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The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis

KIA DENNIS†

ABSTRACT

This article posits that the rating agencies' underestimation of the risks of mortgage backed securities was an economically rational response to legal, regulatory, and market incentives. In particular, revenues from rating mortgage backed securities and other structured finance products grew exponentially between 2001 and 2006, so much so that by 2006, these ratings accounted for a significant part of rating agencies' total revenues. At the same time, however, the costs of inaccurate certification were declining as a result of judicial and regulatory actions favoring limited rating agency liability. As a consequence the benefits of overrating mortgage backed securities were greater than the costs of doing so. With this as a basis for understanding rating agency behavior in the months and years preceding the credit crisis, the article comments on the proposed regulatory overhaul and suggests additional liability be imposed on rating agencies.

INTRODUCTION

It seems apparent now that the real estate boom that swept the country between 2001 and 2006 was actually a real estate bubble. Rising home values, flexible loan products, and a government focus on increasing home ownership encouraged an increasing number of borrowers to purchase homes or to take home equity loans.¹ Both the markets for

† Fellow, University of Baltimore School of Law. I thank Jim Kelly, Michelle Gilman, Cassandra Havard, Audrey McFarlane, Gilda Daniels, and Odeana Neal for their encouragement and their comments on earlier drafts and Ryan McGovern for his research assistance. I am also extremely grateful for the encouragement and support of Neil Dennis and Delria Johnson. Funding for this article was provided by a University of Baltimore School of Law Summer Research Fellowship.

1. See Jo Carrillo, *Dangerous Loans: Consumer Challenges to Adjustable Rate Mortgages*, 5 BERKELEY BUS. L.J. 1, 22–23 (2008) (discussing the proliferation of innovative mortgage products); see also Elizabeth Laderman, *Subprime Mortgage Lending and the Capital Markets*, Fed. Res. Bank S.F. Econ. Letter (Dec. 28, 2001) available at <http://www.frbsf.org/publications/economics/letter/2001/el2001-38.html> (“During the 1990s, the economic expansion was accompanied by a rapid increase in consumer debt, and the concomitant boosts to house values continued to encourage home equity borrowing in particular.”). Home prices began appreciating considerably in 2003 but fell off dramatically in 2006. See OFFICE OF FED. HOUSING ENTERPRISE

mortgage backed securities as well as the residential real estate market in general showed the classic signs of imminent collapse. Mortgage borrowers and investors appeared to believe that the prices and values of homes would rise infinitum. Investors purchased mortgage backed securities at a fevered pace. Over 75% of the subprime mortgages originated in the first quarter of 2007 were packaged and sold as mortgage backed securities.² Investors continued to purchase these securities even as evidence mounted suggesting that homes were being overpriced and that the mortgages backing those securities were becoming increasingly risky.³

Prices, of course, did not continue to rise and mortgage defaults skyrocketed in 2007, triggering a worldwide recession.⁴ In June 2007,

OVERSIGHT, WIDESPREAD HOUSE PRICE DECLINES IN FOURTH QUARTER at 6 (February 26, 2008), available at <http://www.ofheo.gov/media/pdf/4q07hpi.pdf>.

2. *Securitization Takes Huge Bite of Early 2007 Mortgage Originations as Bank Retained Portfolios Shrink*, INSIDE MORTGAGE FINANCE, June 29, 2007.

3. See e.g., Karen Sibayan, Fitch Announces New Subprime Mortgage Product, ASSET SECURITIZATION REPORT (April 21, 2003); Mark Zandi, Household Lending From Here to 2020, Statistical Data Included, J. LENDING & CREDIT RISK MGMT., September 1, 1999; Bonnie Sinnock, Originators Securitized 65% of 1Q Production, ORIGINATION NEWS, August 25, 2003, at 1 (referencing the concerns of some in the lending industry that underwriting standards have weakened and changing economic circumstances may lead to increased losses in the subprime sector); Ted Cornwell, Rising Interest Rates Portend Early Defaults, MORTGAGE SERVICING NEWS, August 1, 2000 at 1 (raising concerns that rising interest rates will lead to increased mortgage defaults); Fitch Announces New Subprime Mortgage Product, Asset Securitization Report, April 21, 2003; Ted Cornwell, "Are MBS Getting Riskier? Loans May Falter in a Downturn," NATIONAL MORTGAGE NEWS, Jan. 31, 2000 (raising concerns about the loan to value ratio and whether subprime loans will continue to perform well if the economy cools); *Collateral Values Tend to Shrink When Subprime Mortgage Go Bad*, NATION MORTGAGE NEWS, March 8, 1999 (discussing the unreliability of appraisals on homes financed with subprime loans). In fact, problems in the mortgage backed securities industry, especially with respect to subprime loans, had begun to surface as early as the late 1990s. Industry insiders raised questions about the loan to value ratios of subprime loans, rising interest rates, overestimated home appraisals, and the general weakening of subprime underwriting. Financial regulators began to observe a relaxation in underwriting and noted a concomitant increase in risk. OFFICE OF THE COMPTROLLER OF THE CURRENCY, SURVEY OF CREDIT UNDERWRITING PRACTICES 2007, October 2007; OFFICE OF THE COMPTROLLER OF THE CURRENCY, SURVEY OF CREDIT UNDERWRITING PRACTICES 2006, October 2006; OFFICE OF THE COMPTROLLER OF THE CURRENCY, SURVEY OF CREDIT UNDERWRITING PRACTICES 2005, October 2005.

4. The delinquency rate for subprime loans was 13.77% in the first quarter of 2007. *Delinquencies Decrease in Latest MBA National Delinquency Survey*, Mortgage Bankers Association, June 14, 2007. This represents a 44 basis point increase over the prior quarter and a 227 basis point year over year increase. By way of comparison, the delinquency rate for prime loans in the first quarter of 2007 was 2.58% representing a 1 basis point increase from the prior quarter and a 33 basis point year over year increase. *Id.* As of the first quarter of 2008, the delinquency rate for subprime loans stood at 18.67% a 12 basis point decrease over the prior quarter and a 385 basis point year over year increase. Prime delinquencies stood at 3.93%, a 22 basis point increase over the prior quarter and a 120 basis point increase over the prior year. *Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey*, Mortgage Bankers Association, September 5, 2008.

investors' confidence began to falter as a result of announcements by Moody's Investors Service (Moody's) and Standard and Poor's (S&P), the two largest bond rating agencies, that they would be downgrading hundreds of subprime mortgage backed securities.⁵ Although the downgrades represented a fraction of the total outstanding subprime mortgage backed securities, these downgrades resulted in a shift in investor sentiment reaching far beyond the specific downgraded securities. Concerns about the quality of the rating agencies' evaluation of mortgage backed securities as well as the quality of ratings on other asset backed instruments grew.⁶ Investors all over the globe have experienced sizable losses as a result of their holdings of mortgage backed securities and other subprime and mortgage related debt.⁷ Noted economist and New York University Stern Business School Professor Nouriel Roubini estimates losses could reach 3.6 trillion for U.S. institutions.⁸

5. Standard & Poor's, *612 U.S. Subprime RMBS Classes Put on Watch Neg; Methodology Revisions Announced* (July 10, 2007); Serena Ng & Ruth Simon, *Ratings Cuts By S&P, Moody's Rattle Investors*, WALL ST. J., July 11, 2007, at A1.

6. Several lawsuits have been filed against rating agencies arising out of subprime crisis. See e.g., N.J. Carpenters Vacation Fund v. Harborview Mortgage Loan, 581 F. Supp. 2d 581 (S.D.N.Y. 2008) (alleging rating agencies assigned higher than warranted ratings to mortgage backed securities). The rating agencies have also been sued by their shareholders alleging violations of the Securities Exchange Act 1934 for misrepresenting or failing to disclose that the agency had assigned higher than warranted ratings to mortgage backed securities and other asset backed securities. See *In re Moody's Corp. Sec. Litig.*, 612 F. Supp. 2d 397 (S.D.N.Y. 2009). Risk spreads on most securities and credit instruments increased. See Bonnie Sinnock, *Heavy Selling Seen Widening MBS Spreads to 1986 Level*, National Mortgage News, March 10, 2008, available at <http://www.nationalmortgagenews.com/premium/archive/?id=158952> (discussing the growing spread between agency mortgage backed securities and Treasuries); John W. Snow, *Medicine for an Ailing Economy*, WALL ST. J., Dec. 26, 2007, at A11; Leslie Wines, 'Fear Trade' Pushes Treasuries Higher, MARKETWATCH, July 26, 2007, available at <http://www.marketwatch.com/news/story/treasuries-rally-weak-stocks-corporate/story.aspx?guid=%7BFF04747D%2D8B56%2D43A9%2DAE93%2D9CC5CE417397%7D> (discussing the widening spread between Treasuries and corporate bonds); Jenny Anderson, *Another New York Attorney General Starts a Wall Street Crusade*, N.Y. TIMES, Dec. 7, 2007, at C6 (In July 2007 some subprime-linked collateralized debt obligations were trading at spreads of 240 basis points over the London interbank offered rate last March.).

7. Investment banks lost money because they were holding mortgage and mortgage-backed securities that they had not yet securitized and sold. Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, BERKELEY BUS. L.J., Vol. 6, Fall 2009 at 47 (forthcoming 2009). Losses at commercial banks are estimated at approximately \$400 billion. Carrick Mollenkamp & Neil Shah, *Market's Tumult: Fortis Sets Plan to Raise \$13 Billion*, WALL ST. J., June 27, 2008, at C2. Pension fund are estimated to have lost \$2 trillion dollars between the second quarter of 2007 and the second quarter of 2008. *The Impact of the Financial Crisis on Workers' Retirement Security: Hearing before the H. Comm. on Ed. & Lab.*, 110th Cong. 1 (2008) (statement of Peter R. Orzag, Director of the Cong. Budget Office). Hedge funds posed their worst losses since 1997 according to EDHEC Risk and Asset Management Research. Funds of fund lost 17% in 2008. EDHEC RISK AND ASSET MANAGEMENT RESEARCH CENTER, *HEDGE FUND PERFORMANCE IN 2008* (2009).

8. Henry Meyer & Ayesha Daya, *Roubini Predicts U.S. Losses May Reach \$3.6 Trillion*, BLOOMBERG, Jan. 20, 2009, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=as0>

As losses mount, lawmakers and angry investors have demanded answers from the investment banks that sold these securities, the asset managers that invested in the securities, the companies that insured these securities and the regulators that were supposed to be overseeing these entities.⁹ In addition, a good deal of investor anger has been focused on the credit rating agencies that analyzed the credit risk of these mortgage backed securities and generally rated them highly.

The rating agencies face charges that they deliberately underestimated the risks of mortgage backed securities in pursuit of their own self interests and to the detriment of the interests of investors, and ultimately the market. Most of the criticism is aimed at weaknesses in the models and methodologies used in determining ratings and the failure of the rating agencies to respond to declines in underwriting and loan quality. These failures have renewed inquiries into whether rating agencies should be more closely regulated.

The dominant view concerning regulation of the rating agencies is based upon the "reputational-capital" theory, which holds that an agency's success is primarily a result of the agency's track record in issuing accurate ratings. If investors believe that an agency's ratings are inaccurate they will stop relying upon those ratings and the agency's profits will suffer. Thus, the agency's interest in maintaining a reputation for accurate ratings will be sufficient incentive to insure accurate ratings and regulation is unnecessary.

Despite the general acceptance of the reputational capital view of rating agency regulation, policymakers have on several occasions inquired into whether regulation and oversight of the rating agencies should be increased.¹⁰ Lawmakers have recognized several discrete issues that undermine rating agencies' performance. These include a lack of transparency regarding the procedures and methodologies used in issuing a rating, conflicts of interests arising out of the fact that agencies are paid by the issuers of the instruments they are hired to rate, and

yBnMR3USK. The International Monetary Fund estimated losses from bad U.S. debt alone could reach \$2.2 trillion dollars. Tom Barkley, *IMF Dims Its Economic Outlook but Says Recovery Can Start By Years End*, WALL ST. J., Jan. 29, 2009, at A8.

9. See *The Financial Crisis and the Role of Federal Regulators: Hearing before H. Comm. On Oversight and Government Reform*, 110th Cong. (2008) [hereinafter *Hearing*]; *Hearing on the Causes and Effects of the AIG Bailout: Hearing Before Comm. on Oversight and Government Reform*, 110th Cong. (2008); *Turmoil in the U.S. Credit Markets: Examining Recent Regulatory Responses: Hearing Before S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2008); *Regulatory Restructuring and Reform of the Financial System: Hearing Before H. Comm. on Oversight and Gov't Reform*, 110th Cong. (2008).

10. See, e.g., Disclosure of Security Ratings, 59 FR 46304 (proposed Sept. 7, 1994) (proposing rules that would mandate the disclosure of ratings for structured finance securities); *Role of the Rating Agencies*, *infra* note 22 (the possibility of increasing oversight of NRSROs is discussed throughout)

regulatory dependency upon ratings.¹¹ Following the corporate scandals typified by Enron and WorldCom, the Securities and Exchange Commission, the primary regulatory body for rating agencies, proposed a number of rules designed to address these issues¹². In 2006, Congress took up the mantle and enacted the Credit Rating Agency Reform Act (the "Act") which required that a rating agency disclose its procedures for issuing ratings and mandated that rating agencies have policies in place to manage conflicts of interest.¹³ The Act also gave the SEC the power to suspend or revoke an agency's designation as an NRSRO for violations of the Act. However, the Act simultaneously limited the SEC's regulatory authority over NRSROs. In particular, the SEC is prohibited from "regulating the substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings."¹⁴ NRSROs have already evidenced an intent to use this language to severely limit the SEC's purview.

