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CREDIT RATING AGENCIES, STRUCTURED SECURITIES, AND THE WAY OUT OF THE ABYSS

LOIS R. LUPICA¹

*Bear in mind, however, that a rating is, in the end, an opinion. The rating assignment is as much an art as it is a science.*²

I. Credit Rating Agencies and Credit Ratings

Since the early twentieth century, credit rating agencies (“CRAs”) have provided opinions about the creditworthiness of securities issuers and the quality of their issuances.³ An issuer’s creditworthiness is a function of the risk that its loan instrument will

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² STANDARD & POOR’S, CORPORATE RATINGS CRITERIA 3 (2008) (statement of Solomon B. Samson, Chief Rating Officer, Corporate Ratings).

³ Standard & Poor’s (“S&P”) stated that

[a] Standard & Poor’s issuer credit rating is a current opinion of an obligor’s overall financial capacity (its creditworthiness) to pay its financial obligations. This opinion focuses on the obligor’s capacity and willingness to meet its financial commitments as they come due. It does not apply to any specific financial obligation, as it does not take into account the nature of and provisions of the obligation, its standing in bankruptcy or liquidation, statutory preferences, or the legality and enforceability of the obligation. In addition, it does not take into account the creditworthiness of the guarantors, insurers, or other forms of credit enhancement on the obligation. The issuer credit rating is not a recommendation to purchase, sell, or hold a financial obligation issued by an obligor, as it does not comment on market price or suitability for a particular investor.

decline in value as a result of its failure to satisfy the contractual terms of its borrowing arrangement.⁴ Although the pronouncements of CRAs have enormous consequences for the financial markets, issuers and investors, until quite recently CRAs have operated largely unnoticed in the shadows of these markets.⁵

This obscurity ended with the relatively recent transformation of the financial markets. As increasing numbers of business borrowers began entering the securitization market—financing their operations by securitizing their assets rather than by accessing more traditional sources of finance—the financial markets’ landscape became dramatically and inexorably altered. Technological innovation coupled with financial wizardry fueled the rapid growth of the securitization markets, leading to increasingly high volume conversions of cash flows into complex securitized and collateralized debt instruments and their derivatives.⁶ A self-

⁴ See, e.g., TIMOTHY J. SINCLAIR, *THE NEW MASTERS OF CAPITAL: AMERICAN BOND RATING AGENCIES AND THE POLITICS OF CREDITWORTHINESS* 4 (2005) (“The higher the rating, the less [the] risk of default on repayment to the lender . . .”).

⁵ *Id.* at 1-2 (“Their arsenal is an occult one, largely invisible to all but a few most of the time.”).

⁶ Alan Greenspan, former Chairman of the Federal Reserve, stated the following regarding technological innovation:

The impact of information technology has been keenly felt in the financial sector of the economy. Perhaps the most significant innovation has been the development of financial instruments that enable risk to be reallocated to the parties most willing and able to bear that risk. Many of the new financial products that have been created, with financial derivatives being the most notable, contribute economic value by unbundling risks and shifting them in a highly calibrated manner. Although these instruments cannot reduce the risk inherent in real assets, they can redistribute it in a way that induces more investment in real assets and, hence, engenders higher productivity and standards of living. Information technology has made possible the creation, valuation, and exchange of these complex financial products on a global basis.

Alan Greenspan, Chairman, Fed. Reserve, *The Revolution in Information Technology*, Remarks Before the Boston College Conference on the New

reinforcing supply and demand cycle emerged, with investment banks and other participants in the securitized debt market creating a seemingly insatiable demand for the sale of asset-backed securities (“ABSs”), mortgage-backed securities (“MBSs”), and other collateralized debt obligations (“CDOs”).⁷

With this insatiable demand for derivative instruments, investors correspondingly demanded accurate and timely information about the risks associated with investment in these securities. Accordingly, CRAs developed methodologies, models, and processes of analysis in order to provide opinions with respect to investment risks in these derivatives.

During the securitization boom, CRAs’ volume of business expanded ten-fold, and they, like all other financial market participants, became caught up in its exuberance.⁸ The high volume of issuances, long runs of high yields, and the complexity of the investments all led to widespread over-dependence of investors on rating agencies to evaluate risk.⁹ With the benefit of hindsight, it is

Economy (Mar. 6, 2000) (transcript available at <http://www.federalreserve.gov/BoardDocs/Speeches/2000/20000306.htm>).

⁷ *Id.* (partially attributing the rise in the supply and demand of securitized financial instruments to the capacity of such instruments to redistribute risk in novel ways).

⁸ Discussing the meltdown of the structured finance market, *The Economist* stated:

Alongside the banks, the “gatekeepers” who were supposed to lend stability and credibility to the new originate-and-distribute model of finance have also been found wanting. Rating agencies’ models underplayed the risk that loans from different lenders and regions could turn sour at the same time. Bond insurers, too, misjudged the risks lurking in CDOs. That failing has undermined the worth of their guarantees and strained their own credit ratings—and hence financial markets.

Fear and Loathing, and a Hint of Hope, *ECONOMIST*, Feb. 14, 2008, available at http://www.economist.com/finance/displaystory.cfm?story_id=10689043.

⁹ *Id.* (discussing the “breakneck growth” of securitization, and identifying such underlying flaws as “the sheer lack of understanding of some instruments” and “the market’s over-reliance on ratings as a short cut to assessing risk”).

clear that such unbridled confidence in rating agencies' opinions was misplaced.¹⁰

In 2008, the financial markets collapsed, and rating agencies were caught in the “conflagration.”¹¹ The failure of the financial markets, attributed to “the collective misjudgment of risk; a zealous search for yield; and the failure of oversight,”¹² has served to shine a spotlight on the activities of CRAs and to raise questions about the nature and scope of their authority and the financial implications of

¹⁰ There were individuals, however, who recognized the large level of risk in the securitization market, even when the market was at its peak. *See, e.g.*, Frederic Dannen, *The Failed Promise of Asset-Backed Securities*, INSTITUTIONAL INVESTOR, Oct. 1989, at 261 (observing that market prices for ABS have not always been an accurate reflection of their credit-enhanced quality); Gary Silverman, Debra Sparks & Andrew Osterland, *A \$2.5 Trillion Market You Hardly Know*, BUS. WK., Oct. 26, 1998, at 123 (observing that there is an “illusion of liquidity” in the ABS market which is leading to more expensive credit for originators, who in turn are passing the higher costs on to consumers); Gary Silverman, *Commentary: Securitization is No Security Blanket*, BUS. WK., Oct. 26, 1998, at 140 (finding that banks are securitizing safe loans and keeping the risky ones, thereby masking their true insolvency probability); Suzanne Woolley, *What's Next, Bridge Tolls?*, BUS. WK., Sept. 2, 1996, at 64 (quoting a rating agency managing director urging caution to ABS investors).

¹¹ *The Economist* eloquently described the situation:

How do you fight a conflagration when smaller blazes erupt almost daily? . . . Though the crisis is far from over, its causes have long been clear. Securitisation—the packaging of bank loans into tradable bonds—grew too complex. The incentives of those involved, especially loan originators, were warped. Lending standards plummeted as a result, not only in mortgages but in credit cards and corporate lending too. Investors over-reached for yield as interest rates fell. Everyone focused on credit ratings rather than the underlying credits. . . . Credit-rating agencies will be expected to distinguish more clearly between ratings for structured products and straight corporate debt, and to flag up conflicts of interest.

Dousing the Fire, ECONOMIST, Mar. 14, 2008, available at http://www.economist.com/finance/displaystory.cfm?story_id=10855889.

¹² *Barbarians at the Vault*, ECONOMIST, May 15, 2008, at 17.

their judgments.¹³ The high profile incidences of CRAs “getting it wrong” have further triggered calls for greater scrutiny and oversight over their operations.¹⁴

The deregulatory efforts of recent years have opened up new opportunities and prospects for many participants in the financial markets, including rating agencies.¹⁵ However, this shifting landscape has also resulted in new disquiet and uncertainty, with initial unease evolving into fundamental questions about the legitimacy of the essentially unregulated credit rating industry.¹⁶

¹³ Until a few decades ago, credit rating was a stagnant business, offering little information beyond that which was already publicly available. Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers* 63 (Univ. of San Diego Sch. of Law Legal Stud. Res. Paper Series, Research Paper No. 07-46, 2006), available at <http://ssrn.com/abstract=900257> (“The rating business remained stagnant for decades.”). Rating adjustments tended to lag behind by almost 18 months and were commonly reflective of information already incorporated into stock prices. *Id.* (“According to a study of 207 corporate bond rating changes from 1950 to 1972, credit rating changes generated information of little or no value. The changes merely reflected information already incorporated into stock market prices—and indeed lagged that information by as much as eighteen months.”).

¹⁴ SINCLAIR, *supra* note 4, at 149-73 (describing a number of high profile rating debacles in a chapter entitled “Blown Calls”). As Senator Lieberman, Chair of the Senate Committee on Governmental Affairs, observed:

[T]he credit rating agencies were dismally lax in their coverage of Enron. They didn’t ask probing questions and generally accepted at face value whatever Enron officials chose to tell them. And while they claim to rely primarily on public filings with the SEC, analysts from Standard & Poor’s not only did not read Enron’s proxy statement, they didn’t even know what information they might contain.

