness in the treatment of municipal and corporate bonds; both require each rating agency to have a clearly stated methodology and appropriate compliance machinery; both would give new legal recourse to investors.

These steps are sensible and needed, but should be ancillary. Conflict of interest lay at the heart of the problem. It should lie at the heart of the solution. The first imperative of reform is to align the incentives of these entities with their mission. That is the aim of the Franken Amendment.

Q. Does the Franken amendment conflict with the goal of reducing investor reliance on credit ratings?

A. Of the 64 senators who voted for the Franken amendment, 31 also voted for the LeMieux amendment, which calls for the removal of references to rating agencies from federal statutes and regulations. Here’s why those 31 Senators, and many other financial reformers, support measures to improve the integrity of credit ratings and reduce investor reliance on them.

To begin with, it is difficult to predict how far or fast the process of reducing reliance will go or whether alternatives will be identified that provide a more reliable measure of creditworthiness. Congress has no jurisdiction over the many state and local agencies that, over the years, have woven credit ratings into their rules. Even at the federal level, while the legislation will keep ratings from being cited as a stand-alone justification for investment decisions, Congress cannot tell investors to disregard credit ratings entirely. As a practical matter, a vast number of pension plans, insurance companies, and other institutional investors will continue to seek outside help in the complex task of tracing asset-backed bonds and other structured, multi-tiered debt securities to their underlying assets; and many are likely to use credit ratings as a significant source of information. For this reason, it makes great sense to improve the accuracy of credit ratings, even as we seek to wean investors off their excessive reliance on ratings.

Some suggest that the creation of the new ratings board would amount to a government endorsement of credit ratings. But we regulate many professions without implying official support for them. If it makes sense to regulate securities analysts, for example, it is entirely appropriate to regulate credit rating agencies, which play at least as important a role in the financial markets.

Q. Would securities issuers have an alternative recourse if they believed that an initial rating lacked credibility?

A. Yes. The amendment allows for multiple ratings of any set of securities. It guarantees, however, that at least one will come from a source that has been independently selected and has won its assignment through an established record of accuracy. Contrary to arguments that having a board-assigned rating would increase reliance on ratings, a wide divergence between one rating and another could prompt investors to seek additional information and do more of their own due diligence. It is therefore at least as likely, in our view, that the Franken amendment would reduce inappropriate reliance on ratings as increase it.
Q. Does the amendment compromise the First Amendment rights of rating agencies?

A. NRSROs and others will remain free to publish and market evaluations of debt securities, regardless of whether they have been chosen to provide an initial rating.

First Amendment objections to the Franken amendment have even less credibility than the industry’s long effort to equate credit ratings with the kind of political speech that enjoys the highest degree of constitutional protection. The House and Senate have already rejected the First Amendment argument by calling for an end to the special liability privileges conferred on NRSROs by the Securities Act of 1933 and the Credit Rating Agency Reform Act of 2006, among other statutes and regulations. The same line of argument cannot credibly be used to argue against the Franken amendment, which in no way inhibits ratings agencies’ ability to issue ratings whenever they choose.

Q. Would the Franken amendment preserve an oligopoly of rating agencies?

A. The amendment would increase competition by opening the field to new and smaller credit rating agencies, including some that have never succumbed to the temptations of the issuer-pays model.

Q. Would the amendment, by creating a new selection mechanism, dampen competition and innovation in the ratings field?

A. The Franken amendment lays the foundation for a ratings market in which competitive forces support diligence, accuracy, and a sense of duty to the purchasers (rather than just the issuers) of debt securities. The only kind of competition it would discourage is the kind we have seen too much of – in which the goal is to attract more business by giving out more generous ratings.

Q. How can the new board objectively measure the accuracy of rating agencies?

A. One standard of comparison is long-term yield: if two securities have the same risk profile, they ought to produce similar rates of return over time. Another possible gauge is the frequency with which investment-grade bonds default or lose significant value. Under the Franken Amendment, simple, transparent measures of this kind would be used to reward the most accurate rating agencies with additional assignments, while those with the poorest records could, in extreme cases, be suspended or removed from the pool.

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