This Article draws upon the works of scholars who have challenged the conventional wisdom that reputational concerns alone are always sufficient to prevent gatekeepers from inaccurate certification.¹⁵ This Article argues that reputational incentives are insufficient to insure accurate ratings under certain circumstances. In particular, reputational incentives are insufficient in new market segments, market segment in which there are a small number of issuers wielding substantial power and ratings driven markets. In making this point, the Article will draw upon evidence of the NRSRO's failures with respect to ratings of mortgage backed securities and collateralized debt instruments.

Part I of this Article discusses the role of the rating agencies in the market for mortgage backed securities and other structured finance products. It also discusses the allegations of misdoing that have been leveled against the rating agencies. Part II then sets forth the reputational capital theory of regulation and criticisms that have been leveled against it. Part III examines situations in which the reputational capital theory may be

11. See, e.g., *Role of the Rating Agencies*, *infra* note 22 at 25, at 45–46; Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, 68 Fed. Reg. 35258 (proposed June 12, 2003); *Assessing the Current Oversight and Operation of Credit Rating Agencies*, S. Comm. on Banking, Housing and Urban Affairs, Mar. 7, 2006.

12. See, e.g., *Conditions for Use of Non-GAAP Financial Measures*, 68 Fed. Reg. 4820 (January 30, 2003); *Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002*, 68 Fed. Reg. 5110 (January 31, 2003); *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, 68 Fed. Reg. 5982 (February 5, 2003).

13. 15 U.S.C.S. § 78o-7(h) (2008).

14. See 15 USCS §78o-7(c)(2).

15. See, e.g., Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 NW. U.L. REV. 133 (2000); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001).

insufficient to ensure accurate rating and discusses how those situations relate to the current crisis. Part IV discusses the rating agencies' exposure to liability. It concludes that rating agencies have little to fear from civil liability which further undermines their incentives toward accuracy. Part V discusses the regulatory response to ratings failures that precipitated the financial crisis and makes a proposal for rating agency duties and increased liability.

I. THE MORTGAGE BACKED SECURITIES MARKET AND THE RATING AGENCIES

A. *History of the Rating Agencies*

Before the late 1980s most U.S. businesses were local operations that relied upon personal relationships in order to cultivate customers and credit.¹⁶ As the economy grew, so did the scope of business relations. Transactions between persons that had no personal relationship became more common and this increased the need for reliable information about business entities.¹⁷ John Moody is widely credited with starting the first bond rating agency which was formed to address the need for information with respect to the creditworthiness of bond issues.¹⁸ Moody's synthesized the relevant information about a bond issuance into an easily understandable symbol that represented the creditworthiness of the issue.¹⁹ Ratings range from AAA to C, with an "AAA" rating indicating that the rating agency believes that the bond has a relatively low chance of defaulting, an "AA" rating indicating a slightly greater chance of default than an "AAA" rated bond and so forth.²⁰ In the years that followed Moody's incorporation, several other credit rating agencies were founded.²¹ The agencies have expanded their rating services to include not only ratings of corporate bonds but issuances of

16. Richard Sylla, *A Historical Primer on the Business of Credit Rating*, in RATINGS RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 19, 23 (Richard M. Levich et al. eds., 2002).

17. *Id.*

18. *Id.*

19. *Id.*; see also Douglas L. Bendt et al., *The Rating Agencies' Approach*, in THE HANDBOOK OF MORTGAGE-BACKED SECURITIES (Frank Fabozzi ed., 2002) (explaining how rating agencies rate mortgage backed securities); Michael F. Molesky, *An Overview of Mortgage Credit Risks from a Rating Agency Perspective*, in THE SECONDARY MORTGAGE MARKET: A HANDBOOK OF STRATEGIES, TECHNIQUES, AND CRITICAL ISSUES IN CONTEMPORARY MORTGAGE FINANCE 317 (Jess Lederman ed., Probus Publishing Co. 1987) (explaining the rating agency view of credit risks of mortgage backed securities).

20. See Standard & Poor's Rating Definitions, Dec. 1, 2008 available at http://www2.standardandpoors.com/spf/pdf/fixedincome/Ratings_Definitons.pdf; Fitch Ratings Definitions, available at http://www.fitchratings.com/corporate/fitchResources.cfm?detail=1&rd_file=ltr#NLTR (last visited Mar. 29, 2009); Moody's Rating & Symbols, http://www.rbcpa.com/Moody's_ratings_and_definitions.pdf (last visited Mar. 29, 2009).

21. *Id.* S&P entered the bond rating market in 1916. *Id.* Fitch was founded in 1913. The

municipal bonds, mortgage backed securities, and other structured finance bonds.²² A high rating allows the issuer of the bond to offer a lower interest rate to investors purchasing the bond.²³

Regulators began incorporating credit ratings into the regulatory scheme for banks in the early 1930s. The Banking Act of 1935 provided that national banks could only purchase securities that were investment securities, which was later defined by the Comptroller of the Currency to be securities that were not “distinctly and predominately speculative” as defined by the rating agencies.²⁴ Other regulatory bodies soon followed suit.²⁵ These regulations prohibited many of the biggest purchasers of bonds, like pension funds, insurance companies, and banks, from purchasing low or unrated debt and, as a consequence, increased the demand for ratings.²⁶

In 1975, the Securities and Exchange Commission issued the first regulation that relied upon ratings from a Nationally Recognized Statistical Ratings Organizations (NRSROs) and recognized Moody's, S&P and Fitch as NRSROs.²⁷ Over time increasing numbers of regulations conditioned favorable regulatory treatment upon the receipt of investment grade ratings.²⁸ For example, a money market mutual fund is limited to investing in “eligible securities” which include securities that receive one of the two highest ratings from an NRSRO.²⁹ The Depart-

History of Fitch Ratings, <http://www.fitchratings.com/jsp/corporate/AboutFitch.faces?context=1&detail=3>.

22. Frank Partnoy, *The Paradox of Credit Ratings*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65, 68-72 (discussing early credit rating practices) (2002); Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 47-51 (2009).

23. Neil D. Baron, *The Role of Rating Agencies in the Securitization Process*, in A PRIMER ON SECURITIZATION, 81-83 (Leon T. Jendall & Michael J. Fishman eds., MIT Press 1996); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 653 (1999) (questioning whether the reduction in rate that comes with an investment grade rating is worth the fee paid for the rating).

24. Frank Partnoy, *The Paradox of Credit Ratings*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65, 71 (2002).

25. *Id.* at 70-75.

26. *Id.*

27. The SEC rule concept was created as part of legislation allowing brokers to set aside lower reserves for securities that had been rated highly, or investment grade, by credible ratings agencies.

28. See Partnoy, *supra* note 24, at 74-75 (listing some of the regulations that incorporate ratings).

29. Rule 2a-7(a)(10)(i) of the Investment Company Act. State and federal regulations also give favorable regulatory treatment to instruments that achieve the highest ratings from these NRSROs and limits certain investors, like pension funds that are ERISA fiduciaries and money market mutual funds to investments receiving the highest ratings from one of the NRSROs which gives these agencies a competitive advantage over non-NRSROs. INVESTMENT COMPANY ACT OF 1940 R. 2A-7(A)(10)(i).

ment of Education uses ratings from NRSROs in setting standards for institutions that wish to participate in student financial assistance programs.³⁰ And several state insurance codes rely upon NRSRO ratings in setting standards for investments by insurance companies.³¹ Many other institutions' internal guidelines mandate investments that have been rated by NRSROs.³² Even foreign jurisdictions have integrated the use of NRSRO ratings into their laws.³³ The designation of a bond as investment grade, then, has important implications on the soundness of many of the institutions that are integral to our financial system.

NRSRO designation is an extremely valuable asset for a rating agency to have. Prior to 2007, only four agencies had been designated NRSROs and of these four Fitch, Moody's and S&P had been grandfathered in by the rules that created the NRSRO designation.³⁴ As a result these three agencies dominate the credit rating market.³⁵ Moody's and S&P combined control 80% of the market for ratings, with Moody's controlling 39% of the market and S&P controlling 40% of the market.³⁶ Together with Fitch these three agencies make up approximately 95% of the market.³⁷ It is no surprise then that NRSROs have played a substantial role in the development of the market for mortgage backed securities.

B. *The Rating Agencies and Securitization*

The origin of mortgage backed securities rests in the nineteenth century where as early as the 1880s, private mortgage companies had begun raising capital by issuing bonds which were secured by the mort-

30. SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS (2003), <http://www.sec.gov/news/studies/credratingreport0103.pdf> (citing 20 U.S.C. § 1070, 42 U.S.C. § 2751, and 34 CFR §§ 668.15(b)(7)(ii) and (8)(ii)).

31. *Id.*

32. Even where there is no legal requirement to do so, many institutions will limit themselves to investments rated by an NRSRO. *Id.* at 28.

33. *Id.*

34. Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 41, 46 (2002). The rating agencies were designated NRSROs by no-action letters. See Letter from Annette L. Nazareth, Director, SEC Division of Market Regulation, to Mari-Anne Pisarri, Pickard and Djinis LLP (Feb. 24, 2003).

35. Moody's and S&P combined control 80% of the market for ratings, with Moody's controlling 39% of the market and S&P controlling 40% of the market. Moody's Corporation 2007 Investors Day Presentation at 10 (Jun 5, 2007); The Economist, *Measuring the Measurers*, May 31, 2007; Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 59 (2004). Together with Fitch these three agencies make up approximately 95% of the market. *Id.* at 59.

36. Moody's Corporation 2007 Investors Day Presentation at 10 (June 5, 2007); The Economist, *Measuring the Measurers*, May 31, 2007; Hill, *supra* note 35, at 59.

37. *Id.*

gages held by the company.³⁸ However, this early market encountered some of the same problems experienced today involving inflated appraisals and fraud in originations and ultimately collapsed during the recessions of the 1890s.³⁹ Almost a century later, securitization would find new life in the hands of the federal government.

Prior to the creation of the Federal Housing Administration (FHA), mortgage lending was dominated by savings and loans which used the deposits from their customers to make loans.⁴⁰ S&L's, therefore, were limited in the number and amount of mortgage financing they could provide.⁴¹ The FHA was created in 1934 in order to provide stability to the mortgage lending market. It does so by insuring mortgagors and their successors in interest against mortgage defaults on loans that have been underwritten using FHA standards.⁴² Between 1938 and 1970, three government sponsored entities were created in order to facilitate the creation of a secondary market for these mortgages: the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Government National Mortgage Association (Ginnie Mae).⁴³ In 1970, Ginnie Mae issued the first mortgage-backed security.⁴⁴ These certificates "passed through" to investors the interest income from a diversified undivided pool of mortgages.⁴⁵

As the biggest purchasers of prime mortgages these government

38. Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2193 (2007) (citing Michael J. Lea, *Innovation and the Cost of Mortgage Credit: A Historical Perspective*, 7 HOUSING POL'Y DEBATE 147, 154 (1996)); Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1379-80 (1991).

39. *Id.* at 2193-94.

40. See Lawrence J. White, *The S&L Debacle*, 59 FORDHAM L. REV. 57, 62-63 (1991) (discussing the inherent problem with S&Ls borrowing from their depositors in order to make long term mortgage loans).

41. *Id.* S&L deposits were short-term deposits which could be withdrawn at any time. Mortgage loans are long-term. If interest rates went up dramatically S&Ls would face serious financial difficulty because they would have made long-term mortgages at fixed interest rates that were now lower than the going interest rates. To keep the depositors from putting their money in higher yielding investments, S&Ls would have to raise the rates that they paid to their depositors. This is problematic, however, because, the S&L would not be generating adequate income from the mortgage loans made in prior years to cover the costs of paying higher interests rates to depositors. *Id.*

42. Kenneth H. Sullivan, *The Mortgage Market*, in HANDBOOK OF MORTGAGE-BACKED SECURITIES 7 (Frank Fabozzi, ed., 1985).

43. THOMAS H. STANTON, *A STATE OF RISK: WILL GOVERNMENT SPONSORED ENTERPRISES BE THE NEXT FINANCIAL CRISIS* 21-23 (1991); Sullivan, *supra* note 42, at 16. At their inception Ginnie Mae and Fannie Mae purchased only FJA or VA insured loans. In 1970, Fannie Mae's charter was amended to allow the purchase of conventional (prime) loans. From its inception, Freddie Mac was permitted to purchase conventional non-FHA or VA insured loans.

44. STANTON, *supra* note 43, at 22.

45. See JOSEPH HU, *BASICS OF MORTGAGE BACKED SECURITIES* 21-30 (2001).

sponsored entities ("GSEs") became de facto regulators of the quality of these mortgages by establishing strict rules regarding what loans they would purchase. Lenders that wished to sell their loans to the GSEs would have to use the financial models and comply with strict underwriting standards and documentation standards established by the GSEs.⁴⁶ Thus, the GSEs played a substantial role in ensuring the quality of the loans backing the mortgage backed securities they issued and increasing investor comport with these securities.⁴⁷ It is in part for this reason that investors do not demand ratings for GSE issued mortgage backed securities.⁴⁸

Investors were drawn to GSE mortgage backed securities for a second reason: Fannie Mae and Freddie Mac issued securities have been viewed by the market to carry an implicit government guarantee based upon the perception that the GSEs were "too big to fail."⁴⁹ In other words, the market behaves as if the government will bail out the GSEs if they get into trouble; therefore, the risk of loss associated with securities issued by the GSEs is lower than with comparable securities. The implicit guarantee increases the attractiveness of these securities.⁵⁰

Private lending institutions quickly saw the potential of securitization to connect the capital markets with the mortgage market.⁵¹ The pri-

46. Freddie Mac, Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families, <http://www.freddiemac.com/corporate/reports/moseley/mosehome.htm> (last visited Jan. 16, 2009); Federal Housing Administration, Mortgage Credit Analysis for Mortgage Insurance on One-to-Four-Unit Mortgage Loans, http://portal.hud.gov/portal/page?_pageid=73,1824174&_dad=portal&_schema=PORTAL (last visited January 16, 2009) (describing mortgage underwriting requirements for FHA loans).

47. Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369 ("Governmental efforts to develop the secondary mortgage market promoted securitization . . . by standardization of mortgages and guarantees of government-related agencies stimulated public demand for these mortgage-backed securities.").

48. David J. Askin, *The Rating of Mortgage Backed Securities*, in HANDBOOK OF MORTGAGE BACKED SECURITIES 497, 501 (Frank Fabozzi ed., 1985).

49. In February 2008, the implicit guarantee became explicit when the federal government seized control of Fannie Mae and Freddie Mac as a result of the credit crisis.

50. The value of the implicit guarantee is reflected in the fact that the GSEs can obtain funding at lower yields than comparable issuers. With non-prime loans, if the borrower is unable to repay the principle and interest, the lender suffers the loss. In contrast, most prime loans carry either an explicit or implicit guarantee from federal government. Sullivan, *supra* note 42, at 15-16; STANTON, *supra* note 43, at 204.

51. The first private label security was issued in 1977. Lewis S. Ranieri, *The Origins of Securitization, Sources of Its Growth, and Its Future Potential*, in A PRIMER ON SECURITIZATION 31, 33-34 (Leon T. Kendall & Michael J. Fishman eds., 1996); Charles M. Sivesind, *Mortgage-Backed Securities: The Revolution in Real Estate Finance*, in HOUSING AND THE NEW FINANCIAL MARKETS 311, 321 (Richard L. Florida ed., 1986); Donald S. Bernstein et al., Comm. on Bankr. and Corporate Reorganization of the Ass'n of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW 527, 529 (1995). Many investors' investment guidelines had been written prior to this product's creation and, as interpreted, did not permit investment in mortgage backed securities. Investors also had difficulty comparing the value of these securities

vate market for mortgage-backed securities, however, grew outside of the market imposed by the GSEs.⁵² Private label mortgage-backed securities do not have the benefit of an implicit government guarantee, and the biggest purchasers of loans were investment and commercial banks, which did not subscribe to the underwriting standards that the GSEs had imposed on the prime market⁵³. The creation of a market for mortgages outside of the constraints of those imposed by the GSEs gave mortgage lenders incentive to lower their underwriting standards and to sell their riskiest loans to investors. Investors lack the information that the lender has that would indicate whether or not a borrower is likely to default. Once the loan is sold, the lender is unaffected by borrower defaults.⁵⁴ This information asymmetry allows lenders the opportunity to profit from the origination of low quality loans, the risks of which are born by investors. Thus, investors turned to the rating agencies for assur-

with other comparable investments because there was no reliable method for valuing the securities. These hurdles led one of the leaders in the creation of mortgage-backed securities to remark, "We had a wonderful concept that was a marketplace failure." Ranieri, *supra*, at 33. The volume of mortgages that a mortgage company can produce is limited by the amount of capital available to the company. Private investors in the aggregate possess large amounts of capital but have generally shied away from investing in mortgages because they lack the ability to cost effectively originate and monitor mortgages. Securitization solves these problems by aggregating hundreds, if not thousands, of loans, thereby reducing the risk of loss associated with any particular loan defaulting. See Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 535-45 (explaining how securitization changed the mortgage lending market).

52. The GSEs were slow to move into the subprime market. In 2000, Fannie Mae and Freddie Mac bought just over 19 billion dollars of the 160 billion dollars worth of subprime loans outstanding. KENNETH TEMKIN ET AL., SUBPRIME MARKETS, U.S. DEP'T OF HOUS. AND URBAN DEV., THE ROLE OF GSEs AND RISK BASED PRICING 21 (2002), available at <http://www.huduser.org/Publications/pdf/Subprime.pdf>.

53. Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2214-15 (2007); *Non Agency MBS Production by Issuer Type*, 1 THE 2008 MORTGAGE MARKET STATISTICAL ANNUAL 14 (2008). In 2006 and 2007, investment banks and commercial banks combined comprised 56.3 % and 68.3 % of the market while GSEs comprised 0.2% and 0.6%

54. It is not uncommon for purchase and sale agreements/pooling agreements to include recourse clauses requiring that the lender buy back or replace loans that default soon after having been sold to the mortgage pool. These provisions, however, are only helpful if the lender is capable of buying back the loan or replacing it. Many of the biggest and most prolific lenders in the last several years have declared bankruptcy or gone out of business. Participants in the market for mortgage-backed securities have attempted to address this problem in several ways, including (1) to make the lender retain some of the credit risk; and (2) by requiring lenders to retain a junior interest, such as the equity tranche, in the mortgage pool. This position means that the lender will be the first to suffer losses if the mortgages in the pool default. A lender in this situation is typically referred to as having taken a "first loss" position. As demand for mortgage-backed securities has grown, lender retention of residuals has waned. Kathleen C. Engle & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2066-68 (2007) (explaining that lenders often sell the junior tranches of mortgage backed securities to investors or into CDOs eliminating their incentive to maximize the credit risk of the loans).

ance that the securities would deliver income as promised⁵⁵. The primary constraint on lenders and issuers as to quality of the mortgages that are originated, purchased and sold is whether or not the loans could be packaged and sold to investors, which was directly influenced by whether or not the rating agencies would rate the mortgage pools with those loans. Thus, the rating agencies became the de facto gatekeepers of the market.⁵⁶

C. Ratings and the Credit Crisis

In the last decade investors' appetite for high yielding structured finance securities seemed insatiable.⁵⁷ Between 1995 and 2004, the dollar amount of private label mortgage-backed security issuances alone grew a staggering 1,666%.⁵⁸

In June 2007, investors' confidence began to falter as a result of announcements by Moody's and S&P that they would be downgrading hundreds of subprime mortgage backed securities.⁵⁹ Although these downgrades represented a small fraction of the total outstanding structured finance securities, these downgrades resulted in a shift in investor sentiment reaching far beyond the specific downgraded securities. By the fourth quarter of 2007, trading in mortgage-backed securities was at a near standstill. Investors grew concerned about the quality of the rating agencies' evaluation of other asset backed instruments.⁶⁰ As uncertainty

55. Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. Banking Inst. 5, 48-50 (2009).

56. Leon T. Kendall, *Securities: A New Era in American Finance*, in A PRIMER ON SECURITIZATION 1, 16 (Leon T. Kendall & Michael J. Fishman eds., 1996) ("The rating agencies . . . have become the gatekeepers."); *Securitisation: Fear and Loathing, and a Hint of Hope*, ECONOMIST, Feb. 14, 2008, at 14 (casting rating agencies as gatekeepers in securitization process).

57. *Securitization Rates for Home Mortgages*, 2 THE 2008 MORTGAGE MARKET STATISTICAL ANNUAL 3 (2008) (giving statistics regarding the growth of subprime originations in 2005, 2006, 2007).

58. *Inside Mortgage Finance, Non-Agency MBS Issuance by Type*, 2 THE 2008 MORTGAGE MARKET STATISTICAL ANNUAL 13 (2008). Over 75% of the subprime mortgages originated in the first quarter of 2007 were packaged and sold as mortgage backed securities. *Securitization Takes Huge Bite of Early 2007 Mortgage Originations as Bank Retained Portfolios Shrink*, INSIDE MORTGAGE FINANCE, June 29, 2007.

59. STANDARD & POOR'S, 612 U.S. SUBPRIME RMBS CLASSES PUT ON WATCH NEG; METHODOLOGY REVISIONS ANNOUNCED, July 10, 2007, at 1-5; Serena Ng & Ruth Simon, *Ratings Cuts By S&P, Moody's Rattle Investors*, WALL ST. J., July 11, 2007, at A1.

60. Several lawsuits have been filed against rating agencies arising out of subprime crisis. See, e.g., N.J. Carpenters Vacation Fund v. Harbor View Mortgage Loan Trust 581 F. Supp. 2d 581, 582 (S.D.N.Y. 2008) (alleging rating agencies assigned higher than warranted ratings to mortgage backed securities). The rating agencies have also been sued by their shareholders alleging violations of the Securities Exchange Act 1934 for misrepresenting or failing to disclose that the agency had assigned higher than warranted ratings to mortgage backed securities and other asset backed securities. See, e.g., In re Moody's Corp. Sec. Litig., 612 F. Supp. 2d 397 (S.D.N.Y. 2009).

about the markets's exposure to subprime mortgage securities grew, risk spreads on most securities and credit instruments increased.⁶¹

Investors angry about losses related to mortgage backed securities have demanded answers from the investment banks that sold these securities, asset managers that invested in these securities, the third parties that insured these securities, and the regulators that were supposed to be overseeing these entities.⁶² A good deal of investor anger has also been focused on the rating agencies and whether they lowered their rating standards in order to continue to receive the massive amount of revenue that was being generated by rating mortgage backed securities.⁶³

1. HISTORICAL DATA

Many of the allegations against the rating agencies have focused on the failures inherent in the rating models. Rating models rely upon the historical performance of a class of assets in order to predict how that asset is likely to perform in the future.⁶⁴ Rating agency critics charge,

61. See, e.g., Bonnie Sinnock, *Heavy Selling Seen Widening MBS Spreads to 1986 Level*, NATIONAL MORTGAGE NEWS, Mar. 10, 2008, available at <http://www.nationalmortgagenews.com/premium/archive/?id=158952> (discussing the growing spread between agency mortgage backed securities and Treasuries); John W. Snow, *Medicine for an Ailing Economy*, WALL ST. J., Dec. 26, 2007, at A11; Leslie Wines, *Treasuries Rally On Weak Stocks And Corporate Bonds*, DOW JONES BUS. NEWS, July 26, 2007 (discussing the widening spread between Treasuries and corporate bonds); Jenny Anderson, *Another New York Attorney General Starts a Wall Street Crusade*, N.Y. TIMES, Dec. 7, 2007, at C6 (In July 2007, some subprime-linked collateralized debt obligations were trading at spreads of 240 basis points over the London interbank offered rate last March).

62. Hundreds of securities lawsuits have been filed related directly to subprime losses. See Cornerstone Research, *Litigation Against Financial Services Firms Dominates Securities Class Action Filings*, Jan. 6, 2009, http://securities.stanford.edu/clearinghouse_research/2008_YIR/20080106.pdf; Nancy Trejos, *Livid Investors Launch A Volley of Lawsuits*, WASH. POST, Jan. 18, 2009, at F01.

63. Hearing, *supra* note 9; *Hearing on the Causes and Effects of the AIG Bailout: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. (2008) (discussing rating shopping). E-mails produced as evidence during the hearing show that investors had been complaining to the rating agencies about the decline in their rating standards. See, e.g., E-mail from Mary Elizabeth Brennan to Moody's Subprime Working Group (July 11, 2007 22:55 GMT), available at <http://oversight.house.gov/story.asp?ID=2250> (hereinafter "Brennan email").

64. An important part of the rating process is estimating the expected losses from the asset pool which will be used to determine the required level of credit enhancements necessary for a tranche to receive a particular credit rating. Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit*, Fed. Reserve Bank of N.Y. Staff Rep. 318 (Mar. 2008), at 40 (hereinafter "Understanding the Securitization of Subprime Mortgage Credit"); *The Role of Credit Rating Agencies in the Structured Finance Market: Hearing Before the Subcomm. on Capital Markets, Ins., and Gov't Sponsored Enterprises of the H. Comm. on Fin. Serv.*, 110th Cong. 16–17 (2007) (statement of Mark Adelson), available at http://frwebgate.access.gpo.gov/cgi-bing/getdoc.cgi?dbname=110_house_hearings&docid=f:39541.pdf. The model for estimating loss distribution is based on historical data concerning the frequency of default and foreclosure, underwriting characteristics, and local and economic conditions. Using this model, portfolio specific estimates and assumptions relating to the probability of default of the obligors in a mortgage pool, the recovery or loss rates given a default, and the default correlations—the

among other things, that the agencies based their rating models on historical data that did not reflect the characteristics of subprime mortgages and subprime mortgage pools.⁶⁵

Most rating agencies relied upon loan data from 1992 through 2000 in estimating the probability of default and expected magnitude of losses from subprime loans in a given pool.⁶⁶ Using this information to estimate more recent subprime mortgages, however, leads to unjustifiably low loss expectations for several reasons. First, although subprime mortgages have been around for some time now, subprime originations comprised a small portion of all mortgage lending until 2004.⁶⁷ Mortgage data compiled for the period 1992 through 2000 would be a very poor sample set upon which to evaluate future subprime mortgage performance.⁶⁸

More importantly, a data set comprising mortgages originated between 1992 and 2000 will include few of the innovative subprime mortgage products that were popular in the years preceding this crisis.⁶⁹ Prior to 2002, interest only loans were virtually non-existent in subprime mortgage pools. The rate of inclusion of 2/28 adjustable rate mortgages also increased dramatically after 2002. This is significant because interest only loans and adjustable rate mortgages are at a greater risk of default than traditional mortgages.⁷⁰ A 1992 through 2000 data set that

tendency of multiple defaults to occur within a given period of time—the rating agency will determine the overall credit quality of a pool. Mark H. Adelson, *CDO and ABS Underperformance: A Correlation Story*, J. OF FIXED INCOME, December 2003, at 53, 53 (proposes that there was an underestimation of correlations in the rating agencies' default model).

65. Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions* 9–10 n.10 (working paper, 2007), available at <http://ssrn.com/abstract=1027475> (“However, given the lack of historical default data and the analytical challenges in assessing credit risk exposures . . . it is likely to be a more important issue in the credit risk than in the market risk world. . . . This applies, in particular, for structured finance instruments As a result, model-based risk assessments can be a long way from ‘true’ values.”); Brennan email, *supra* note 63 (challenging Moody’s rating methodology).