Press Release, Senate Committee on Homeland Security and Governmental Affairs, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs (Oct. 8, 2002).

¹⁵ See JACOB S. HACKER, *THE GREAT RISK SHIFT: THE NEW ECONOMIC INSECURITY AND THE DECLINE OF THE AMERICAN DREAM* 3-5 (2008).

¹⁶ *Id.* (arguing that Americans are bearing increasingly greater economic risks).

Particularly in light of the credit market's information asymmetries, the public's confidence in CRAs has been called into question.¹⁷

This article examines the role of credit rating agencies in the evolving financial markets. The movement away from relationship-based lending sited on trust to the less personal and more distensive capital markets made an objective assessment of creditworthiness essential to structure legitimate financial transactions, as well as to evaluate the credibility of investor decision-making. As CRAs have devoted a greater share of their resources to develop methods of rating these progressively more exotic securities, their dedicated influence over the organization of and participation in the capital markets has grown exponentially, thus making the issue of the accuracy of credit ratings and the accountability of CRAs ever-more critical.¹⁸

II. The Emergence of the Securitization Market

Driven by bankers, speculators, traders, lawyers, accountants, investors, CRAs and other participants, the financial markets have experienced a massive transformation in virtually every respect over the past decade and a half.¹⁹ Advanced information

¹⁷ Federal Reserve Chairman Bernanke observed that

since August, mortgage lenders, commercial and investment banks, and structured investment vehicles have experienced great difficulty in rolling over commercial paper backed by subprime and other mortgages. More broadly, a loss of confidence in credit ratings led to a sharp contraction in the asset-backed commercial paper market as short-term investors withdrew their funds. . . .

Ben S. Bernanke, Chairman, Fed. Reserve, Liquidity Provision by the Federal Reserve, Address at the Federal Reserve Bank of Atlanta Financial Markets Conference (May 13, 2008) (transcript available at <http://www.federalreserve.gov/newsevents/speech/bernanke20080513.htm>).

¹⁸ U.S. SEC. EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 5 (Jan. 2003) ("[T]he importance of [credit rating agency] opinions to investors and other market participants, and the influence of these opinions on the securities markets, have increased significantly").

¹⁹ DANIEL J. BOORSTIN, THE AMERICANS: THE DEMOCRATIC EXPERIENCE 55-56, 204-05, 210-11, 419 (1973) (chronicling the emergence in the mid-

systems²⁰ have led to the emergence of the securitization market in which public and private investors are able to purchase wide arrays of innovative investment products.²¹ These investment products include complex securitized assets and derivatives backed by mortgage loans,²² credit cards, and other consumer-credit receivables.²³

nineteenth century of CRAs in response to wholesalers' need for reliable credit rating information, which emerge from practices such as the use of lawyers in the west to investigate local businesses for credit worthiness, the ever expanding complexity of accounting in the industrial age, the development of Certified Public Accountants in response to new forms taxation, and the development of new forms of incorporation and investment trusts).

²⁰ See Julie L. Williams & James F.E. Gillespie, Jr., *The Impact of Technology on Banking: The Effect and Implications of "Deconstruction" of Banking Functions*, 5 N.C. BANKING INST. 135, 136-40 (2001) (describing the role of technology in the bank deconstruction phase of the 1990s).

²¹ Securitization, or structured finance, is a process whereby an entity pools together its interests in identifiable cash flows and then sells them to investors in the form of securities. These cash flows can be sold with or without collateral support. The securitizing entity initially sells its cash flows to a Special Purpose Corporation, commonly referred to as an SPC, which then in turn, transforms these cash flows into securities. The securities, backed by the cash flows (asset-backed securities or ABS, or mortgage-backed securities or MBS) are then sold to private or public investors. A firm can originate a securitization transaction only if it has earnings in the form of cash flow from long- or medium- term obligations owed to it by what are known as account debtors. See generally SECURITIZATION OF FINANCIAL ASSETS (Jason H.P. Kravitt ed., 2d ed. 1997 & Supp. 2008) (explaining the structure of securitization transactions); JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 3 (1988) (describing securitization as a method of finance).

²² The Securities and Exchange Commission ("SEC") states that

[MBSs] are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and

The securitization market was born in 1970 with the first mortgage-backed security issuance.²⁴ Non-real-estate public-asset-backed security issuances took off in the mid 1980s, when the

interest payments made by borrowers on the loans in the pool, a process known as securitization.

U.S. Sec. Exch. Comm'n, Mortgage-Backed Securities, <http://www.sec.gov/answers/mortgagesecurities.htm> (last visited Jan. 15, 2009).

²³ SYLVAIN RAYNES & ANN RUTLEDGE, *THE ANALYSIS OF STRUCTURED SECURITIES: PRECISE RISK MEASUREMENT AND CAPITAL ALLOCATION* vii (2003) (describing structured securities, which include asset-backed securities, as “debt securities backed by the pooled receivables of existing loans, leases, trade financings, bonds, or other financial assets whose credit risk generally has been delinked from the credit of the originator or seller by sale, swap or assignment.”); see also Lois R. Lupica, *Asset Securitization: The Unsecured Creditors’ Perspective*, 76 TEX. L. REV. 595, 660 (1998) [hereinafter Lupica, *Asset Securitization*]; Lois R. Lupica, *Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization*, 33 CONN. L. REV. 199, 208-230, 236-240 (2000). In January 1989, the non-seasonally adjusted outstanding pool of securitized assets from revolving and non-revolving consumer loans was \$802,841,790,000. In April 2006, that same pool of securitized assets was valued at \$2,292,839,490,000. Federal Reserve Statistical Release G-19, Consumer Credit Historical Data, Mar. 6, 2009, http://www.federalreserve.gov/releases/g19/hist/cc_hist_mt.html.

²⁴ The following excerpt illustrates the history:

[t]he first MBS was brought to market by Ginnie Mae in 1970. Throughout the 1970s and early 1980s the major type of MBS security was the pass-through security . . . A major innovation for the MBS market occurred in 1983 when Freddie Mac issued the first Collateralized Mortgage Obligations (CMOs). These new instruments appealed to investors with special maturity and cash-flow requirements. However, the first CMO issues faced complex tax, accounting and regulatory obstacles. Much of those legal issues were resolved with the passing of the Tax Reform Act of 1986, which included the Real Estate Mortgage Investment Conduit (REMIC) tax vehicle. After 1986 the issuance of CMOs grew enormously.

IVO KOLEV, FINANCIAL POLICY FORUM DERIVATIVES STUDY CENTER, PRIMER: MORTGAGE-BACKED SECURITIES (2004), <http://www.financialpolicy.org/fpfprimermbs.htm>.

increasing use of computers in the financial services sector enabled the funds tracking and analysis that enabled the pooling and redistributions of income-generating loans.²⁵ Since the early days of these markets, the volume of issuances has grown exponentially.²⁶ In 2006, the approximate combined market for ABSs and CDOs was between \$10.7 and \$12.7 trillion.²⁷ At its market peak, securitization was hailed as “one of the most significant financial innovations in the global capital markets during the past 15 years.”²⁸ Commentators once believed that securitization would forever continue to “evolve

²⁵ Lowell L. Bryan, *Structured Securitized Credit: A Superior Technology for Lending*, J. APPLIED CORP. FIN., Fall 1988, at 10-11 (describing Franklin Savings’ \$100 million securitization of government loans). This issuance was followed by a deal originated by General Motors Acceptance Corporation in 1986. *Id.*

²⁶ See Federal Reserve Statistical Release G-19, *supra* note 23.

²⁷ Matt Miller, *Chain of Fools*, THE DEAL, Oct. 3, 2008, <http://www.thedeal.com/newsweekly/features/chain-of-fools.php>.

²⁸ Adam Reinebach, *As Franchise Loan Industry Expands, Securitization Deals are Following*, INVESTMENT DEALERS’ DIG., May 11, 1998, at 13 (forecasting that the franchise asset class will significantly expand in the next years); Adam Reinebach, *The Outlook for ABS is So Rosy That It’s Scary*, INVESTMENT DEALERS’ DIG., June 1, 1998, at 26 (describing the securitization of intellectual property futures, utility losses, and reinsurance risk while stating that the rapid growth of securitization is a result of a combination of low and stable interest rates and good economic conditions); Matthew Schifrin & Howard Rudnitsky, *Rx for Receivables*, FORBES, May 6, 1996, at 52 (describing the securitization of pharmaceutical receivables); Suzanne Wooley & Stan Crock, *You Can Securitise Virtually Everything*, BUS. WK., Jul. 20, 1992, at 78 (“Few financial innovations have been more of a bonanza to Wall Street than asset-backed securities.”); Michael Gregory, *SG Cowen Brings First Rights Deal*, STRUCTURED FINANCE NEWS, Mar. 13, 2000, http://www.structuredfinancenews.com/issues/2000_11/161855-1.html?type=printer_friendly (describing the securitization of a sports stadium naming rights contract); *Standard & Poor’s: U.S. Asset-Backed Securities Market Will Continue Expansion*, PRNEWswire, Feb. 10, 2000 (statement of Dr. Joseph Hu, head of the Standard & Poor’s Structured Finance research team, that asset securitization is one of the greatest innovations in the last decade and a half); see also Kim Clark, *On the Frontier of Creative Finance*, FORTUNE, Apr. 28, 1997, at 50 (describing trends in securitization); Ron J. Feldman, Senior Vice President, Federal Reserve Bank of Minneapolis, *Will the Securitization Revolution Spread?* (Sept. 1995), http://www.minneapolisfed.org/research/pub_display.cfm?id=3684 (describing securitization as a “profound change in banking”).

