April 6, 2007

Nancy M. Morris, Secretary
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Dear Ms. Morris:

I am writing to comment about SEC proposed rules on the regulation of credit rating agencies (NSROs). While I am a member of Standard and Poor's Academic Council, the views expressed below are my own.

The Credit Rating Reform Act of 2007 was passed, according to the SEC, for two reasons: (1) to increase the transparency of how NSROs achieve such status from the SEC (and potentially reduce barriers to entry in the business); and (2) NSROs' presence in the markets is so great that they deserve to be regulated. I believe the importance of the first reason is greatly overstated, as it relies much too heavily on the notion that NSROs are monopolies. I completely disagree with the logic of the second reason.

The NSROs are businesses that exist to make a profit on the product they sell, much as Businessweek only provides rankings of MBA programs for the purpose of increasing its profits and Siskel and Ebert provided opinions on movies for the purpose of increasing their incomes. One could as easily argue that Businessweek has such a strong impact on MBA programs that it should be regulated or that Siskel and Ebert should have provided evidence that their backgrounds were suitable as movie reviewers before they ever went on the air. NSROs differ from other businesses that sell their opinions because there are many federal and state regulations that rely on ratings to differentiate between various classes of credit risky instruments and this is at the heart of the concern about reason (1). If government agencies had the ability to evaluate this risk as readily and effectively as the NSROs, there would be no need to confer the NSRO status on any business. The government recognizes that NSROs are good at credit risk evaluation and adopts their opinions because these companies that have built reputations as providers of information.

Yet the Act and the proposed rule implicitly portray the NSROs as businesses whose profits mainly exist because regulations so frequently rely on their products and who may endanger the system when they provide inaccurate ratings. This view pervades the SEC rule, as it so frequently raises the issue of whether NSROs abuse their position and are coercive, as if these firms would not exist if they were no longer able to force issuers to buy their product with the help of the government. If this is a monopolistic industry with inefficient output, then focusing on barriers to entry is reasonable. But if it is not, the SEC rule may instead reduce the industry's usefulness. The proposed rule is likely to lower the information content of ratings as regulations make it harder for NSROs to provide independent opinions. A major concern should be whether these new regulations will destroy an important tool that the government uses to differentiate credit risk in its regulation. If ratings become uninformative, the regulation of financial institutions that rely so heavily on these ratings loses its effectiveness. We know from past experience that financial institutions that have lax or ineffectual regulation are not only more likely to fail but can lead to systemic financial crises.

Are the barriers to entry so high? It is true that the number of NSROs is small and they are fairly profitable. And it is true that nearly all bonds issued in the US have a rating from at least one NSRO. However, the business of evaluating credit risk is not conducted solely by the rating agencies. Consider KMV, which was a serious contender for the profits of the major rating agencies, despite the supposed difficulty of obtaining NSRO status. KMV was started by Kealhofer, Vasicek, and McQuown, none of whom separately or as a group could be described as having superior resources for overcoming steep barriers to entry. Yet within a relatively short period of time, KMV's EDF product was considered the most successful and reliable predictor of the probability of default, superior to any bond rating. Another new competitor is CreditSights, whose analysts report on the credit risk of corporate bonds much in the same way Moody's and S&P do. New entrants are able to compete for investors' cash by providing opinions on credit risk, suggesting NSROs' power is not that great.

The SEC's rules presume that the rating agencies are more likely to abuse their so-called monopoly power than issuers are to abuse their option to shop for ratings. "Ratings shopping" is the practice of seeking out ratings from several NSROs and only paying for the more favorable one, or only asking for a rating from one NSRO because that one will likely give a favorable rating. A bond with only one rating is far more likely to be the result of ratings shopping than abuse of power by the NSROs. Shopping for ratings is akin to retaking the SAT several times and only reporting the highest score to the colleges. A college would like to know all the scores its applicants receive on the tests, just as a bond investor would like to know what all firms think of the bond he is about to buy. The high school student would rather only have the highest score revealed. The SEC's proposal on notching is equivalent to undoing ratings shopping not by requiring all the scores to be reported but by requiring that the other test scores be rerecorded as if they also equaled the highest score. This will surely lower the value of ratings to regulators of financial institutions that invest in credit risky instruments.

The second argument for regulating rating agencies, that their large role in the markets warrants oversight, is in stark contrast to the rest of the SEC's rules. The NSROs are largely in the business of providing information about credit risk to institutional investors, who are the major investors in corporate bonds and structured finance products. Most other SEC rules are written from the point of view that institutional investors are sophisticated, well-informed investors who do not require substantial help from the SEC. This view is why the SEC created the definition of a "qualified institutional buyer" (QIB) as well as the rationale for defining the "accredited investor." The QIB is the basis for Rule 144a, under which nearly all speculative-grade bonds are currently issued. It is also the reason why the SEC declines to regulate hedge funds: They are only bought by accredited investors who do not need the help of the SEC in evaluating their risk or expected return. Surely the large role of hedge funds dominates that of the NSROs in financial markets, yet that is not sufficient reason for regulating them. If the goal of the Act is to prevent another meltdown like that of Enron or Worldcom, as the proposed rules imply, the SEC's very scarce resources would be much better spent on ensuring that current reporting rules are enforced rather than ensuring that QIBs are not abused by NSROs.

Sincerely,

Jean Helwege
Associate Professor of Finance
Penn State University