66. Ashcraft & Schuermann, *supra* note 64, at 41; Bill Hunt, Glenn Costello, & Suzanne Mistretta, *ResiLogic: U.S. Residential Mortgage Loss Model*, Residential Mortgage Criteria Report at 1 (Aug. 14, 2007) (Fitch rating model for mortgage backed securities is based upon performance history of residential mortgages originated between 1992 and 2000).

67. *Securitization Rates for Home Mortgages*, *supra* note 57, at 3.

68. Subprime lending comprised 1.4% of all mortgages originated in 1983. By 2000, subprime loans comprised 10.2% of all mortgages. Between 1994 and 2000, subprime mortgages grew at an average annual rate of 26%. Sally Pittman, *Arms, But No Legs to Stand On: “Subprime” Solutions Plague the Subprime Mortgage Crisis*, 40 TEX. TECH L. REV. 1089, 1097 (2008).

69. Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 FED. RESERVE BANK OF ST. LOUIS REV. 31, 41–43 (2006).

70. See generally Donald F. Cunningham & Charles A. Capone, Jr., *The Relative Termination Experience of Adjustable to Fixed Rate Mortgages*, 45 J. FIN. 1687, 1702 (1990) (concluding that adjustable rate mortgages default at greater rates than fixed rate mortgages).

contains few of the newer mortgage products could not be expected to have accurately predicted the performance of such products. Yet, rating agency insiders contend that the agencies were unwilling to implement newer models that were based upon the newer mortgage products.⁷¹ Thus, the models used to predict the loss estimates for subprime mortgage-backed securities issued after 2002 failed to anticipate the higher default rates associated with the increased securitization of non-traditional subprime mortgage loans. Second, housing values primarily appreciated during the period from 1992 through 2000. This meant that homeowners who found themselves nearing default were able to sell the home and avoid default and the losses attendant therewith. In fact, a large portion of outstanding subprime loans defaulted in 2001. In the fourth quarter of 2002, the delinquency rate for subprime mortgages was over five times greater than the rate for conventional loans.⁷² The foreclosure rate for subprime loans during this time was 7.79% compared to 0.86% for conventional loans.⁷³ Losses from these delinquencies, however, were relatively low because house prices were appreciating over this period.⁷⁴ While house prices were appreciating, homeowners who could not cure their delinquencies were able to sell, and lenders were able to foreclose without realizing large losses.⁷⁵

Losses from defaulting mortgages are much higher in a depreciating housing market where defaulting owners cannot sell as fast or for as much as they can in an appreciating market situation.⁷⁶ By 2005, it had become apparent that housing values were in fact declining.⁷⁷ Yet, the agencies were slow to incorporate depreciating home values into their

71. Hearing, *supra* note 9.

72. The delinquency rate for prime loans was 2.65% in the fourth quarter of 2002, while the delinquency rate for subprime loans was 13.29% for the same period. *MBA Survey Shows Mortgage Delinquencies Down in Last Quarter of 2002*, MORTGAGE BANKERS ASSOCIATION, Mar. 24, 2003.

73. *Id.*

74. STANDARD & POOR'S, S&P/CASE SHILLER U.S. NAT'L HOME PRICE INDEX, Q3 (2008), http://www2.standardandpoors.com/spf/pdf/index/csnational_values_112555.xls. In 2001 and 2002, the indices shows appreciation of between 8% to 11%.

75. *Id.*; MARK DOMS, FREDERICK FURLONG, & JOHN KRAINER, FED. RESERVE BANK OF S.F., HOUSE PRICES AND SUBPRIME MORTGAGE DELINQUENCIES 2 (June 8, 2007), <http://www.frbsf.org/publications/economics/letter/2007/el2007-14.html#subhead3> (hereinafter "House Prices and Subprime Mortgage Delinquencies_h"). The study finds that higher rates of house-price appreciation are associated with lower rates of delinquencies and that this may be because homeowners in appreciating markets have options other than delinquency.

76. *Id.* at 2-3.

77. DAVID G. WOOD, U.S. GOV'T ACCOUNTABILITY OFFICE, RECENT DEFAULT AND FORECLOSURE TRENDS FOR HOME MORTGAGES AND ASSOCIATED ECONOMIC AND MARKET DEVELOPMENTS 4, 24 (2007), <http://www.gao.gov/new.items/d0878r.pdf>; U.S. NAT'L HOME PRICE INDEX, *supra* note 75. Housing price appreciation leveled out in 2005 and began declining in 2006.

models. For example, Fitch was relying upon an assumption that home prices were appreciating as late as March 2007 although median national home price data showed depreciation of 2.7% in 2006.⁷⁸ Investors were rightfully upset upon hearing the news.⁷⁹ Relying upon mortgage default and loss data from the period 1992 through 2000 would lead to an underestimation of default and loss estimates once the housing market began declining. This is just what happened.⁸⁰

2. UNDERWRITING

Investors also accuse the rating agencies of being slow to incorporate the effects of the deterioration of underwriting standards into their ratings. Declines in the underwriting standards of residential mortgage loans have been reported, most notably by the Office of the Comptroller of the Currency, since early 2003.⁸¹ In each of the years 2004 through 2007, the Office of the Comptroller of the Currency reported that banks eased their underwriting standards, with 65% of banks easing standards in 2007.⁸² The Office of the Comptroller of the Currency indicates in its 2006 report that 26% of banks eased underwriting standards for residential mortgage lending with an increased presence of nontraditional products, such as interest-only loans and payment option adjustable rate mortgages.⁸³ Moreover, a 2008 study analyzing the quality of subprime mortgage loans originated between 2001 and 2007 found that the quality

78. Mason & Rosner, *supra* note 65, at 25.

79. Investors have become increasingly vocal about the scarcity of information regarding the assumptions that were used in the ratings of mortgage-backed securities. Mason & Rosner, *supra* note 65, at 25; Aaron Unterman, *Innovative Destruction: Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53, 100 (2009); Letter from the American Bar Association to Ms. Florence E. Harmon, Acting Secretary, SEC (July 28, 2008), at 8.

80. The same result occurs even if the home ended up in foreclosure. The losses associated with that foreclosure would be lower than in a declining home appreciation situation. A study found that half of subprime loans made in 2000 were delinquent at some point and 22.9% entered into foreclosure proceedings. However, only 12.9% of those that entered foreclosure ended in foreclosure. 11.1% of homeowners that entered foreclosure proceedings prepaid their mortgages prior to having their homes foreclosed upon suggesting that they were able to sell or refinance. ELLEN SCHLOEMER ET AL., CTR. FOR RESPONSIBLE LENDING, LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS, 12 (2006), <http://www.responsiblelending.org/pdfs/CRL-foreclosure-rprt-1-8.pdf>.

81. OFFICE OF THE COMPTROLLER OF THE CURRENCY, 2003 SURVEY OF CREDIT UNDERWRITING PRACTICES (2003), <http://www.occ.treas.gov/2003underwriting/creditunderwriting2003.htm>. The OCC reported that 6% of banks eased underwriting standards and that in general the past year's trend of tightening credit standards had turned.

82. OFFICE OF THE COMPTROLLER OF THE CURRENCY, SURVEY OF CREDIT UNDERWRITING PRACTICES 2007 4-5 (2007), <http://www.occ.treas.gov/cusurvey/2007UnderwritingSurvey.pdf>.

83. OFFICE OF THE COMPTROLLER OF THE CURRENCY, Survey of Credit Underwriting Practices 2006, at 6 (Oct. 2006), <http://www.occ.treas.gov/2006Underwriting/2006UnderwritingSurvey.pdf>.

of these loans deteriorated steadily over this period.⁸⁴ The data set of loans used in this study was comprised largely of adjustable rate mortgages, which typified the subprime market and are now the leading type of loan in default.⁸⁵

Despite obvious deterioration in subprime underwriting, the rating agencies did not begin to adjust their rating models until well after the deterioration began. For example, it was not until April 2007 that Moody's announced that it would begin to request additional loan level information with respect to adjustable rate mortgages.⁸⁶ This information included the frequency of interest rate resets, minimum payment amount and penalty, negative amortization rate and payment options after adjustment.⁸⁷ The frequency of interest rate resets, for instance, is an important factor in determining the likelihood that a borrower will default on his mortgage.⁸⁸ So too is the negative amortization rate⁸⁹. Too often, borrowers with negative amortization loans found themselves owing more on their homes than they owed when they purchased them, despite having made timely monthly payments. As housing prices decline, borrowers may decide that it is more economical to default on the mortgage rather than continue to overpay for their homes.⁹⁰

Although Moody's is now requesting the information above, such

84. YULIYA DEMYANYK & OTTO VAN HEMERT, UNDERSTANDING THE SUBPRIME MORTGAGE CRISIS 18, 21 (2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396. The data set of loans used in this study was comprised largely of hybrid adjustable rate mortgages.

85. *The Housing Decline: The Extent of the Problem and Potential Remedies: Hearing Before the Subcomm. on Fin.*, 110th Cong. 1 (Dec. 13, 2007) (testimony of Jack Kemp, Founder and Chairman, Kemp Partners, available at <http://finance.senate.gov/hearings/testimony/2007test/121307testjk.pdf>).

86. Moody's Revised U.S. Mortgage Loan by Loan Data Fields, April 3, 2007; See also Fitch, U.S. RMBS: Criteria Update to RESiLogic Model, August 14, 2007, available at http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=336966§or_flag=3&market_sector=2&detail=

87. *Id.*

88. Cunningham & Capone, *supra* note 70, at 1697 (finding that adjustable rate mortgages with low cap on the total interest rate change and fewer interest rate adjustments have a lower likelihood of default).

89. U.S. GOV'T ACCOUNTABILITY OFFICE, ALT. MORTGAGE PRODUCTS: IMPACT ON DEFAULTS REMAINS UNCLEAR, BUT DISCLOSURE OF RISKS TO BORROWERS COULD BE IMPROVED, 13 (2003) available at www.gao.gov/new.items/do61021.pdf.

90. See Kristopher Gerardi et al., *Subprime Outcomes: Risky Mortgages, Homeownership, and Foreclosures*, Fed. Reserve Bank of Bos. 1 (Working Paper No. 07-15, 2008), available at <http://www.bos.frb.org/economic/wp/wp2007/wp0715.pdf> (finding that home price depreciation plays an important role in generating defaults and foreclosures). Substantial scholarly attention has been paid to the pricing of mortgages and incidences of mortgage terminations—default, foreclosures and sales. The option pricing theory posits default and foreclosure as options that become more rational in response to house price depreciation. See Patrick H. Hendershott & Robert Van Order, *Pricing Mortgages: An Interpretation of the Models and Results*, 1 J. FIN. SERVICES RES. 19 (1987); James B. Kau & Donald C. Keenan, *An Overview of the Option-Theoretic Pricing of Mortgages*, 6 J. HOUSING RES. 217 (1995).

information is still not required in order for an issuer to obtain a rating. Moody's classifies loan data into three categories: "primary" information, "highly desirable" information, and "desirable" information.⁹¹ Primary information is required to be supplied by issuers who seek Moody's ratings.⁹² Information classified as "highly desirable" is just that—desirable. It remains at the discretion of the issuer whether to provide such information. The first month of the interest rate reset, minimum payment amount after reset, negative amortization rate and payment options after adjustment have all been classified by Moody's as "highly desirable."⁹³ Therefore it is not clear how much of this information has actually been incorporated into ratings issued after April 2007, few though they are.⁹⁴

It is clear, however, that rating agencies were aware of criticism of their ratings models for some time prior to their downgrades. Several large investors had expressed concerns about mortgage-backed security ratings and were warning the rating agencies that their models and methodologies were flawed and had even ceased to use ratings in their purchasing decisions.⁹⁵ Some have suggested that the rating agencies knew that there were problems with their models and that they declined to fix them because doing so would have negatively impacted revenues. Frank Raitner, a former managing director at S&P, testified before Congress that the agency refused to implement more accurate rating models in an effort to keep profits high and expenses low.⁹⁶

The rating agencies' reported reactions to investors' complaints make little sense in the context of the reputational capital argument. Investors were increasingly indicating that the agencies methodologies were inaccurate and that the ratings of mortgage-backed securities could not be trusted. Yet, the rating agencies largely ignored these criticisms. Such responses are hard to reconcile with the reputational capital argument upon which rating agencies commonly rely as a rationale against increasing regulatory oversight. Moreover, Mr. Raitner's testimony before Congress undercuts the agencies' claims of reputational concerns

91. Moody's Revised U.S. Mortgage Loan, *supra* note 86.

92. *Id.*

93. *Id.*

94. In addition, several studies have found that faulty assumptions about default correlations contributed significantly to overestimated ratings for mortgage-backed securities. Mason & Rosner, *supra* note 65, at 25–27; Adelson, *supra* note 64, at 54; Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 83–89 (Y. Fuchita & R. Litan, eds.) (2006).

95. Brennan email, *supra* note 63; see also Aaron Lucchetti, *Credit Crunch: Ratings Raised a Red Flag; Moody's Analyst Aired Concerns on CDOs to No Avail*, WALL ST. J., June 7, 2008, at B2.

96. Hearing, *supra* note 9, at 24, 26.

as sufficient deterrence.⁹⁷ Although S&P denies that it purposely overlooked problems or rejected more accurate versions in order to maximize profits, they and other ratings agencies have admitted to weaknesses in their models.⁹⁸ Yet, they contend that they could not have anticipated the extent of the defaults and losses.⁹⁹ In light of the criticisms and warnings that were being leveled internally and externally, the rating agencies' assertions that they could not have anticipated the model failures appear disingenuous.