and expand.”²⁹ Standard & Poor’s (“S&P”) observed during the 1990s that securitization’s continued attractiveness to investors was due to the high quality and stability of the issued assets.³⁰

To be sure, securitization has offered myriad benefits to many financial market participants.³¹ Securitized and derivative financial products have allowed both financiers and investors to hedge market and currency risk while simultaneously meeting the goals of financial institutions to borrow cheaply, transfer and diversify risk, access new sources of capital, and take advantage of economies of scale.³² It has also resulted in unprecedented profits booked by participants in the financial markets³³—including rating agencies.³⁴

²⁹ Stephen L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 134-141 (1994) (describing the process and uses of securitization and referring to securitization as “alchemy”); Greenspan, *supra* note 6; Debra Sparks, *Bad Loans Made Good*, BUS. WK., Oct. 26, 1998, at 12, available at <http://www.businessweek.com/1998/43/b3601155>; *Standard & Poor’s*, *supra* note 28 (“Asset securitization is one of the most significant financial innovations in the global capital markets during the past 15 years,” says the report’s author, Dr. Joseph Hu ‘Not only will the issuance volume expand, but the variety of underlying assets and innovative structures will also grow.’”).

³⁰ Shane Kite, *Insiders’ Predictions Point to Maturing Market*, Oct. 18, 1999, http://www.structuredfinancenews.com/issues/1999_42/161611-1.html; *Standard & Poor’s: U.S. Asset-Backed Securities Market Will Continue Expansion*, *supra* note 28; Akil Salim Roper, *ABS Market Expected to Grow in 1999*, 17 PRIVATE PLACEMENT LETTER 2, 2 (1999).

³¹ See, e.g., Schwarcz *supra* note 29, at 136, 146-54 (describing the benefits securitization offers issuers, including providing a source of off-balance sheet funding and reducing net financing costs).

³² Lupica, *Asset Securitization*, *supra* note 23, at 605; see also RAYNES & RUTLEDGE, *supra* note 23, at vii.

³³ Banking profitability began reaching record highs at the turn of the millennium. *Condition and Performance of Commercial Banks*, U.S. OFFICE OF THE COMPTROLLER OF THE CURRENCY: QUARTERLY J., Dec. 1999, at 1, available at http://findarticles.com/p/articles/mi_qu3887/is_199912/ai_n8863440. In the three months ending September 30, 1999, banks reported \$19.4 billion in net income, a record level. *Id.* Both return on assets and return on equity in the banking industry as a whole had also reached record levels. *Id.*

³⁴ See, e.g., Moody’s Corp., Annual Report (Form 10-K), at 25 (Mar. 2, 2009) (depicting that Moody’s Corp. earnings were higher than that of its peer groups as well as the S&P 500 composite index).

While minimizing risk and making money is what the finance industry does (rewards are meted out based on who does this best), with escalating profits comes the risk of complacency.³⁵ Bankers and CRAs fell into this complacency by failing to recognize and address some of securitization's fault lines and failings in the market's operation.³⁶ A central failing of the market is directly tied to the "too-clever-by-half"³⁷ structure of many of these complex transactions: few truly understood these transactions, the nature of the investments being sold, and how to evaluate the risk associated with the underlying assets.³⁸

We now know, with the benefit of hindsight, that the full measure of risk³⁹ was not captured or reflected in the ratings in this

³⁵ With the creation of a robust secondary market for loans, in turn resulting in enormous balance-sheet flexibility, securitization has accounted for 20 to 30 percent of investment banks' profits. *Fear and Loathing*, *supra* note 6, at 77.

³⁶ *What Went Wrong*, *ECONOMIST*, Mar. 19, 2008, http://www.economist.com/finance/displaystory.cfm?story_id=10881318.

³⁷ As *The Economist* observed,

[t]here is a growing consensus that loose credit and too-clever-by-half financial wizardry sowed the seeds of America's still-deepening economic malaise. One practice in particular has been singled out for censure—the bundling of loans into assets that could be sold on to investors. The charge is that by breaking the link between those who vet borrowers and those who bear the cost when they default, securitisation led to the lax lending that both fuelled and felled America's housing market.

Chain of Fools, *ECONOMIST*, Feb. 7, 2008, http://www.economist.com/finance/displaystory.cfm?story_id=10641119.

³⁸ The SEC released findings in the summer of 2008, after an "extensive 10-month examinations of three major credit rating agencies," indicating "significant weaknesses in ratings practices and the need for remedial action by the firms to provide meaningful ratings and the necessary levels of disclosure to investors." Press Release, Sec. & Exch. Comm'n, SEC Examinations Find Shortcomings in Credit Rating Agencies' Practices and Disclosures to Investors (July 8, 2008), *available at* <http://www.sec.gov/news/press/2008/2008-135.htm>.

³⁹ The central risks facing investors purchasing MBSs and ABSs are the credit quality of the underlying receivables, the value of the underlying collateral (if collateralized), the issuers' operational risks, uncertainty in

market.⁴⁰ Appreciating and accurately valuing the assets supporting ABSs and MBSs is fundamental to any risk assessment.⁴¹ In the

governing law, and the bankruptcy of the issuer. The S&P website states that the Servicer Evaluation review process includes “Management and Organization; Internal Controls; Historical Portfolio Performance; Cash Management; Organizational Efficiency; [and] Loan Asset/Administration.” Standard & Poor’s, Servicer Evaluations, http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/ratings_sf_se/2,1,9,6,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0.html (last visited Jan. 16, 2009). S&P conducts analysis with respect to ABS services with “a dedicated team of analysts assess[ing] a wide range of a servicer’s business practices . . . through on-site meetings and analyses of company materials and data, summarizing in a report its findings and recommendations.”).

⁴⁰ If a debtor in bankruptcy has securitized a portion of its assets, its trustee will be concerned with any and all vulnerabilities presented by the transaction’s structure, as well as the extent to which its contractual agreements are enforceable under the law. *See* 11 U.S.C. § 544 (2000). If even one element of the transaction is vulnerable to challenge, the ABS investors’ return on its investment will be compromised. Accordingly, the degree of risk to which ABS investors are subject is in large part a factor of the successful structuring of the bankruptcy-remote transaction. A bankruptcy-remote transaction structure isolates the special purpose entity (“SPE”) from the effects of the securitizing debtor’s bankruptcy. This is accomplished by (i) ensuring that the asset transfer meets the judicial test of a “true sale;” (ii) providing for the SPE’s separateness, so that a court will not substantively consolidate the SPE and the originator; and (iii) compliance with relevant legal formalities, such a perfection of security interests, and due organization of each entity under applicable law. A bankruptcy-remote transaction structure is one that also protects SPE investors from the SPE’s potential bankruptcy. To minimize the chance of an SPE’s insolvency, transaction sponsors commonly include a variety of pre-petition bankruptcy waivers, or “hindrance mechanisms” in an SPE’s organizational documents. Examples of these hindrance mechanisms include (i) provisions in the SPE’s organizing documents, limiting its purpose and activities; (ii) limitations on the SPE’s indebtedness; (iii) guarantees that become effective upon the occurrence of an entity’s bankruptcy; (iv) provisions in charter documents that require unanimous consent of all managers, in order to file for bankruptcy; (v) an agreement by the debtor that a bankruptcy filing would be in “bad faith”; (vi) an agreement by the debtor to waive the terms of the automatic stay, pre-petition; and (vii) an agreement by the debtor to seek court abstention, upon a filing for bankruptcy. *See* Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1564-80; Gary Gorton & Nicholas S. Souleles,

absence of a precise understanding and valuation of securitized assets, the exercise in arbitrage fails, and the credit rating becomes based upon a misunderstanding that in turn determines the faulty MBS, ABS, or CDO pricing.⁴² This has the potential to lead to further failings in the fundamental structuring of transactions, with, for example, senior tranches' fallibility far greater than their rating (and pricing) suggests.⁴³

Special Purpose Vehicles and Securitization 9-10, 35-36 (Nat'l Bureau of Econ. Research, Working Paper No. 11190, 2005).

S&P has also stated that bankruptcy-remote transaction structuring is always a large factor in overall SPE structure: "At the heart of every structured finance transaction is a vehicle designed to protect investors in the event of a bankruptcy. The credibility of these bankruptcy-remote vehicles and the criteria by which their levels of risk are measured stand as the foundation of today's structured finance market."

Standard & Poor's—Ratings, Structured Finance, http://www2.standardandpoors.com/portal/site/sp/en/us/page.family/ratings_sf/2,1,9,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0.html (last visited Jan. 16, 2009).

⁴¹ See generally Thomas J. Gordon, *Securitization of Executory Future Flows as Bankruptcy-Remote True Sales*, 67 U. CHI. L. REV. 1317, 1318 (2000) (providing background information on the process of securitization); Lupica, *Asset Securitization*, *supra* note 23, at 595 (describing the risks associated with securitization); RAYNES & RUTLEDGE, *supra* note 23; Schwarcz, *supra* note 29, at 134-41 (detailing the process and benefits of asset securitization).

⁴² The press release describing the SEC report on rating agency performance noted that

[t]he SEC staff's examinations found that rating agencies struggled significantly with the increase in the number and complexity of subprime residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDO) deals since 2002. The examinations uncovered that none of the rating agencies examined had specific written comprehensive procedures for rating RMBSs and CDOs.

Press Release, Sec. & Exch. Comm'n, *supra* note 38; see also U.S. SEC. & EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 36-37 (2008), available at http://www.sec.gov/news/studies/2008/cra_examination070808.pdf.

⁴³ As the SEC states in its report,

Whether the financial modeling tools developed to quantify the risk of investing in these securitized and derivative products were incomplete,⁴⁴ flawed,⁴⁵ or otherwise inadequate,⁴⁶ or whether the rating agencies, blinded by extraordinary profits⁴⁷ and conflicts of interest,⁴⁸ ignored the risks revealed by these models is not yet clear. What has become clear, as the CRAs have tried to dust themselves

[a] key step in the process of creating and ultimately selling a subprime RMBS and CDO is the issuance of a credit rating for each of the tranches issued by the trust (with the exception of the most junior “equity” tranche). The credit rating for each rated tranche indicates the credit rating agency’s view as to the creditworthiness of the debt instrument in terms of the likelihood that the issuer would default on its obligations to make interest and principle payments on the debt instrument.

U.S. SEC. & EXCH. COMM’N, *supra* note 42, at 7.

⁴⁴ It is clear that rating agencies gave high ratings to subprime-mortgage securities that subsequently sank in value, and then reacted slowly as defaults rose. *The Role of Credit Rating Agencies in the Structured Finance Market: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 110th Cong. 49-50 (2007) (examining the extent to which credit rating agencies contributed to the subprime mortgage crisis).

⁴⁵ See note 42 and accompanying text.

⁴⁶ CRAs’ ratings either did not accurately reflect such risks at the time of issue, or lagged behind once circumstances changed. *Rating the Raters: Enron and the Credit Rating Agencies: Hearing Before the S. Comm. on Governmental Affairs*, 107th Cong. 44 (2002) (statement of Jonathan R. Macey, Professor of Law) (examining the failure of rating agencies in predicting Enron’s collapse).

⁴⁷ *Anatomy of a Deal*, BUS. WK., Oct. 26, 1998, at 128-29, available at <http://www.businessweek.com/1998/43/b3601156.htm> (last visited Jan. 17, 2009) (stating that “[s]ecuritization is a money machine” for mortgage brokers, finance companies, investment bankers and institutional investors). In the past years, for example, Moody’s earnings rose over 375%, largely as a result of the proliferation of structured finance deals. Partnoy, *supra* note 13, at 65-67. Until very recently, structured finance transactions accounted for 43 percent of Moody’s revenues. *Id.* at 60.

⁴⁸ Aaron Lucchetti, *Rating Game: As Housing Boomed, Moody’s Opened Up*, WALL ST. J., Apr. 11, 2001, at A1 (detailing the changes in institutional culture at Moody’s that may have led to conflicts of interest, as Moody’s officials became more socially connected to investment bankers by making themselves more accessible and accepting social invitations).

off and repair both their balance sheets and their reputations, is that there are specific points of systemic failure in their rating methodology, analysis, organization, and processes.⁴⁹

III. The Influence of Credit Ratings

Credit Rating Agencies are private organizations performing a quasi-public function.⁵⁰ Since the early twentieth century, investors

⁴⁹ The following is S&P's description of its decision to review its method of rating collateralized debt obligations:

Standard & Poor's Ratings Services announced in a recent article that it is conducting a comprehensive review of all assumptions and methodologies it uses to assign ratings to corporate synthetic collateralized debt obligation (CDO) transactions. . . .As a first step in the review, Standard & Poor's examined the global corporate synthetic CDOs it rates to identify any systemic concentration risks in this sector. The article notes that this sector as a whole generally appears to have considerable exposure to 100 global corporate issuers. While the high rate of name overlap among these portfolios does not make any individual portfolio riskier than another, the sector could see an increase in downgrades if these 100 names experience negative rating migration.

"In our analysis, we identified a number of key risks we saw for corporate synthetic CDOs. These include: collateral performance, such as default/credit events, rating transition, sector correlation, and recovery rates; counterparty jump to default risk; and widening CDS spreads," credit analyst Belinda Ghetti said.

"As a result of our review, we will likely look for more credit enhancement for all rating categories, and adjust our ratings on outstanding corporate synthetic CDOs. . . . In the interim, Standard & Poor's is committed to promoting transparency in the corporate synthetic CDO market. . . ." Ms. Ghetti stated.

Press Release, Standard & Poor's, Advance Notice of Criteria Change for Corporate Synthetic CDO's Published (Jan. 12, 2009).

⁵⁰ Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 934 (1998); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The*

and regulators have looked to CRAs to evaluate the creditworthiness of an obligor or a securities issuer. While their ostensible function is to address information asymmetries inherent in many public debt finance transactions, in practice, their judgments about issuers and issuances goes beyond a mere evaluation of credit. The internal policies of CRAs in developing ratings criteria have the effect of “adjust[ing] the ‘ground rules’ inside international capital markets, thereby shaping the internal organization and behavior of institutions seeking funds.”⁵¹ The criteria developed and operationalized by ratings agencies influence the level of activity of the finance markets, the allocation of capital, as well as the cost of credit.⁵² Until recently, financial markets generally considered the pronouncements of CRAs to be both trustworthy and authoritative.

Very few rating agencies, however, hold this authority. If too much power and influence is held by too few institutions and if these few institutions have exclusive access to too much information about securities and issuers, the potential for competition is thwarted, and behavior corrupted. Currently, only three CRAs qualify as Nationally Recognized Statistical Ratings Organizations (“NRSRO”): Moody’s, S&P, and Fitch. Qualification as an NRSRO requires a certain amount of ratings volume, a substantial track record and recognition in the market.⁵³ An agency’s reputation is developed over many years by rating a multitude of types of issuers and issuances. Thus, the NRSRO designation and the structure and function of the market act as a barrier to entry.⁵⁴ The influence of the few NRSROs goes even

Challenge of Fashioning Relevant Reforms, 84 B.U. L. REV. 301, 302 (2004); Peter B. Oh, *Gatekeeping*, 29 J. CORP. L. 735, 742 (2004).

⁵¹ SINCLAIR, *supra* note 4, at 15.

⁵² Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, in CREDIT RATING AGENCIES: NEED FOR REFORM IN CANADA?, at 14 (Capital Markets Institute Policy Series, Aug. 2005) (“Through their activities, [CRAs] influence the conditions under which issuers will have access to debt markets, the conditions of their relationships with lenders, and the structure of their transactions.”).

⁵³ Credit Rating Agency Reform Act of 2006, 15 U.S.C.A. § 78o-7 (2008).

⁵⁴ The imperfectly competitive market is further exacerbated by the essential nature of a rating agency’s reputational capital. *Rating the Rating Agencies: The State of Transparency and Competition: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. (2003) (statement of Annette L. Nazareth, Director, Division of Market Regulations, SEC). It has

further, however: a number of regulatory schemes have integrated private credit assessments into their rubric. For example, the streamlined purchase of securities by institutional investors is conditioned upon an NRSRO rating of a certain level.⁵⁵ These so-called regulatory licenses⁵⁶ function in lieu of the public regulation of security issuances to a certain strata of investors and serve to amplify CRA opinions' utility in the public markets.

As complex securitization and multi-level derivative transactions have become ever-more commonplace, information asymmetries between issuers and investors have grown larger. This has made investor reliance on the opinions of CRAs increasingly cost-effective and efficient. It has also exaggerated CRAs' market influence as well as the consequences of inaccurate pronouncements. The huge sway CRAs have over activity in the financial markets has made their present-day failures exceedingly conspicuous, thus leading to calls for greater accountability. As the public seeks to identify the villain in the current financial drama, credit rating agencies got caught up in the chase and have recently been subject to pervasive and widespread censure.

IV. Rating Agencies' Points of Systemic Failure

As the structured finance markets have increasingly relied upon CRAs to correct extreme information asymmetries, their power and influence has grown. The tremendous authority wielded by CRAs in the market for securitized assets has revealed numerous points of potential systemic failure inherent in CRAs' rating system. This potential has been realized on a grand scale as a result of the recent unprecedented stresses in the financial markets. In response,

been further alleged that "the largest rating agencies have abused their dominant position by engaging in certain aggressive competitive practices." *Id.* These practices have included providing unsolicited ratings, thereby forcing issuers to pay for ratings they did not request. *Id.*

⁵⁵ Partnoy, *supra* note 13, at 66 (arguing that that because of the "regulations that depend exclusively on credit ratings issued by [NRSROs]," economic rents are generated that persist, even in the face of inaccurate ratings, when they would otherwise suffer from a decline in reputational capital).