Although there is at best inconclusive evidence that the rating agencies purposely used models that would lead to inflated ratings, or that they purposely ignored red flags regarding the quality of underlying loans, the premises of the reputational capital argument upon which the rating agencies so eagerly rely suggest that they should have taken more efforts to address potential, if not realized, problems. It seems likely that rating agencies were driven, not by reputational concerns during the height of the mortgage-backed securities craze, but rather by profit maximizing impulses.

II. GATEKEEPING AND REPUTATIONAL CAPITAL

Gatekeeping is a common legal and market mechanism for preventing fraud and other wrongdoing in the securities markets. Gatekeepers are private entities that certify the quality of the disclosures of securities issuers seeking to access the securities markets or the relative quality of the security itself.¹⁰⁰ Securities market "gatekeepers" include auditors, securities analysts, lawyers, and rating agencies.¹⁰¹ The rating agencies,

97. *Id.*

98. See *Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 130–31 (2008), available at <http://oversight.house.gov/documents/20081023162631.pdf>. The heads of all three rating agencies testified that there have been problems with the models that were used to forecast the performance of subprime related instruments including the historical data used in the models. *Id.* at 120, 126–27, 130–31.

99. See, e.g., *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies: Hearing Before the H. Comm. on Oversight and Gov't Reform* 110th Cong. 2 (Oct. 22, 2008) (Statement of Stephen W. Joynt, President and Chief Executive Officer Fitch, Inc.); *Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 2–4 (Oct. 22, 2008) (Testimony of Deven Sharma, President Standard & Poor's).

100. Certifications generally take one of two different forms. The certifications always establish that the issuer met some minimum standard but it may go further than that and issue a certification as to the relative quality. For instance, the auditors will certify that the securities issuer employed reasonable methods to produce its financial statements. The rating agencies issue certifications as to the quality of the security relative to other like securities.

101. See Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 n.20 (characterizing accounting, law and investment banking firms as gatekeepers); David Millon, *Who "Caused" the Enron Debacle?*, 60 WASH. & LEE L. REV. 309, 311 (2003) (discussing the gatekeeping functions of securities analysts, credit rating agencies, and auditors).

for instance, issue certifications in the form of letter ratings which indicate that a security is either low or high quality relative to other securities. Obtaining this certification is the "gate" that issuers must pass through in order to gain entrée to the securities markets. Because the certification of these entities is necessary to access the market, they are in a position to deny market access to securities issuers engaged in wrongdoing by withholding their certification.¹⁰² Gatekeepers, however, can be induced to issue inaccurate certifications by direct bribes from issuers seeking to obtain a high rating for a low quality security or more subtle pressure being brought to bear by issuers.¹⁰³ Central to the effectiveness of gatekeeping strategies is ensuring that gatekeepers accurately certify. A gatekeepers' interest in cultivating and maintaining a reputation for honesty is some incentive against inaccurate certification.

The importance of reputation to business entities, and especially gatekeepers, has long been recognized by economists and in the business world. Business entities that rely upon repeat business will refrain from cheating their customers and in doing so they build a reputation for being honest.¹⁰⁴ The reputation has value to the business in so far as it helps attract customers who rely upon the good reputation in their search for quality services or products.¹⁰⁵

Much attention has been paid to the role that reputation plays in disciplining securities market gatekeepers against inaccurately certifying. Several scholars have relied upon the reputation capital theory to argue that the market generates ample incentives for gatekeepers, like the NRSROs, to accurately signal quality of securities to purchasers in the market.¹⁰⁶ In this view, imposition of substantial regulations or liability is unwarranted because reputational concerns will be sufficient to

102. Kraakman, *supra* note 101, at 53 (defining gatekeepers as those "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers.")

103. Following the audit scandals of the 1990s which were typified by Enron, commentators opined about the extent to which issuers were able to use the purchase of consulting services as inducement to get auditors to acquiesce in auditing wrongdoing. Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 210–11 (2000); Peter K.M. Chan, *Breaking the Market's Dependence on Independence: An Alternative the "Independent" Outside Auditor*, 9 FORDHAM J. CORP. & FIN. L. 347, 348 (2004).

104. ADAM SMITH, LECTURES ON JUSTICE, POLICE, REVENUE AND ARMS 253–54 (Edwin Cannan ed., 1956.) ("A dealer is afraid of losing his character and is scrupulous in observing every engagement. When a person makes perhaps twenty contracts in a day, he cannot gain so much endeavouring to impose on his neighbours, as the very appearance of a cheat would make him lose.")

105. See, e.g., Benjamin Klein & Keith Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981).

106. See Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 71 (2004); see also Steven Schwartz, *Private Ordering Of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1 (2002) ("Rating agencies are already motivated to provide accurate and efficient ratings because their profitability is directly tied to reputation.")

prevent the agencies from inaccurately certifying.¹⁰⁷ The crux of this argument is that NRSROs, as profit maximizing entities, will not jeopardize their primary asset, their reputations, by issuing fraudulent or inaccurate certifications.¹⁰⁸ The long term financial losses that the agencies would suffer as a result of a decline in reputation, perhaps by the loss of business once it is discovered that they inaccurately certified, will always outweigh the benefits that were received as a result of that inaccurate certification.¹⁰⁹

Ratings agencies have relied heavily on the reputational capital theory in their efforts at escaping substantial regulatory obligations and oversight.¹¹⁰ Following the Enron scandal, the rating agencies beat back a SEC inquiry into whether they should be more strictly regulated by relying upon the reputational capital argument.¹¹¹ And Congress has

107. See, e.g., Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL STUD. 295, 312 (1988) (arguing that "brand name" reputation and explicit warranties will provide auditors enough incentive to screen companies for fraud); Howell E. Jackson, *Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions*, 66 S. CAL. L. REV. 1019, 1072-73 (1993) (questioning the effectiveness of gatekeeper liability for attorneys); Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 951-58 (1998) (proposing a self-tailored liability regime); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53 (2003) (proposing a diligence based liability).

108. But see Klein & Leffler, *supra* note 105, at 617, 621 (Reputational concerns are not an absolute deterrence to corporate deception.); Donald C. Langevoort, *Commentary, Stakeholder Values, Disclosure, and Materiality*, 48 CATH. U. L. REV. 93, 94 (1998) ("Reputation provides a check on the incentive to deceive, but hardly a complete one.").

109. This argument has been accepted by some courts. See *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) ("An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses [the accounting firm] would suffer from a perception that it would muffle a client's fraud . . . It would have been irrational for [firm partners] to have [participated in fraud.]"); *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) ("[A]ccounting firms—as will all rational economic actors—seek to maximize their profits . . . it seems extremely unlikely that [the defendant audit firm] was willing to put its professional reputation on the line by conducting fraudulent auditing work").

110. In the aftermath of the Enron scandal, the rating agencies came under fire for having failed to lower the rating on Enron's debt until four days before the company filed for bankruptcy. In a subsequent investigation conducted by the Senate Committee on Governmental Affairs, the rating agencies were asked about their accountability to investors. The agencies responded that their concern for their reputations as repeat players in the market is sufficient to ensure accountability. See STAFF TO THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, *FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS* (2002) (Despite the rating agencies assurances, Committee staff concluded that "credit analysts do not view themselves as accountable for their actions."); see also Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services, *Testimony Before The Senate Committee On Banking, Housing And Urban Affairs* (Mar. 7, 2006); Kathleen A. Corbet, President, Standard & Poor's, A Division of The McGraw-Hill Companies, Inc., *Testimony Before The Committee On Banking, Housing And Urban Affairs* (Feb. 8, 2005).

111. See, e.g., Letter from Leo C. O'Neill, Former President, Standard & Poor's, to Jonathan G. Katz, Sec'y, U.S. Sec. and Exch. Comm'n (July 28, 2003) (arguing against diligence requirements and other oversight for the rating agencies); Letter from Charles D. Brown, Gen. Counsel, Fitch, to Jonathan G. Katz, Sec'y, U.S. Sec. and Exch. Comm'n (July 28, 2003); Letter

generally signed on to the reputational capital theory, declining to impose increased liability or aggressive oversight of NRSROs¹¹².

A small group of scholars, however, have challenged the focus on reputation as sufficient to insure effective gatekeeping. These scholars recognize private gatekeepers as profit maximizing entities and argue that reputational incentives are only one factor that gatekeepers look to when deciding whether or not to engage in inaccurate certification.¹¹³ The profit maximizing gatekeeper will balance the short term gains that could be achieved by making an inaccurate certification with the long term losses that are likely to be suffered if it is revealed that they inaccurately certified.¹¹⁴ It may be that in many cases this balancing will keep the gatekeeper from inaccurately certifying. However, in circumstances in which the benefits from inaccurate certification are greater than the costs, gatekeepers will inaccurately certify.¹¹⁵ For instance, some have argued that accounting firms shift from primarily providing auditing services to providing much more profitable consulting services, increased the benefits of inaccurate auditing and contributed to the accounting scandals of the late 1990s.¹¹⁶

from Raymond W. McDaniel, President, Moody's Investors Service, to Jonathan G. Katz, Sec'y, U.S. Sec. and Esch. Comm'n (July 28, 2003) (arguing for limited oversight that does not include exposure to civil litigation).

112. See e.g. *Rating the Rating Agencies: The State of Transparency and Competition, Hearing before the Subcommittee on Capital Markets, Insurance & Gov't Sponsored Enterprises*, 108th Cong. (2003).

113. See Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 202-210 (2000); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 318-323 (2004).

114. See Partnoy, *supra* note 15, at 497; see also Coffee, *supra* note 113, at 326 ("it could have become more profitable for firms to realize the value of their reputational capital by trading on it in the short run rather than preserving it forever."); Klein & Leffler, *supra* note 105, at 635 (challenging the reputational capital theory as it relates generally to the performance of contractual duties).

115. See Partnoy, *supra* note 15, at 497; see also Coffee, *supra* note 113, at 310 (Gatekeepers may find it advantageous to inaccurately certify when (1) there has been a sudden decline in the threat of costs of inaccurate certification, (2) the benefit of inaccurate certification has significantly increased, (3) the value of their reputation has declined, (4) investors come to expect a certain amount of inaccuracy or (5) principal/agent problems cause agents not to act in a manner that is contrary to the principles reputational concerns).

116. See, e.g., Prentice, *supra* note 15, at 172; Jerry W. Markham, *Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws*, 28 N.C. J. INT'L L. & COM. REG. 725, 770 (2003) (discussing the challenge to auditor independence that arose out of auditors engaging in both the consulting and auditing business.); Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1178 (2003) (an auditor that provides both auditing and consulting services to the same client is subject to pressure to yield to client preferences on the accounting treatment of particular matters in exchange for a greater volume of consulting business, which generated greater profits than the auditing business).

The ability then of reputational concerns alone to serve as sufficient incentive for effective ratings then may be affected by the market in which the agency is rating.

There is much evidence that suggest that rating agencies issued unwarrantedly high ratings on mortgage backed securities and CDOs.¹¹⁷ Such behavior by the rating agencies can be explained in light of their profit maximizing motivations and is not totally inconsistent with the reputational capital theory. The rapid increase in demand for ratings of mortgage backed securities and CDOs created an environment in which the benefits of inaccurate ratings outweighed the potential costs. First, the profits from issuing inaccurate ratings on mortgage backed securities were far greater than they had been with respect to inaccurate ratings of more traditional asset classes. The issuance of inaccurate ratings of mortgage backed securities created a market in which the rating agencies were able to generate significantly higher revenues from rating mortgage backed securities than they had been previously earning.¹¹⁸ Second, evidence of rating shopping in the market for mortgage backed securities and CDOs suggests that the value the agencies placed upon their own reputations may have declined.¹¹⁹ Moreover, the value of the agencies' reputation may have also declined in the midst of the market's exuberance for these investments. Investors' seemingly insatiable demand for mortgage backed securities may have led them to place a lower value on the reputation of the agency rating those instruments. Finally, the threat of liability arising from the rating agencies' inaccurate certification has diminished in the past several years.¹²⁰ Rating agencies enjoy a unique position under the securities laws whereby they are not subject to liability under Section 11 when their ratings are included in prospectuses.¹²¹ Thus, liability costs are relatively low for rating agencies and serve as a weak deterrent to issuing inaccurate ratings.

Before delving into why the rating agencies may have found it

117. See, e.g., *Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110 Cong. (2008).

118. See Part III *infra*.

119. See *The Role of Credit Rating Agencies in the Structured Finance Market, Hearing Before the Subcomm. on Capital Markets, Ins., & Gov't Sponsored Enterprises of the House Comm. on Fin. Serv.* 65 (2007) (statement of Mark Adelson) .

120. The credit rating agencies have been enormously successful in avoiding liability for inaccurate ratings. As will be discussed further below, courts have overwhelmingly sided with the credit rating agencies.

121. Section 11 subjects "experts" to negligence liability for the statements they make in registration statements. Securities Act of 1933, 17 C.F.R. § 230.436(g)(1) ("The security rating assigned to a class of debt securities, a class of convertible debt securities or a class of preferred stock by a nationally recognized statistical rating organization. . . shall not be considered a part of the registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act.")

profitable to issue higher than warranted ratings, it is important to understand the role that they played in the market for mortgage backed securities and the current financial crisis. The next section explores how the rating agencies became an integral part of the formation, growth and downfall of the mortgage backed securities market. It then discusses the accusations that rating agencies issued inaccurate ratings on mortgage backed securities.

III. REPUTATION MAY BE AN INSUFFICIENT DETERRENT IN SEVERAL CIRCUMSTANCES

A. *Reputation is an insufficient deterrent in new markets*

Proponents of minimal rating agency regulation rely heavily upon the reputational capital theory in arguing that oversight is unnecessary.¹²² But reputation may be an insufficient incentive to accurately rate credit instruments when the rated product is new to the market¹²³. This is because the NRSRO has no reputation to loose with respect to rating the new product¹²⁴. Critics will respond that an agencies' overall reputation will be negatively impacted by inaccurate ratings in the new market segment¹²⁵. However, the issuance of inaccurate ratings in one market segment has very little effect on the agencies reputation in other markets or its overall reputation. Past NRSRO failures have had little effect upon an agencies' ability to attract business in market segments unrelated to the failure¹²⁶.

Following the outcry against the NRSROs performance with respect to the ratings of Enron's debt, Moody's reported a quarterly year over year increase in each of the four market segments in which it issues ratings.¹²⁷ This trend appears to be holding with respect to the current credit crisis. Moody's has reported a substantial decline in revenue in the structured finance market as a result of declining mortgage backed securities and CDO issuances.¹²⁸ However, revenues in the financial

122. See Part II *supra*.

123. John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, COLUMBIA BUS. L. REV., Vol. 2009, No.1 at 35-48 (forthcoming 2009).

124. See e.g., *Id* at 40-43 (using econometric model to show that in a multi-period economy rating agencies may have little incentive to decline to issue low quality ratings).

125. Hill, *Regulating the Rating Agencies*, *supra* note 35 at 50-51; Schwartz, *Private Ordering of Public Markets*, *supra* note 106 at 6-9.

126. Hunt, *supra* note 123 at 48 (suggesting that rating agencies face little "negative spillover" from issuing low quality ratings in new market segments).

127. See Moody's Corp., Quarterly Report (Form 10-Q) (Mar. 31, 2002).

128. See Moody's Corp., Quarterly Report (Form 10-Q), at 20 (Sept. 30, 2008).

institution and public finance sectors have grown.¹²⁹ These results suggest that a negative reputation in one market segment may not impact revenues in other market segments.

Building upon this trend it is clear the reputational incentives prove to be insufficient deterrents in new markets. Consider that as much as rating agencies may care about their reputations, it means very little if issuers do not solicit their ratings. Issuers will respond to NRSROs that insist on adhering to stricter rating standards that result in lower ratings than other rating agencies by taking their business elsewhere. And as the other agencies would be generating more revenue from rating mortgage backed securities, it is likely that they would also be generating more capital from investors.¹³⁰ This could be the case even if the rating agency's reliance upon the more conservative assumptions proves to be correct in the long run as it may be some time before the rating agencies' conservative approach is proven to be the correct approach.¹³¹ In other words the NRSRO is faced with the choice of issuing inaccurate ratings and making high profits for some limited period followed by lower profits in that segment or making low or no profits in the segment in every period¹³². In the context of the mortgage backed securities market of the last several years, this would have translated into potential losses in the multi-millions.¹³³

The rating agencies' income from rating securitized debt shows just how profitable this market was. The rating agencies' income from structured finance ratings had been growing steadily through the 1990s and into the early 2000s, but the real estate boom supercharged rating agen-

129. *See id.* (Public finance grew 10.8%, financial institutions 1.7%. Revenue in corporate finance declined 8.6%. Similar results can be seen in each quarter of 2008).

130. Moreover, it is more than likely that the rating agency will be subject to and bear cost associated with any remedial measures aimed at preventing future misbehavior whether or not they actually engaged in such behavior. Under these circumstances even if the rating agency acquiesces to issuer pressure, it is no worse off than the other rating agency once the act is revealed. *See* Millon, *supra* note 101, at 23 ("if [an agency] makes an investment decision that proves to be a loser he or she is less likely to be criticized if others made the same mistake than if the manager acted in a contrarian manner"); *see also* David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465, 466 (1990) ("[A]n unprofitable decision is not as bad for reputation when others make the same mistake—they can share the blame if there are systematically unpredictable shocks."); Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 1023 U. CINN. L. REV. 1023, 1039–41 (1999).

131. *See The Role of Credit Rating Agencies in the Structured Finance Market, Hearing Before the Subcomm. on Capital Markets, Ins., and Government Sponsored Enterprises of the H. Comm. on Fin. Serv.*, 110th Cong. 8 (2007).

132. Hunt, *supra* note 123 at 45-48 (attempting to prove this assertion using econometric modeling).

133. *See* Part III, *supra* (discussing the benefits of inaccurate ratings).

cies' profits¹³⁴. In 1998, Moody's revenue from rating structured finance instruments was approximately \$143 million or 29% of total revenues.¹³⁵ In just four years revenues had more than doubled to just over \$381 million.¹³⁶ And this was before the real estate market really began to climb. By 2006, revenues from rating structured finance products were just shy of \$886.7 million and comprised 44% of Moody's total revenue.¹³⁷ Actual revenue generated from rating mortgage backed securities for S&P and Fitch are not publically available.¹³⁸ However, the fact that S&P has approximately the same market share as Moody's suggest that their revenues are comparable.¹³⁹ Under the circumstances, the profit maximizing choice is to issue inaccurate ratings.

B. *Reputation may be insufficient where there are a small number of issues wielding substantial market power*

A common criticism of the reputational capital standard for regulating NRSROs is that reputational incentives are often outweighed by the conflict of interest inherent in the issuer pay model¹⁴⁰. NRSROs counter, and policymakers have seemingly accepted the argument, that no single issue comprises enough of the agencies' revenues or is likely to pay fees high enough to induce a rating agency to compromise its ratings or reputations.¹⁴¹ Whatever merit this argument may hold in markets where there are a substantial number of issuers, it is clearly unsustainable in markets with a limited number of issuers.

The reality is that there are significant distinctions between issuers of corporate bonds and issuers of mortgage backed securities that could lead rating agencies to acquiesce to demands for unwarranted ratings in one market segment and not the other. While there are thousands of different entities, both business and municipalities, that comprise the universe of corporate bond issuers, issuers of mortgage backed securities are a much smaller and more homogeneous group comprised of a few

134. See e.g. Aaron Lucchetti, *Ratings Game: AS Housing Boomed Moody's Opened Up*, WALL ST. J., April 11, 2008, at A1.

135. Moody's Corp., Annual Report (Form 10-K), at 20 (March 15, 2001). The company does not specify how much of the revenues from rating structured finance products can be attributed to mortgage backed securities specifically.

136. Moody's Corp., Annual Report (Form 10-k), at 17 (March 21, 2003).

137. Moody's Corp., Annual Report (Form 10-k), at 20 (March 1, 2007).

138. S&P is a subsidiary of the McGraw Hill Companies which does not release separate financial information for the rating division. Fitch is a subsidiary of the French company Fimalac which does not release revenue figures for the ratings division.

139. See REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS, *supra* note 30.

140. See Partnoy, *The Siskel and Ebert of the Financial Markets? Two Thumbs Down for the Credit Rating Agencies*, *supra* note 24, at 648-654.

141. See Part II *supra* (discussing reputational arguments relied upon by the rating agencies).

very powerful investment banks and mortgage companies.¹⁴² More importantly, mortgage backed securities issuers access the credit markets on a much more frequent and regular basis than do corporate issuers and as discussed earlier they generate much greater fees and revenue than do corporate clients¹⁴³. As a result, mortgage backed securities issuers have much more leverage to use in an effort to force rating agencies to issue the ratings they desire.¹⁴⁴ In fact, the prominence of rating shopping in the mortgage backed securities market suggests that reputational concerns were in fact outweighed by the agencies' interests in maintaining their market share.¹⁴⁵

Rating shopping occurs when an issuer presents its mortgage backed securities to multiple rating agencies and selects the rating agency that grants the highest rating.¹⁴⁶ It is made possible in part because under the current ratings process a rating agency is only paid if the issuer chooses to have the agency issue the rating.¹⁴⁷ Thus an issuer is able to obtain a preliminary rating from each rating agency and then chose to publish the highest rating. The issuer can play the rating agencies against each other by threatening to take the deal to another agency if they do not receive the rating they desire. This led rating agencies to attempt to "win" business by relaxing their ratings standards.¹⁴⁸

Rating shopping was a common practice in the mortgage backed securities market and raised concerns among many industry experts prior to the credit crunch. In written testimony before Congress, one securities expert testified that "it is indisputable the securitization issuers in the MBS, CMBO, and CDO areas engage in ratings shopping. They do so openly."¹⁴⁹ Evidence produced at a congressional hearing held

142. Nine of the top ten private label issuers in 2007 were either commercial banks or investment banks. See THE 2008 MORTGAGE STATISTICAL ANNUAL vol. 1 at 16.

143. This is born out by the number of mortgage-backed securities issues done in the years 2004 through 2007 by the top non-GSE issuers. See THE 2008 MORTGAGE STATISTICAL ANNUAL vol. 1 at 16-19. No single corporate client could ever be expected to issue this many bonds in one year.

144. John C. Coffee, Adolf A. Berle Professor of Law Columbia University Law School, Testimony Before the Senate Committee on Banking, Housing and Urban Affairs (Apr. 22, 2008).

145. See *id.*

146. See Mark Adelson, *Rate Shopping—Now the Consequences*, NOMURA FIXED INCOME RESEARCH, Feb. 16, 2006, http://www.adelsonandjacob.com/pubs/Rating_Shopping.pdf.

147. 73 C.F.R. §§ 36212, 36216 (2008).

148. *Id.*

149. *The Role of Credit Rating Agencies in the Structured Finance Market, Hearing Before the Subcomm. on Capital Markets, Insurance & Gov't Sponsored Enterprises of the H. Comm. on Fin. Serv.*, 110th Cong. 65 (2007) (Statement of Mark Adelson); see also Aaron Lucchetti, *Bond-Rating Shifts Loom In Settlement—N.Y.'s Cuomo Plans Overhaul of How Firms Get Paid*, WALL ST. J., June 4, 2008, at C1 ("there is a lot of rating shopping that goes on . . . What the market doesn't know is who's seen certain transactions but wasn't hired to rate those deals."); 73 Fed. Reg. 36212, 36218.

recently suggest that the rating agencies were worried about losing clients to rating agencies that used more generous standards.¹⁵⁰ In an email from May 2004, a managing director at S&P laments the loss of a large mortgage backed securities deal to Moody's.¹⁵¹ S&P was not chosen to rate the deal because it was requiring credit enhancement to account for certain interest rate risks that Moody's was apparently ignoring.¹⁵² The director suggests that S&P needs to "have a paradigm shift in thinking," implying that unless S&P takes a position similar to Moody's it will continue to lose deals.¹⁵³ Former industry insiders have recounted specific instances in which management relaxed standards or pressured analysts to give favorable ratings to mortgage backed securities and CDOs.¹⁵⁴

Moreover, although the rating agencies deny that they relaxed their standards, the SEC has recently issued a report finding that the rating agencies frequently made adjustments to their rating standards and models when issuing ratings.¹⁵⁵ Without identifying the agency, the report finds that one agency regularly lowered the loss estimates that were indicated by their statistical models and did not disclose this practice.¹⁵⁶ The report also finds that rating agencies used cash flow models that were not incorporated into their published models or publically disclosed.¹⁵⁷ In many of these cases the rating agency had no documentation explaining the deviation from the model's outputs. At least two of the three rating agencies frequently used such "out of model adjustments" according to the report.¹⁵⁸

If the rating agencies and their proponents are correct that reputational concerns alone are sufficient disincentive to issuing inaccurate rat-

150. *Credit Rating Agencies and the Financial Crisis, Hearing Before H. Comm. on Oversight and Gov't Reform*, 110th Cong. (2008), available at <http://oversight.house.gov/documents/20081023162631.pdf>

151. *Credit Rating Agencies and the Financial Crisis, Hearing Before H. Comm. on Oversight and Gov't Reform*, 110th Cong. 84–86 (2008), available at <http://oversight.house.gov/documents/20081023162631.pdf>

152. *See id.* at 86.

153. *Id.*

154. *See, e.g., The Financial Crisis and the Role of Federal Regulators, Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 73, 213 (2008), available at <http://oversight.house.gov/documents/20081024163819.pdf>; Elliot Blair Smith, *Race to Bottom at Moody's, S&P Secured Subprime's Boom, Bust*, BLOOMBERG, Sept. 25, 2008 ("the [standard] shifts and shifts, and can shift quite a bit.").

155. SEC. & EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATION OF SELECT CREDIT RATING AGENCIES 14, 19 (2008) available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

156. *See id.* at 14.

157. *See id.*

158. *Id.*

ings, rating shopping should not be a problem.¹⁵⁹ Rating agencies could not be induced to relax their standards because to do so would be injurious to their reputations and long term financial prospects. However, as the discussion above indicates the agencies were not only concerned with the impact strict credit criteria would have on their revenues, but there is evidence suggesting they lowered their standards in response to issuer pressure.

For better or worse, the securitization is likely to be with us for many years to come despite the current crisis¹⁶⁰. This also means that the concentration of issuers in structured finance markets like the market for mortgage backed CDOs is likely to persist. This concentration arises from the fact that there are only a few institutions that have the capacity to purchase large quantities of debt and to package them into marketable liquid securities. Because these issuers will dominate the market they will continue to have a significant amount of market power.

C. Significant investors may not be basing their purchasing decisions on reputation

Increased leverage or pressure from issuers may not be the only explanation for rating agencies' lack of accuracy. The regularity of ratings shopping may also suggest that investors were not relying upon ratings for their accuracy.¹⁶¹ The foundation of the reputational capital theory is that rating agencies and other gatekeepers view their reputations as paramount because investors punish agencies with bad reputations by refusing to do business with them.¹⁶² A market rife with ratings shopping investors should at a minimum demand a discount for accepting such ratings. Yet, during the past several years, rating agency revenues have increased dramatically, primarily as a result of ratings of mortgage backed securities and other structured finance products.