⁵⁶ See *Turmoil in the U.S. Credit Markets: The Role of Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. 2 (Apr. 22, 2008) (statement of John C. Coffee, Jr., Professor of Law) [hereinafter Statement of Professor Coffee].

scholars,⁵⁷ the press, lawmakers,⁵⁸ and market participants have called for reform: CRAs must not only be made accountable for their ratings; they must also, going forward, be far more reliable.

A. Independent Verification of Information and Greater Transparency

Rating agencies have been criticized for not conducting independent diligence in connection with their structured securities rating analysis.⁵⁹ Exclusive reliance upon issuers and underwriters as information sources leaves open the potential for the ratings information inputs to be either biased or incomplete.⁶⁰ There is little short-term incentive for issuers to completely disclose information about all aspects of the underlying assets because selectively

⁵⁷ See generally Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 648-654 (1999); Partnoy, *supra* note 13, at 63-64, 72-73, 86-92 (criticizing the quality and accuracy of information provided by credit rating agencies).

⁵⁸ See Definition of Nationally Recognized Statistical Rating Organization, Securities Act Release No. 8570, Exchange Act Release No. 51,572, Investment Company Act Release No. 26,834, 70 Fed. Reg. 21,306 (proposed Apr. 25, 2005) (to be codified at 17 C.F.R. pt. 240); COMMITTEE OF EUROPEAN SECURITIES REGULATORS, CESR'S TECHNICAL ADVICE TO EUROPEAN COMMISSION ON POSSIBLE MEASURES CONCERNING CREDIT RATING AGENCIES ¶¶ 154-192 (2004); Press Release, International Organization of Securities Commissions, IOSCO Releases Code of Conduct Fundamentals for Credit Rating Agencies (Dec. 2004).

⁵⁹ Statement of Professor Coffee, *supra* note 56, at 9 (“[I]n the case of structured finance products . . . rating agencies do request and receive information, but they do not audit, verify or even sample it. . . . Put simply, this is the equivalent of an auditor accepting an issuer’s statements about its revenues, costs, inventories and contingent liabilities at face value. Absent some efforts at verification, it is doubtful that the ratings on structured finance will ever again be credible to much of the debt market.”).

⁶⁰ There is a special exemption in Regulation Fair Disclosure (“Regulation FD”) for credit rating agencies: The issuer can selectively give information to some rating agencies, and not others. 17 C.F.R. §§ 240, 243, 249 (2008) (“The third exclusion from coverage in Rule 100(b)(2) is for disclosures to an entity whose primary business is the issuance of credit ratings, provided the information is disclosed solely for the purpose of developing a credit rating and the entity’s ratings are publicly available.”).

choosing which information to provide may well increase an issuer's credit rating.⁶¹

Moreover, rating agencies have been criticized for the lack of transparency with respect to the information utilized in arriving at a rating,⁶² as well as regarding their internal methodologies, processes, and fee structure.⁶³ The lack of disclosure of fee structures and a lack of transparency of ratings process in general has served to undermine public confidence in their pronouncements.⁶⁴

B. The Accuracy and Limitations of Quantitative Models

As the market for asset-backed securities and derivative products exploded, rating agencies endeavored to keep pace with the increasing volume of issuances. In their efforts to identify and capture risk, they developed new quantitative methods of rating the increasingly exotic security issuances. These methods included the design of complex models to ostensibly analyze, evaluate, and determine the quality of the underlying assets' cash flows and thus the securities' risk.⁶⁵

⁶¹ Stéphane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach* 7, 33-34 (2005), <http://www.droitdesaffaires.org/pdf/enhancing.pdf>.

⁶² Cf. MOODY'S INVESTOR SERVICE, *INSIDE MOODY'S: CREDIT POLICY 2-11* (Apr. 2008), <http://v2.moodys.com/moodys/cust/content/content.ashx?source=StaticContent/Free%20Pages/Credit%20Policy/CreditPolicy.pdf> (citing the increasing lack of confidence in credit ratings and explaining how Moody's methods and models are designed to encourage transparency).

⁶³ Rousseau, *supra* note 61, at 46-47.

⁶⁴ See SEC. INDUS. & FIN. MKTS ASSOC., *RECOMMENDATIONS OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION CREDIT RATING AGENCY TASK FORCE 2-9* (2008), http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf (recommending that CRAs disclose their rating methodology, the information they rely upon in formulating their ratings, their surveillance procedures, and comparable CRA performance so as to increase market confidence in their credit ratings).

⁶⁵ According to reports made in the early 1990s, this analysis involved a review of the receivable pool's historic record in order to discard those receivables perceived to be high risk. Jonathan E. Keighley, *Risks in Securitisation Transactions*, in *THE GLOBAL ASSET BACKED SECURITIES MARKET: STRUCTURING, MANAGING AND ALLOCATING RISK 100-01* (Charles Stone et al. eds., 1993) (explaining steps to restructuring the

A great deal of criticism has been leveled at the quantitative models CRAs used to assess risk.⁶⁶ The most pointed criticism is that these models too often “got it wrong.” This was either because too much confidence was placed on numerical, objective analysis, or not enough contextual attention was paid to these numerics.⁶⁷

originator’s asset pool). Receivables with a history of late payment, an origination from specific, less desirable industries or depressed geographical regions, or from classes of less financially dependable obligors were eliminated from the pool or required to be credit-enhanced. *Id.* Specific loss probability parameters were set, and those receivables not falling within these parameters, or not sufficiently credit enhanced, were eliminated from the pool. *Id.* Before long, scientists and mathematicians developed statistical tools for measuring and quantifying risk. The most commonly used model, known as VaR (Value at Risk) measured “the boundaries of risk in a portfolio over short durations, assuming a “normal market.” The VaR measurement appealed to investors because “it expresses risk as a single number, a dollar figure, no less. . . . For instance, if you have \$50 million of weekly VaR, that means that over the course of the next week, there is a 99 percent chance that your portfolio won’t lose more than \$50 million.” Joe Nocera, *Risk Mismanagement: Were the Measures Used to Evaluate Wall Street Trades Flawed? Or was the Mistake Ignoring Them?*, N.Y. TIMES MAG., JAN. 4, 2009, at 24, 26.

⁶⁶ See, e.g., Statement of Professor Coffee, *supra* note 56, at 4 (“In hindsight, it is now evident that the [quantitative] models used by the ratings agencies to estimate the risk of loss on structured finance products (especially CDOs) were flawed and inaccurate.”); Nocera, *supra* note 65, at 26 (“Given the calamity that has since occurred, there has been a great deal of talk, even in quant circles, that this widespread institutional reliance on VaR was a terrible mistake.”).

⁶⁷ Alan Greenspan, former Chairman of the Federal Reserve, stated in 2008 that

[t]he . . . surge in global demand for U.S. subprime securities by banks, hedge, and pension funds supported by unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem. Demand became so aggressive that too many securitizers and lenders believed they were able to create and sell mortgage backed securities so quickly that they never put their shareholders’ capital at risk and hence did not have the incentive to evaluate the credit quality of what they were selling. Pressures on lenders to supply more “paper” collapsed subprime underwriting standards from 2005 forward. Uncritical acceptance of credit ratings by

Moreover, the mathematical models commonly used reflected risk based upon short-term, rather than long-term historical data. As Alan Greenspan, former Chairman of the Federal Reserve, stated in his “mea culpa” testimony before a Congressional Oversight Committee:

The whole intellectual edifice [underpinning the advances in derivatives markets] . . . collapsed in the summer of last year because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today⁶⁸

Further, CRAs’ quantitative models failed or were slow to consider the impact of changed underwriting practices on the part of front line lenders. Little, if any, scrutiny was made of the securitized receivables and supporting collateral; as such, high loan to value ratio loans (“HLTV loans”: between 90% and 125%) and no-documentation loans (commonly known as “liar loans”) were often not reflected in the models’ risk rating.⁶⁹ With no independent verification conducted by rating agencies about the actual

purchasers of these toxic assets has led to huge losses. It was the failure to properly price such risky assets that precipitated the crisis. In recent decades, a vast risk management and pricing system has evolved, combining the best insights of mathematicians and finance experts supported by major advances in computer and communications technology. A Nobel Prize was awarded for the discovery of the pricing model that underpins much of the advance in derivatives markets. This modern risk management paradigm held sway for decades.

The Financial Crisis and the Role of Federal Regulators: Hearing Before the Comm. of Government Oversight and Reform, 110th Cong. 3 (2008) (testimony of Dr. Alan Greenspan, Former Chairman of the Federal Reserve).

⁶⁸ *Id.* at 3-4.

⁶⁹ *See* Statement of Professor Coffee, *supra* note 56, at 7.

underwriting standards employed, the quantitative analysis of risk failed to factor in this data.⁷⁰

In addition, the quantitative risks assessment models failed to take into account what is known as “default dependence” or “default contagion.”⁷¹ A default is “dependent” or “contagious” when conditions are such that a default by one borrower increases the default probability of other borrowers.⁷² For example, the stress experienced by the subprime mortgage market rapidly spread to other financial sectors.⁷³ As the current economic environment is demonstrating, risk can be both interconnected and contagious.⁷⁴

Finally, the limitations inherent in any quantitative modeling tool were not fully recognized by the credit analysts ultimately responsible for rating the MBSs, ABSs and derivatives.⁷⁵ Over-

⁷⁰ See *id.* at 9.