One reason for this may be that in the last two decades the growth of mutual funds, pension funds and other institutional investors has changed the face of the market.¹⁶³ An ever increasing number of investors now invest through mutual funds, pensions and other

159. Prentice makes a similar claim with regard to the practices that were prevalent in the auditing market prior the audit scandals of the 1990s.

160. Mara DerHovanesian, *A Smart Idea Spoiled*, *BUSINESS WEEK*, July 7, 2008 at 40.

161. This argument forms the bases of several articles written by Frank Partnoy. See, e.g., Partnoy, *supra* note 23; Partnoy, *supra* note 24.

162. See Part II *supra*.

163. Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 *BROOK. J. CORP. FIN. & COM. L.* 339, 348 (2009) ("[A]s of December 31, 2006, the assets under management of domestic mutual funds comprised 54% of the combined aggregate market capitalization of the NYSE and Nasdaq.").

intermediaries.¹⁶⁴ Assets managed by mutual funds between 1990 and 2006 increased 14.35% annually.¹⁶⁵ Pension funds increased from \$5,086.3 billion in 1994 to \$14,027.6 billion in 2007.¹⁶⁶ These institutions are often restricted by state and/or federal regulations to investing in securities that have been rated "investment grade."¹⁶⁷ As the number of institutional investors grew so too did the demand for highly rated products. Much of the structured finance market, which includes the mortgage backed securities and CDOs that are at the center of the current crisis, are designed to obtain an investment grade ratings.¹⁶⁸

Many of the financial managers of these institutional investors, however, have internal analytics specialists and profess not to place much emphasis on the ratings given by NRSROs¹⁶⁹. This suggests that some very significant investors are not basing their purchases of ratings upon the reputation of the NRSRO. Institutional investors' regulatory induced need for investment grade ratings has created an environment in which NRSROs maintain a market for their ratings as long as they issue high ratings on desirable securities. Institutional investors are not solely motivated to purchase ratings because of their accuracy and informational value but must do so if they wish to purchase a particular class of assets whether or not they believe that NRSROs have a reputation for accuracy.¹⁷⁰ Reputational incentives for the NRSRO to rate below investment grade are therefore weakened.

IV. THE THREAT OF RATING AGENCY LIABILITY DECLINED WITH THE ENACTMENT OF THE CREDIT RATING AGENCY REFORM ACT OF 2006 2

The potential for liability is one of the major deterrents to wrongdoing-

164. *See id.*

165. *See id.*

166. *See id.* at 349.

167. In fact 98% of subprime mortgages were financed by bonds rated investment grade, AAA to BBB-, 80% of these were financed by bonds rated AAA. IMF, GLOBAL FINANCIAL STABILITY REPORT: CONTAINING SYSTEMIC RISKS AND RESTORING FINANCIAL SOUNDNESS, 59 (Apr. 2008), available at <http://www.imf.org/external/pubs/ft/gfsr/2008/01/index.htm>.

168. Among the largest purchasers of mortgage backed securities are institutional investors like pension funds, banks, and savings and loans. Inside Mortgage Finance, *supra* note 58; Kenneth R. Harney, *Mortgage Bargains Available*, WASH. POST, Jan. 9, 1985, at E1; Vikas Bajaj & Christine Haughney, *More People With Weak Credit are Defaulting on Mortgages*, N.Y. TIMES, Jan. 26, 2007, at C2; Steven Pearlstein, *Credit Market's Weight Put Economy on Shaky Ground*, WASH. POST, Aug. 1, 2007, at D01; Ruth Simon et al., *Housing-Bubble Talk Doesn't Scare Off Foreigners; Global Investors Gobble up Mortgage-Backed Securities, Keeping Prices Strong*, WALL ST. J., Aug. 24, 2005, at A1.

169. Houtman B. Shadab, *supra* note 7 at 52.

170. Partnoy, *supra* note 23, at 653.

ing for most business entities.¹⁷¹ The rating agencies, however, have largely avoided liability for inaccurate ratings. One of the agencies' more successful defenses against liability is grounded in the First Amendment¹⁷². The agencies have asserted that they are financial publishers and that their ratings are matters of public concern.¹⁷³ As publishers they assert that they are entitled to the heightened protections of the "actual malice" standard¹⁷⁴. A publisher will not be liable for false statements unless the statement is made with knowledge that it was false or with a reckless disregard for its truth or falsity (i.e. actual malice).¹⁷⁵ The agencies have also argued that their ratings are protected by the First Amendment for a second and more important reason. The Supreme Court has extended full constitutional protections to opinions that do not contain "provably false connotations;" therefore, such opinions are incapable of forming the basis of liability.¹⁷⁶ The rating agencies contend that their ratings are nothing more than opinions as to the future performance of an issuer or asset pool.¹⁷⁷ As such, ratings are incapable of being false or true and fall under the full protection of the First Amendment¹⁷⁸. Most of the courts hearing claims against the rating agencies have extended First Amendment protections to the rating agencies relying upon these arguments.¹⁷⁹

Interestingly, the cases in which courts have rejected the agencies' First Amendment arguments have involved instances in which the rating

171. See SYLVIA LAW & STEVEN POLAN, *PAIN AND PROFIT: THE POLITICS OF MALPRACTICE* 1 (1978) (noting that a common rationale for imposing negligence liability is deterrence); see also RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (7th ed. 2007) (same).

172. Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1689-92 (2008) (discussing rating agency success with First Amendment defenses); Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, *supra* note 94 at 83-89.

173. STANDARD & POOR'S, A CONSTITUTIONAL ANALYSIS OF H.R. 2990 (2005) at 17, available at www2.standardandpoors.com/portal/site/sp/en/us/page.article/3,1,1,0,1121065383180.html.

174. *County of Orange v. McGraw Hill Co., Inc.*, 245 B.R. 151, 154-57 (C.D. Cal. 1999) (the court found that the actual malice standard applies); *In re Enron Corp. Sec. Deriv. & ERISA Litg.*, 511 F. Supp. 2d 742, 825 (S.D. Tx 2005) (same).

175. *Hustler Magazine v. Falwell*, 485 U.S. 46, 56 (1988); *N.Y. Times Co. v. Sullivan*, 376 U.S. 254, 280 (1964); *Rosenbloom v. Metromedia, Inc.*, 403 U.S. 29, 52 (1971).

176. *Milkovich v. Lorain Journal Co.*, 497 U.S. 1, 20 (1990).

177. Letter from Raymond W. McDaniel, *supra* note 111.

178. *Id.*

179. See *Compuware Corp. v. Moody's Investors Servs., Inc.*, 499 F.3d 520, 529 (6th Cir. 2007) (public concern); *County of Orange v. McGraw Hill Co., Inc.*, 245 B.R. 151, 154-55 (C.D. Cal. 1999) (applying actual malice standard); *Jefferson County Sch. Dist. No. R-1 v. Moody's Investor's Servs.*, 175 F.3d 848, 856 (10th Cir. 1999) (ratings are non-falsifiable opinions); *In re Pan Am Corp.*, 161 B.R. 577, 581-82 (S.D.N.Y. 1993) (rating agency was a journalist entitled to First Amendment protections). *But see Am. Sav. Bank, FSB v. UBS Painewebber, Inc.*, 2002 U.S. Dist. LEXIS 24102 (S.D.N.Y. 2002); *Commercial Fin. Servs., Inc. v. Arthur Anderson LLP*, 94 P.3d 106, 110 (Okla. Civ. Div. 4 2004).

agency did not publish the rating in question in their subscriber based newsletter, but instead, the ratings were contracted for by the issuer and paid for by the issuer.¹⁸⁰ It may be that the First Amendment is not a viable defense to claims arising out of the rating agencies issuances of issuer paid ratings. If this is the route courts ultimately take it could have major implications for the agencies as much of their revenue is derived from the issuer paid business model.¹⁸¹ Certainly, ratings of mortgage backed securities were paid for by the issuers of those securities. In any event, the rating agencies have largely been shielded from liability for their ratings.

Still, the protections afforded rating agencies under the First Amendment do not fully explain why rating agencies would have been incentivized to overestimate ratings of mortgage backed securities. After all, the rating agencies' immunity from civil liability was well established prior to the uptick in mortgage backed securities that led to the current crisis.¹⁸² The factor that changed the balance of the scales was the enactment of the Credit Rating Agency Reform Act of 2006 (the "CRARA").¹⁸³ The CRARA was enacted with the purpose of "improving ratings quality" and promoting "accountability, transparency and competitions in the credit ratings industry."¹⁸⁴ The CRARA changed the process by which rating agencies received recognition as NRSROs and ordered the SEC to adopt rules regarding the adoption by NRSROs of procedures designed to prevent the misuse of information and manage conflicts of interest.¹⁸⁵

The CRARA also contained provisions that arguably further weakened civil liability as a constraint upon the rating agencies. The CRARA does not create a private right of action against the rating agency for violation of any of its provisions.¹⁸⁶ More importantly, it could be read as supporting the rating agencies claims to First Amendment protection. The CRARA makes clear that a rating agency registering as an NRSRO

180. *Am. Sav. Bank, FSB*, 2002 U.S. Dist. LEXIS 24102; *Commercial Fin. Services, Inc.*, 94 P.3d at 110.

181. See *Moody's Corp.*, Annual Report (Form 10-K), at 28 (Feb. 29, 2008). In 2007, revenues from subscription based research totaled \$421.5 million representing 18% of total revenues. Ratings revenue for the same year totaled \$1,779.9 or 78% of total revenues. *Id.* Moreover, from 2005 to 2007, subscription based revenues consistently comprised approximately 17-18% of Moody's revenue. *Id.*

182. See, e.g., *In re Pan Am Corp.*, 161 B.R. at 586; see also Gregory Husisian, What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability, 75 CORNELL L. REV. 411, 413-14 (1990) (reasoning that the First Amendment should shield the rating agencies from liability for inaccurate ratings).

183. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006).

184. *Id.*

185. 15 U.S.C.S. § 78o-7(g)(1) (LexisNexis 2009); 15 USCS § 78o-7(h)(1).

186. 15 USCS § 78o-7(m)(2).

does not constitute “a waiver of, or otherwise diminish, any right, privilege or defense that a nationally recognized statistical rating organization may otherwise have” under state or federal law.¹⁸⁷ In light of the several court decisions extending First Amendment protections to ratings, of which Congress clearly knew of at the time of the CRARA’s passage, this provision could be used as evidence of Congress’ tacit support of the rating agencies First Amendment defense¹⁸⁸.

Moreover, even if the First Amendment defense is ultimately found not to apply in the context of ratings, provisions of the CRARA could be interpreted as limiting liability in general. The CRARA expressly forbids the SEC or any state from regulating the substance of the ratings.¹⁸⁹ Just what constitutes regulation of the “substance of ratings” is not addressed in the act or in the legislative history for the act.¹⁹⁰ However, the rating agencies have already taken an expansive view of its scope. Moody’s has argued that the provision preempts all state securities laws as they apply to NRSROs.¹⁹¹ In the case in question, the court refused to hold that the presumption that Congress does not intend to overturn state law had been overcome.¹⁹² Furthermore, the court rejected Moody’s broad interpretation, instead reflecting that the CRARA provision “seemed to mean that states may not tell NRSROs what ratings they should give or dictate how they arrive at their ratings.”¹⁹³ The decision, however, seems to rest to some extent on the courts unwillingness to apply the CRARA to conduct that occurred prior to the enactment of the CRARA.¹⁹⁴ The conduct in question occurred in 2000 and 2001 and the complaint was filed in June 2003¹⁹⁵. This leaves open the question of whether courts may be more amenable to the rating agencies preemption arguments for incidents arising after the enactment of the CRARA.

187. 15 USCS § 78o-7(m)(1).

188. Kettering, *supra* note 171 at 169 (raises the potential argument that the CRARA impliedly forecloses rating agencies from raising the First Amendment defense).

189. 15 USCS § 78o-7(c)(2) (“Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings.”).

190. The CRARA gives no guidance as to what actions might constitute regulating the substance of credit ratings. The SEC expresses its belief that requiring NRSROs to make and keep certain records relating to the conduct of its business and prohibiting NRSROs from modifying or threatening or offering to modify a rating in a manner contrary to its procedures does not contravene the CRARAs prohibition on regulating the substance of ratings. 72 Fed. Reg. 33564, 33601, 33585.

191. *In re Nat’l Century Fin. Enter., Inc., Inv. Litig.*, 580 F. Supp. 2d 630, 650 (S.D. Ohio 2008).

192. *Id.* at 651.

193. *Id.* at 651.

194. *Id.* at 652.

195. *Id.*

A final point that arises out of the CRARA concerns the interaction between the provision prohibiting regulation of the substance of rating and the provision preserving the rights of state securities commissions to bring actions for fraud and deceit against NRSROs.¹⁹⁶ The CRARA's prohibition on regulating the substance of ratings, read in conjunction with the exception for state fraud and deceit actions, could be used to argue that the only state law actions a state commission is permitted to bring against NRSROs are fraud or deceit actions¹⁹⁷. In fact, in 2002 the Senate Committee on Government Affairs published a report that noted that NRSROs are "officially" protected from liability for "all but fraud under the securities laws¹⁹⁸." In any event, it is clear that the CRARA provided the rating agencies with several more bases for arguing that they are not subject to liability. In doing so the CRARA further weakened the effect of liability as deterrence to rating agency misrating.