⁷¹ *Id.* at 4.

⁷² See *id.*

⁷³ Moody's stated that

[c]redit problems initially localized in subprime US mortgages quickly spread to other complex financial vehicles with subprime exposure and triggered a broad repricing of risk. This affected not only a variety of financial vehicles holding subprime paper . . . but also bled into other asset classes, such as Alt-A mortgages, commercial mortgages, leveraged loans, covered bonds, the corporate sector more generally, and, prospectively, credit card securitizations.

MOODY'S INVESTOR SERVICE, *supra* note 62, at 7.

⁷⁴ See *id.* at 7-8.

⁷⁵ The following observation was attributed to Nassim Nicholas Taleb, Distinguished Professor of Risk Engineering at New York University:

Wall street risk models, no matter how mathematically sophisticated, are bogus; . . . the essential reason for this is that the greatest risks are never the ones you can see and measure, but the ones you can't see and therefore can never measure. The ones that seem so far outside the boundary of normal probability that you can't imagine they could happen in your lifetime—even though, of course, they do happen, more often than you care to realize. Devastating hurricanes happen. Earthquakes happen. And once in a great while, huge financial

reliance on “math” to the exclusion of consideration of subjective factors impacting credit quality such as the issuer’s management quality, competitive market position, financial policy, capital structure, cash flow protection, accounting practices, and the general economic environment led to inaccurate conclusions about levels of risk.⁷⁶ Analysts cast aside their judgment in favor of the illusion of an objective risk numerical.⁷⁷

catastrophes happen. Catastrophes that risk models somehow always manage to miss.

Nocera, *supra* note 65, at 28 (quoting Professor Taleb).

⁷⁶ The SEC report on credit ratings agencies describing the general procedures CRAs use in rating issuers, additionally noted that

[t]he primary credit considerations used in the corporate finance area involve both non-financial and financial factors. Some of the non-financial or qualitative considerations include: (1) stability of markets, (2) diversity of markets, (3) efficiency of operation (e.g., distribution system and operating margins), (4) peer group analysis, (5) competition and market positions, and (6) government regulation. Financial or quantitative considerations include: (1) cash generation or use, (2) balance sheet strength, (3) debt/capitalization ratios, (4) interest coverage ratios, (5) operating cash flow to total debt ratios, and (6) fixed charge ratios.

U.S. SEC. & EXCH. COMM’N., *supra* note 18, at 25 n.64, 25-27.

⁷⁷ Professor Coffee stated that

[t]he real purpose and point of this proposal is to supplement the quantitative model of the rating agency with some minimal auditing (or at least sampling) that tests the quality of the information that the rating agency is relying upon. Otherwise, the oldest rule about quantitative models is “GIGO”—garbage in, garbage out. In effect, this proposal seeks to invent a new gatekeeper to complement the role of the rating agency because, in the world of structured finance, the rating agency is flying blind. Worse yet, because rating agencies commonly provide issuers and underwriters with their quantitative models, the latter know precisely how to “game the model” with only slightly misleading information to produce the desired result.

C. Conflicts of Interest

The most oft-cited criticism of CRAs grows out of their practice of having issuers pay for their own ratings, thus creating a potentially corrupting conflict of interest.⁷⁸ Such a system leaves open the temptation for CRAs to modulate their opinion as to the credit risk of securities issued by repeat issuers.⁷⁹ Because issuers of securities—who are rationally seeking the highest possible ratings for the lowest possible cost of issuance—are also the parties paying CRAs to issue the ratings, this arrangement has the potential to skew the outcome of the rating process. If the rating agency's opinion is based on a faulty factual foundation, or one that is arrived at in the context of conflicting interests, its value is lost, and the system loses its efficiency. In light of the fact that structured finance transactions have accounted for approximately 40 percent of CRA's revenues,⁸⁰ and most of the business originates from the finite investment banking community, this concern may be well placed.⁸¹

Moreover, the emergence of CRA consulting divisions offering risk-assessment services to issuers presents further potential

Statement of Professor Coffee, *supra* note 56, at 12.

⁷⁸ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (“We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.”).

⁷⁹ U.S. SEC. EXCH. COMM’N, *supra* note 18, at 41 (“The practice of issuers paying for their own ratings creates the potential for a conflict of interest. Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally, and temper their diligence in probing for negative information.”). Moody’s, S&P, and Fitch all offer customized credit risk management services and quantitative tools through their ancillary business divisions.

⁸⁰ See Portnoy, *supra* note 13, at 60, 62-69 (describing the CRAs’ revenue structure).

⁸¹ See generally Press Release, U.S. Sec. & Exch. Comm’n, SEC Examinations Find Shortcomings in Credit Rating Agencies’ Practices and Disclosure to Investors (July 8, 2008) (available at <http://www.sec.gov/news/press/2008/2008-135.htm>) (“[S]ignificant aspects of the rating process were not always disclosed or even documented by the firms, and conflicts of interest were not always managed appropriately.”).

for conflicts of interests.⁸² This is tantamount to the criticism leveled at accounting and law firms for offering ancillary consulting services: services offered by such ancillary businesses present the risk of compromising the validity of professional opinions.⁸³ If a CRA is both selling issuer models (analytics and data for the purpose of designing or improving its internal risk systems) as well as rating such issuer, that CRA is “highly unlikely to downgrade [that issuer’s] risk capabilities if [that issuer] has bought one of [the CRA’s] risk systems.”⁸⁴

V. *Responses to the Public Failure*

A. *Self-Regulation by NRSROs*

In response to the public pillory and the demands for greater accountability and transparency, each NRSRO has recently released what may be seen as “self-assessments” or critiques of their practices. These reports, likely published as part of an effort to avoid being subject to an onerous regulatory framework, explicitly outlines their points of systemic failure.⁸⁵ Framed as prescriptions for these

⁸² See U.S. SEC. EXCH. COMM., *supra* note 18, at 42.

⁸³ *Id.* at n.117.

⁸⁴ Chris Marrison & Howard Radley, *A Risky New Role for the Rating Agencies*, FIN. TIMES, Dec. 5, 2003, at 19.

⁸⁵ FITCH RATINGS, FITCH RATINGS CODE OF CONDUCT 1-17 (2009), http://www.fitchratings.com/web_content/credit_policy/code_of_conduct.pdf; MOODY’S INVESTORS SERVICE, REPORT ON THE CODE OF PROFESSIONAL CONDUCT 4-17 (2009), <http://www.moody.com> (follow “Code of Professional Conduct” hyperlink; then follow “Report on the Code of Professional Conduct—2008” hyperlink); MOODY’S INVESTOR SERVICE, INSIDE MOODY’S: CREDIT POLICY, *supra* note 73; STANDARD & POOR’S, STANDARD & POOR’S REVISES ITS APPROACH TO RATING SPECULATIVE GRADE CREDIT 3 (2008), http://www2.standardandpoors.com/spf/pdf/media/leadership_actions_ratings_051308.pdf; STANDARD & POOR’S, WHAT STANDARD & POOR’S IS DOING TO INCREASE TRANSPARENCY AND INFORMATION TO ENHANCE U.S. RMBS RATINGS 2-6 (2008) http://www2.standardandpoors.com/spf/pdf/media/subprime_rmbs_050508.pdf; see also Press Release, Moody’s Investors Service, Moody’s Investors Service Updates its Code of Professional Conduct (Nov. 20, 2008) available at <http://www.iminers.com/render.php?eid=116842583&symbol=MCO&whichmodule=pressroom>; Press Release, Moody’s Investors Service, Moody’s Analytics Adds Comprehensive Credit Risk Measures to its Credit Quotes Pricing and Valuations Service (Oct. 16, 2008) available at

recent failures, the reports set forth a litany of voluntary policy changes to the processes used to rate ABSs, MBSs, and derivative products.⁸⁶ They each address an array of issues, including a lack of transparency concerning data and operations, inaccurate quantitative modeling, and the potential for conflicting loyalties.⁸⁷

To illustrate,⁸⁸ each NRSRO has adopted internal policies that require analysts to conduct a qualitative review of all loan originators, including an assessment of each originator's

<http://www.iminers.com/render.php?eid=115055943&symbol=MCO&whicmodule=pressroom>.

⁸⁶ See PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 1 (2008), available at http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf (“[I]t seems clear from experience to date that the principal underlying causes of the turmoil in financial markets were: . . . a significant erosion of market discipline by those involved in the securitization process, including . . . credit rating agencies . . . [and] flaws in credit rating agencies’ assessments”); see also Standard & Poor’s, S&P’s Views of Current Developments in the Financial Markets, <http://www.spviews.com/> (last visited on Apr. 5, 2009) (“Recently there has been much public discussion around credit rating agencies and problems in the subprime mortgage market. As the foremost provider of credit ratings, Standard & Poor’s [] believes it is important that any dialogue about credit ratings be based on accurate information about how credit ratings agencies work and how ratings are used. This special section of our website has been designed to give readers a better understanding of the role S&P’s ratings play in capital markets; the thoroughness, transparency and integrity of our approach; and the rigor of our decision-making processes.”).

⁸⁷ PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 86, at 1-2, 8-10 (identifying the principal underlying causes of the recent turmoil in the financial markets, including many CRA failings).

⁸⁸ Whereas analysts rating corporate bonds rely largely on publicly available information (such as audited financial statements and public disclosure filings), prior to the effective date of Moody’s criteria to be applied to rating MBSs, information about the receivable and underlying collateral came directly from the issuer or underwriter. Statement of Professor Coffee, *supra* note 56, at 9 (stating that CRAs “accept the representations and data provided by issuers, loan originators, and underwriters at face value and without undertaking any real effort to verify.”). There was little or no independent due diligence prior to a CRA issuing a rating. *Id.* (“To be sure, ratings agencies do request and receive information, but they do not audit, verify or even sample it. Put simply, this is the equivalent of an auditor accepting an issuer’s statements about its revenues, costs, inventories and contingent liabilities at face value.”).

underwriting policies and procedures, property valuation procedures, closing and funding procedures, an evaluation of third party originators (meaning mortgage brokers), credit risk management processes, originator financial stability, quality control and audit procedures, legal and regulatory compliance, and a review of originators' technology.⁸⁹ In addition, in some cases, a third party must be engaged to conduct diligence on MBSs & ABSs to complement the role of rating agencies.⁹⁰

Moreover, given the extent to which CRAs relied upon quantitative models to analyze the risk associated with increasingly complex structured securities, each NSRO has enacted new internal policies to try to address the shortfalls and limitations inherent in their quantitative modeling. For example, a "responsible party" has been deputized to review the methodologies and models used in the rating process.⁹¹ As Moody's Credit Policy publication describes it:

⁸⁹ See, e.g., KATHRYN KELBAUGH, MOODY'S, STRUCTURED FINANCE, MOODY'S ENHANCED APPROACH TO ORIGINATOR ASSESSMENTS FOR U.S. RESIDENTIAL MORTGAGE BACKED SECURITIES 1-2 (2008) ("[O]riginator ability factors include (a) sales and marketing practices (b) consistency in underwriting loans within prescribed underwriting guidelines (c) property valuation management practices, policies and procedures . . . closing and post closing policies and practices including lien perfection procedures (d) management of brokers and correspondents (e) credit risk management. . . . Key attributes of originator stability include financial strength, management strength, staff quality, quality control, internal audit, technology and other support functions that lead to operational stability.").

⁹⁰ See, e.g., *id.* at 2 ("Finally, Moody's will seek to review the results of the third-party pre-securitization loan-level review for each transaction . . . whether the transaction was rated by Moody's or not."). In addition, the issue of a lack of diligence as to the financial integrity of credit enhancement providers has been a key concern. As the highly publicized insolvency of a number of mainline providers of credit enhancement has demonstrated, CRAs' reliance on such insurers was misplaced. Apparently, the capitalization of these backstop insurers of ABSs, MBS, and CDOs was not fully considered by rating analysts in arriving at their risk ratings.

⁹¹ See, e.g., Progress Update, Standard & Poor's, S&P's Steps to Further Manage Potential Conflicts of Interest, Strengthen the Ratings Process, and Better Serve the Market (Apr. 10, 2008), available at http://www2.standardandpoors.com/spf/pdf/media/Leadership_Actions_Full_Update.pdf (describing the changes S&P has made in its governance, analytics, information and education and stating that "[S&P has] hired a Senior Director of Model Quality and [has] staffed and established the group."); S&P's Leadership Actions, <http://www.spnewactions.com/documentation/>

Methodologies and models are simplifications of reality that focus on key credit factors and interaction but necessarily omit many more. They encourage rating consistency and transparency, but their output is far from definitive; the output in fact is used as an input itself into the final rating decision. Proper use of a model or scorecard includes a sophisticated understanding of its limitations. The “indicated rating” from a model is a starting point for rating committee discussion but always supplemented with some combination of additional information, ratios and statistics, and qualitative judgment, which may justify assigning a rating higher or lower than the modeled output.⁹²

Apparently addressing the perceived dangers inherent in over-reliance on a numerical output, Moody’s has also vowed to “focus intensively on how risks interconnect, on the sometimes sharp increase in correlations and contagion across markets, and on sources of systemic instability.”⁹³

Finally, as part of the CRAs’ voluntary response to the expressed concern about conflicts of interest, they have explicitly outlined the organizational divisions between credit analysts and business development staffs.⁹⁴ They further claim that there will be

index.html (last visited Apr. 9, 2009) (stating that S&P will “[e]stablish a Model Oversight Committee within the Quantitative Analytics Group, which will be separate from and independent of the business unit, to assess and validate the quality of data and models used in our analytical processes.”).

⁹² MOODY’S INVESTOR SERVICE, *supra* note 62, at 5.

⁹³ *Id.* at 7-8.

⁹⁴ S&P has outlined specific initiatives, including hiring an ombudsman and demanding disclosure of collateral by originators in structured-finance securities; plans to reduce conflicts of interest through measures such as preventing analysts from covering issuers for more than five years. Progress Update, Standard & Poor’s, *supra* note 91. “Moody’s has separated its credit-ratings operations from its marketing and analytics and Fitch is reassessing the way it grades certain types of debt.” Karen Freifeld, *Moody’s, S&P Reach Settlement Agreement With Cuomo, People Say*, BLOOMBERG, June 3, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=azlGhfVz3JU&refer=home>; *see also* MOODY’S

no relationship between credit analysts' compensation and future business development.⁹⁵ Moreover, the rating agencies' ancillary services divisions will be firewalled from the divisions conducting the ratings analyses.⁹⁶

B. The SEC Amendments and Proposals

The adoption and publication of these self-enforcing policies by the NRSROs, however, did not result in a completely successful dodge of the regulatory bullet. On February 2, 2009, the Securities and Exchange Commission (the "SEC" or the "Commission") released new rules governing certain aspects of the conduct of NRSROs in their rating of structured securities and other related debt instruments.⁹⁷ According to the SEC's release, these new requirements are intended to "address concerns about the integrity of . . . credit rating procedures and methodologies,"⁹⁸ as well as "increase the transparency of the NRSROs' rating methodologies, strengthen the NRSROs' disclosure of ratings performance, prohibit the NRSROs from engaging in certain practices that create conflicts of interest, and enhance the NRSROs' recordkeeping and reporting obligations to assist the Commission in performing its regulatory and oversight functions."⁹⁹

The SEC rule amendments, the product of much negotiation and compromise, require that NRSROs provide improved disclosure of information upon which ratings are based, as well as disclosure of "performance measurements statistics and the procedures and methodologies."¹⁰⁰ For example, CRAs are prohibited from issuing a

INVESTORS SERVICE, MOODY'S CREDIT POLICY: STRENGTHENING ANALYTICAL QUALITY AND TRANSPARENCY 6-7 (Aug. 2008).

⁹⁵ See, e.g., MOODY'S INVESTORS SERVICE, *supra* note 94, at 7 ("Analysts are not compensated on the basis of the financial performance of their business unit or on the fees derived from the ratings that they oversee.").

⁹⁶ See, e.g., *id.* ("Moody's has separated all non-rating services from the credit rating agency.").

⁹⁷ Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 59,342, 74 Fed. Reg. 6,456 (Apr. 10, 2009).

⁹⁸ *Id.*

⁹⁹ *Id.* at 6,456-57. See 17 C.F.R. § 240.17g-2 (2009).

¹⁰⁰ Specifically, the instructions require an NRSRO to provide descriptions of the following areas (as applicable): policies for determining whether to initiate a credit rating; sources of information used in determining credit

rating on a structured product unless information about the underlying assets is made available.¹⁰¹ Moreover, all of an agency's ratings and subsequent rating actions must be made publicly available, although the CRAs fought for and received a six-month lag time for the release of such information.¹⁰² Performance statistics must also be published for one, three, and ten years within each rating category, as must information about how frequently credit ratings are reviewed.¹⁰³ In addition, the amendments addressed the issue of conflicts of interest by prohibiting CRAs from structuring the same financial products that they rate, and by separating the fee negotiation from the rating process.

The SEC, however, tabled a number of proposed measures in an effort to collect further public comment. These measures include a requirement that NRSROs to publicly disclose the specific information they used to arrive at or to monitor the rating of structured securities. The proposal requires (i) the NRSRO to disclose to other NRSROs that it was rating the security; (ii) the issuer, sponsor or underwriter to represent that it was giving the same information to the other NRSROs in order for them to determine a rating, and (iii) NRSROs to certify annually how it is using the information they seek and receive with respect to structured finance products from other NRSROs. These proposed rules would apply when an issuer, sponsor, or underwriter hires an NRSRO to rate a structured finance product. Other proposals still out for further public comment include changes in the rating symbols for structured

ratings; the models and metrics used to determine credit ratings; policies for using credit ratings of other agencies in determining credit ratings for securities or money market instruments; procedures for interacting with the management of a rated obligor or issuer; the structure and voting process of credit ratings committee; procedures for informing rated obligors or issuers about credit rating decisions and for appeals of final or pending rating decisions; procedures for reviewing credit ratings; and procedures to suspend the maintenance of a credit rating. 74 Fed. Reg. 6,456 n.34.