V. A PROPOSAL FOR REGULATION OF NRSROs

The inclusion of ratings into so many facets of the financial regulatory scheme has given the Moody's, S&P, Fitch and other NRSROs a quasi-regulatory role and resulted in their ratings having a [serious] impact upon the U.S. and global financial markets. Despite this, NRSROs owe no clear legal responsibility to the public to rate with care. At present, the regulatory scheme for NRSROs requires mandatory disclosures be made by rating agencies as to their rating policies and methodology. These disclosures have been enhanced in the wake of the financial crisis.¹⁹⁹ However, the regulatory regime involves very little direct oversight of the performance of an NRSRO for the purpose of preventing or punishing poor performance. This section discusses the disclosure requirements for NRSROs and proposes imposing a diligence requirement.

A. *Increased Disclosure*

Government bodies have scrambled to respond to the NRSROs failures. The SEC has implemented sweeping new rules with respect to disclosures of information used by credit rating agencies in developing

196. 15 USCS § 78o-7(o)(2).

197. And in fact some scholars have pointed out that the CRARA's provisions appear to preempt many state laws. *See e.g.* Kettering, *supra* note 171 at 1688-1689 (arguing that the CRARA could preempt state tort law).

198. STAFF TO THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS, 105-106 (2002).

199. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6456 (Feb. 9, 2009).

ratings.²⁰⁰ The new rules rightly focus on increasing the transparency and accountability of the NRSROs. The new rules require that NRSROs:

- (i) disclose their policies regarding whether and if so how information used in ratings are verified;²⁰¹
- (ii) publish information about ratings actions for enumerated categories of ratings in order to enhance comparisons across agencies;²⁰²
- (iii) disclose how frequently the agency reviews its ratings and if different criteria is used in the review than was used to issue the initial rating;²⁰³
- (iv) make all information used to rate [mortgage backed securities] available to other credit rating agencies;²⁰⁴ and
- (v) document any out of model adjustments made to ratings.²⁰⁵

The rules are consistent with the SECs broad policy based approach to rating agency disclosures.

While the disclosures would be helpful, they do not go far enough. For instance, the new rules only require disclosure of the rating agencies' policies regarding verification of underlying assets and information. The usefulness of such general disclosures is likely to be limited because such disclosures could be written in a way that would allow a significant amount of deviation in the use of information and extent of verification among similarly situated asset backed securities.

NRSROs should be required to disclose, in connection with the publication of each rating, a summary of the material information that was used in deriving the rating. While this disclosure would not entail releasing specific loan level information for each loan in a mortgage pool, NRSROs would be obligated to reveal exactly what type of loan level data was relied upon, giving the investor the opportunity to evaluate the limitations of the rating. For instance, simultaneously with the release of the rating Moody's would disclose the type of optional "desirable" or "highly desirable" information, if any, that was used in determining the rating.

The disclosure described above would be superior to the SEC's initial proposal which would have made public all information used in a rating.²⁰⁶ Many of the comments on the initial proposal to publically

200. *Id.*; see also Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36212 (June 25, 2008); References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. § 40088 (July 11, 2008) (proposing to eliminate references to nationally recognized statistical ratings organizations from SEC rules and regulations).

201. 74 Fed. Reg. 6456, 6459–60 (Feb. 9, 2009).

202. *Id.* at 6457–59.

203. *Id.* at 6459–60, 6474–76.

204. 74 Fed. Reg. 6485, at 6494 (Feb. 9, 2009).

205. 74 Fed. Reg. 6456, 6463 (Feb. 9, 2009).

206. 73 Fed. Reg. 36212, 36219–36222 (June 25, 2008).

disclose all information used in a rating raised valid concerns about confidentiality²⁰⁷. In response to these concerns the SEC issued a revised proposed rule which would make all information used in a rating available to other NRSROs. In exchange for the ability to access this information other agencies will be required to issue a certain number of unsolicited ratings.²⁰⁸ In this way NRSROs would act as checks on each other. A NRSRO issuing an unwarranted rating would run the risk that some other NRSRO would issue an unsolicited rating that would bring the inaccuracy to light. The potential of this provision may be limited, however, because NRSROs are under no obligation to access such information. The rule instead relies upon market forces to drive NRSROs to engage in self monitoring. The proposed rule also does little to increase the market's ability to police rating agencies as the SEC seems to acknowledge.²⁰⁹ Moreover, because the rule expresses a belief on the part of the SEC that the rating agencies can and will police each other, it may lead investors to rely even more heavily on rating agencies. An investor may come to believe that if an agency's ratings have not been challenged it is because they are accurate. This may be the case but it may well be that the agencies simply are not policing each other.

It is also important that NRSROs disclose any sources used to verify the information relied upon in determining the rating and the assumptions made in determining a particular rating. This would include disclosure of a summary of any diligence conducted by the rating agency, or provided to the rating agency by any party, used to verify the accuracy of information provided by the issuer if such information was used in formulating the rating. And because the ratings of mortgage backed securities depend upon statistical modeling it is vital that the assumptions used in these models are also made available. Disclosure of information used in deriving ratings, methodology and verification are useless without knowledge of the assumptions utilized in the models.

The benefit of requiring rating specific disclosure is twofold. First, investors would be able to see whether the rating for a particular security incorporated pool specific information such as originator characteristics, debt to income ratios, appraisals, interest and payment reset data and other loan specific information in generating a rating for the particular

207. See e.g. Dottie Cunningham, *Commercial Mortgage Securities Association Comments to Proposed Rules for Nationally Recognized Statistical Rating Organizations* available at www.sec.gov/comments/s7-18-08/s71808-27.pdf (September 29, 2008).

208. 74 Fed. Reg. 6485, 6496 (Feb. 9, 2009). A non-solicited NRSRO would be required to certify that it will determine and maintain credit ratings for at least 10% of the issued securities if it accesses information of solicited NRSROs 10 or more times in a year.

209. 74 Fed. Reg. 6485, 6495 (Feb. 9, 2009) ("The Commission acknowledges that investors and other market participants may benefit from greater disclosure of this information.").

security. Based upon this information investors will be able to appreciate better the scope and limits of a rating. This is in contrast with the more general discussions of methodology, policies and procedures that rating agencies currently publish.²¹⁰ Second, such disclosure could enhance the strength of reputation as a deterrent to inaccurate or insufficient rating standards. Investors would be able to compare the type and range of loan level information used by each rating agency forcing the rating agencies to compete with respect to the optimal levels of loan level information used in ratings as well as the optimal level of verification. Rating agencies that do not use sufficient ratings standards stand to suffer immediate reputational-market costs in the form of investors discounting or ignoring their ratings. Investors will be able to discount or discard individual ratings based on spurious data. Moreover, the regulators will be able to evaluate rating standards in real time and obtain a clearer picture of ratings practices.

Although these reporting requirements may lead to a better understanding of the limits and scope of ratings, they fail to address the structural problem that has lead to inaccurate ratings which is that NRSROs occupy a privileged position in the market with no attendant enforceable duty to accurately rate. This is particularly astounding given the quasi-regulatory function that regulators have given to NRSROs.

B. *Increased Liability*

The recent failures of NRSROs have revealed the insufficiency of our current legal regime which imposes limited liability and relies upon reputation as the principle constraint upon NRSROs. In addition to condition NRSRO status upon the aforementioned reporting requirements, policymakers should require that NRSROs be subject to diligence obligations. This requirement would oblige NRSROs to use reasonable care when issuing a rating.

Under this proposal a new body or committee (the "Committee") would be created within the SEC and vested with the powers similar to those of the Public Company Accounting Oversight Board (the "PCAOB"). These powers would include the ability to conduct investigations of alleged violations of the proposed reporting requirement and breaches of the diligence obligation. The Committee would have the authority to conduct disciplinary proceedings, impose sanctions, and subpoena testimony and documents relevant to an investigation.

In the past, the NRSROs have argued that increased liability and oversight will lead to deadweight losses due to unbeneficial documenta-

210. See, e.g., STANDARD & POOR'S, CORPORATE RATINGS CRITERIA (2008), available at http://www2.standardandpoors.com/spf/pdf/fixedincome/corporate_criteria_2008.pdf.

tion. The agencies contend that liability and oversight will force agencies to take similar views and stifle their ability to issue useful opinions²¹¹. This is a common criticism of negligence regimes which holds that negligence regimes increase the amount of documentation that an entity must produce in order to avoid liability, but that this documentation does not increase the quality of the product or service the entity produces.²¹² As a result, the costs incurred with producing this documentation are pure losses in the sense that they do not produce any benefit. This argument, however, assumes that the rating agencies are applying the optimal level of care in the absence of a duty to do so. As discussed earlier in this Article that claim is at best dubious.²¹³ Moreover, with respect to NRSROs this argument is undercut by the imposition by the SEC of the documentation and reporting requirements discussed above.²¹⁴ Thus, the NRSROs already have to produce such documentation and incur no increased costs if a diligence requirement is imposed.

The corollary to NRSROs suffering little reputational or liability costs from inaccurate ratings is that investors bear the costs of such ratings. The NRSROs argue that this is proper because it makes investors responsible for their investment decisions.²¹⁵ Certainly, investors must conduct diligence and bear ultimate accountability for their choices. But it does not follow that the costs of inaccurate ratings should fall to investors. For one thing the NRSROs are in a better position to assure that they have taken reasonable care in determining the rating. The usefulness of rating agencies is based upon the difficulty that individual investors have in gathering all the information and developing the expertise necessary to evaluate securities. The NRSROs have developed the relationships, business models and requisite expertise to conduct credit analysis and assure the accuracy of that analysis at a far lower cost than investors ever could. Thus, putting the cost of inaccurate ratings on NRSROs would lead to more accurate ratings at a lower cost.

Scholars have for years debated the advantages and disadvantages of applying strict liability verses negligence liability regimes to gate-

211. Moody's Comments to Securities and Exchange Commission's Concept Release on Rating Agencies & the Use of Credit Ratings Under the Federal Securities Laws (July 28, 2003) available at <http://www.sec.gov/rules/concept/s71203/moodys072803.htm>.

212. See, e.g., Husisian, *supra* note 182, at 434-35.

213. See Part III *supra*.

214. See Part IVa *supra*.

215. See, e.g., *Securitisation: Fear and Loathing, and a Hint of Hope*, *supra* note 56, at 14 (with respect to criticisms about their ratings of mortgage backed securities the rating agencies respond that ratings are not meant to replace investor diligence).

keepers in general.²¹⁶ Proposals for strict liability are primarily based on the argument that it is the most cost effective.²¹⁷ Strict liability eliminates the administrative costs associated with defining the contours of the standard of care and of determining fault or breach of a duty. Moreover, because the gatekeeper is subject to strict liability, it is still incentivized to exercise due care.²¹⁸ However, recognizing that a pure strict liability scheme would likely lead to excessive deterrence, driving gatekeepers from the market altogether, scholars favor modified strict liability regimes which cap the liability of gatekeepers at some determinable amount.²¹⁹ Proposals have included caps which are established by statute and caps that are established by contract.²²⁰

Modified strict liability proposals suffer from the same infirmity that strict liability advocates find objectionable in negligence schemes, they come with administrative costs. Whether a cap on liability is determined outright by regulators or is the product of negotiation between the gatekeeper and its principle within minimum levels established by regulators, costs will be incurred in developing the knowledge required to determine the efficient cap just as costs would be incurred in developing the appropriate standard of care. Nor is it assured that the administrative costs of imposing regulatory caps will be lower than the administrative costs of a diligence based system. Regulators will incur costs associated with monitoring the effects of the cap and devising a mechanism to ensure that the cap is kept up to date with changes in the industry. Establishing liability and monitoring levels of caps are likely to involve similar kinds of investigatory inquiry and work as investigating breaches of duty. Therefore, a modified negligence scheme may be no more costly than modified strict liability schemes.²²¹

Strict liability regimes based upon contract and other liability regimes like them that would allow NRSROs to choose the level of liability they would like to be subject to are unlikely to lead to optimal ratings accuracy. For one thing, as Professor Coffee points out, issuers have little incentive to demand high levels of liability and may in fact use the promise of low levels of liability in order to induce acquiescence

216. Partnoy, *supra* note 15, at 540–46; Coffee, *supra* note 113, at 346–49; Hamdani, *supra* note 107, at 117–120; Choi, *supra* note 107, at 951–58.

217. Partnoy, *supra* note 15, at 540–46; Coffee, *supra* note 113, at 351–53.

218. Coffee, *supra* note 113, at 343.

219. Partnoy, *supra* note 15, at 540–46; Coffee, *supra* note 113, at 351–53.

220. Partnoy, *supra* note 15, at 540–46 (proposing contractual caps), Coffee, *supra* note 113, at 350–53 (proposing regulatory caps).

221. The Committee will also benefit from a wealth of legal development on the issue of determining the negligence standard of care which may further reduce the administrative costs of this proposal.

to wrongdoing.²²² The possibility of such complicity may be even greater with respect to ratings markets in which there are a small number of similarly situated, high revenue generating issuers as is the case in the structured finance market.²²³

Furthermore, NRSROs are unique among gatekeepers in that they are not subject to any real threat of civil liability. It is unlikely that an NRSRO would voluntarily opt into a scheme that imposes greater liability than they would otherwise have. Thus, contractual liability schemes may not lead to any significant increase in care among rating agencies.

CONCLUSION

The rating failures that precipitated the credit crisis have once again turned regulators' focus to the rating agencies. As proposals for regulating the agencies move forward, it is imperative that lawmakers recognize that reputational concerns, while an important deterrence to wrongdoing, have their limits. Hot markets and large profits increased the benefits of inaccurate ratings significantly. The value placed upon reputation by both the rating agencies and investors appears to have declined. The probability of liability for engaging in wrongdoing can also have a major impact upon whether a rating agency will find it beneficial to inaccurately rate. The task before lawmakers and regulators is to fashion a system that is flexible enough to capture changes in these variables. Both increased exposure to liability and increased disclosure can be used to achieve this goal.

222. Coffee, *supra* note 113, at 351.

223. See Part III *supra*.