¹⁰¹ *Id.* at n.184.

¹⁰² The time lag was, according to the SEC, a response to concerns about loss of revenues that NRSROs earn from selling their data packages. The SEC is still considering how to improve public disclosure on subscriber paid credit ratings. *Id.* at 6,462.

¹⁰⁶ NRSROs must publish a random sample of 10 percent of the ratings histories paid credit ratings "in each class of credit ratings for which it is registered and has issued 500 or more issuer-paid credit ratings." New ratings should be reflected in the sample within six months. *Id.* at 6,469.

finance products and amendments designed to reduce SEC rule reliance on NRSRO ratings.

C. The New York Attorney General's Settlement

The “voluntary” reforms¹⁰⁴ followed on the heels of an extensive investigation of credit rating agency practices with respect to residential mortgage-backed securities conducted by the New York Office of the Attorney General, under the supervision of the Investor Protection Bureau chief. This investigation concluded with a settlement agreement dated as of June 2008 pursuant to which each NRSRO agreed to implement a number of reforms to their rating of residential mortgage-backed securities.¹⁰⁵ In accord with the terms of the settlement, NRSROs are required to (i) establish a fee-for-service structure, whereby rating agencies will be compensated for determining a rating, regardless of whether they are ultimately hired to deliver the rating; (ii) disclose information about all mortgage-backed securitizations submitted by investment banks for initial review, so investors are able to determine whether issuers sought any rating they ultimately decided not to use; (iii) establish criteria for the review of mortgage loan originators and their lending processes, and publicly disclose such information; (iv) establish criteria for the collection of information about the mortgages backing the rated MBSs, and publicly disclose such information; (v) conduct an annual self-critique of their residential mortgage-backed securities rating practices, to identify and remediate practices that could compromise their independent opinions; and (vi) require that investment banks and other financially responsible parties provide representations and warranties with respect to the loans underlying rated residential mortgage-backed securities.¹⁰⁶

VI. The Opportunity in the Rating Agency Crisis

It is popularly understood that the Chinese word “危機” translated as “crisis,” is composed of two characters: one for

¹⁰⁴ See Part V.A, *supra*.

¹⁰⁵ Press Release, Office of the Attorney General of the State of New York, Attorney General Cuomo Announces Landmark Reform Agreements with the Nation's Three Principal Credit Rating Agencies (June 5, 2008).

¹⁰⁶ *Id.*

“danger” and one for “opportunity.”¹⁰⁷ Crisis provides the chance for change and growth—which is the opportunity. Periods of crisis may, however, lead some to experience the risk of regression, stagnation, or even obsolescence—the danger. The translation of these two component characters offers a concise description of the two pathways currently open to credit rating agencies.

The voluntary measures adopted by the rating agencies, the SEC’s recently-adopted amendments, the proposed rules, and the terms of the Attorney General’s settlement address many of the points of central concern that have surfaced in the recent market turmoil. However, they do so in a piecemeal, fragmented fashion: they were developed reactively, not proactively, and it shows. A comprehensive reform of the regulatory landscape is called for.

Any reform initiative must be measured by how robustly three central objectives are met: (i) increasing the reliability and accuracy of ratings of MBSs, ABSs, and derivative securities; (ii) increasing competition within the market in which rating agencies operate and decreasing incentives for behavior that implicates conflicting interests and loyalties; and (iii) enhancing market

¹⁰⁷ The earliest citations found by linguist and lexicographer Benjamin Zimmer, Research Associate, Institute for Research in Cognitive Science, University of Pennsylvania, were published in the Chinese Recorder, an English-language newspaper for missionaries in China. In January, 1938, an unsigned editorial entitled “The Challenge of Unusual Times” read:

The Chinese term for crisis is “danger-opportunity” (危機). Without the danger there cannot arise the opportunity. It is very fitting then that in this time of “danger-opportunity” there should go forth a call to a Forward Movement in the Christian Church in China.

Benjamin Zimmer, *Crisis = Danger + Opportunity: The Plot Thickens*, LANGUAGE LOG, Mar. 27, 2007, <http://itre.cis.upenn.edu/~myl/languageblog/archives/004343.html> (citing *The Challenge of Unusual Times*, LXIX CHINESE RECORDER 2 (1938)). Professor Zimmer observes that this translation is not without its detractors. See Victor H. Mair, *Danger + Opportunity ≠ Crisis: How a Misunderstanding About Chinese Characters Has Led Many Astray*, Pīnyīn.info, <http://www.pinyin.info/chinese/crisis.html> (last visited Jan. 18, 2009) (“There is a widespread misperception, particularly among the New Age sector, that the Chinese word for ‘crisis’ is composed of elements that signify ‘danger’ and ‘opportunity.’”).

transparency,¹⁰⁸ thereby offering means for investors to conduct independent diligence of MBSs', ABSs', and CDOs' credit quality in order to decrease exclusive reliance on rating agency opinions.

One way of ensuring these objectives are met going forward is to require CRAs to have far greater accountability. An independent and expert oversight board must be created, with the authority and funding to comprehensively oversee the rating process. Moreover, specific penalties must be built into the internal or external regulatory structure for getting a rating wrong. Penalties, such as the loss of NRSRO status if default rate of rated securities exceeded certain specified levels, or the forfeiture of a fee if a default rate exceeds certain benchmarks,¹⁰⁹ would alter the culture and behavior in the current system. Lifting the exemption from civil liability for negligent, reckless, or fraudulent behavior would go even further and put rating agencies on an equal footing with other players in the financial markets.

The financial crisis may be partly attributed to a failure of imagination—no one in the financial markets or in government ever thought that market conditions could get this bad. Rating agencies also suffered from a failure of imagination. Going forward, analysts must now ask the “what if?” question in order to factor in to risk assessments what is essentially the unknown.

Of course, in order to dig completely out of the current MBS, ABS, and CDO-rooted crisis, policy and regulatory reforms must not be limited to rating agencies; fundamental measures must be put in place to alter the incentives driving all the participants in the financial markets. Securitizing originators must be required to retain a significant portion of the securities they originate. In this way, credit-underwriting risk is shared, and not simply transferred. Disclosure and oversight of derivative transactions, including credit default swaps, must be regulated, if at all, under federal securities

¹⁰⁸ See, e.g., Press Release, Standard & Poor's, Remarks for Deven Sharma, FDIC Conference 16-17 (Jul. 9, 2008), available at http://www2.standardandpoors.com/spf/pdf/media/Sharma_FDIC_Final.pdf (“While the wide range of structured finance products—think CDOs of ABS, ABCP conduits, or HELOCs—have found eager buyers, it also appears that not all of these buyers fully understood what they were buying. Due diligence is, of course, ultimately the responsibility of the investor. But I also believe that the issuers have a responsibility to be transparent regarding the risks associated with the assets they are securitizing.”).

¹⁰⁹ Statement of Professor Coffee, *supra* note 56, at 14.

laws and not simply by state insurance statutes. Moreover, pricing models for mortgage- and asset-backed securities must more accurately reflect the market reality that cash flows and the value of collateral, including real estate, cyclically fall—as well as rise.

CRA's must resist re-entering the race to the bottom in search of extraordinary short-term profits. Moreover, they must make an effort to alter market norms so that there is a return to the idea that a rating is a valuable complement to, and not a proxy for, an investor's own due diligence.¹¹⁰ In the past, rating agencies disclaimed that to be the case, while at the same time they contributed to the culture of absolute reliance on their opinions.

Given the adverse position in which rating agencies find themselves—what may fairly be categorized as an abyss—this moment is ripe for consideration of how they can avoid getting ensnared in blinding market bubbles in the future. Every assumption, process, and methodology employed must be questioned and examined. We have to look at the issue of regulation (both self-imposed and external) differently. We must spend more time imagining future scenarios and less time relying on information from the past. The question becomes, “How do we make certain that this moment is tantamount to ‘the storm of the century,’ rather than simply a dip in the future cycle of extreme booms and busts?”

VII. Conclusion

Credit rating agencies' faulty and inadequate pricing and risk assessments have had catastrophic and wide-ranging systemic effects. One of the consequences of the 2008-2009 financial crisis has been the decimation of rating agencies' reputational capita—the most valuable assets they have. Their credibility in the market must be re-established and their integrity restored in order to regain investors' and the public's confidence in their opinions. Their behavior and role in the markets must be dramatically re-imagined. We now have the opportunity to address CRA's role in the financial crisis and attend to their deficiencies in process, methodology and policy. CRA's will either support a more robust regulatory infrastructure and dramatic modification of their practice and emerge from the ashes, or they will become irrelevant. The question that

¹¹⁰ See generally *id.* at 15 (“[R]atings speak to credit risk, and credit risk only. They don't talk to suitability, price, duration or any of the myriad of other factors investors need to look at before buying a security.”).

remains, however, is whether the 2008-2009 financial crisis will serve as an opportunity for genuine and meaningful reform for the credit rating agencies,¹¹¹ or, will it result in the regression, stagnation, and the ultimate obsolescence of CRAs?

¹¹¹ It has been said that it is difficult to predict an event not yet experienced. The 2008-2009 financial crisis is (we hope) a once in a lifetime event.

