XI. The Use of Credit Ratings for Mortgage-Backed Securities

A. Introduction

Credit Rating Agencies have been an integral part of the financial system for over a century, and credit ratings themselves played in integral role in the 2008 financial crisis. In the U.S., nationally recognized statistical rating organizations ("NRSROs") rate securities for security underwriters and dealers. Before a security is sold to an investor, a rating agency, usually Moody's Investors Service, Inc. or Standard & Poor's Corp. (S&P)[1], gives the instrument a rating. NRSROs use sophisticated models to determine the likelihood that the debt will be repaid, and base the rating on these models. Investment grade securities range from BBB to AAA, with BBB having less than 1% chance of default and AAA having less than .05% chance of default.[2] Ratings below BBB are below investment grade and are considered junk.[3] NRSROs' ratings are important because many players in the financial market depend on the ratings. Most financial institutions may only hold securities of the highest rating, banks must meet risk-based capital requirements that depend on the ratings of their investments and many investors lack the capacity to independently investigate the quality of the instrument.[4]

Beginning in the late 1970s, underwriters began bundling individual mortgages to be sold as mortgage backed securities ("MBSs")[5], which consist of either commercial mortgages

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[1] *See Wall Street and the Financial Crisis: The Role of Credit Rating Agencies: Hearing Before the Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 111th Cong. 1 (2010) (statement of Sen. Carl Levin, Chairman, Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs) [hereinafter *Wall Street and the Financial Crisis*].

[2] *Id.* at 2.

[3] *Id.*

[4] Zeke Faux & Jody Shenn, *Subprime Mortgage Bonds Get AAA Rating S&P Denied to U.S.*, BLOOMBERG (Aug. 31, 2011, 2:25 PM), http://www.bloomberg.com/news/2011-08-31/subprime-mortgage-bonds-getting-aaa-rating-s-p-denies-to-u-s-treasuries.html; *Wall Street and the Financial Crisis, supra* note 1, at 2.

[5] Efraim Benmelech & Jennifer Dlugosz, *The Credit Rating Crisis* 166 (Nat'l Bureau of Econ. Research, Working Paper No. 15045, 2010),

("CMBSs") or residential mortgages ("RMBSs").[6] Recently, dealers began bundling RMBSs together to form collateralized debt obligations ("CDOs").[7] To determine the likelihood that a security will default, an NRSRO looks into aspects of its underlying assets, such as the value of the property, the equity in the property and the income and credit score of the borrower.[8] In the years leading up to the crisis, RMBSs were increasingly backed with subprime[9] and option-ARM[10] mortgages, both of which have high default rates.

B. NRSROs Role in the 2008 Financial Crisis

The most damaging mistakes NRSROs made leading up to the financial crisis were on RMBSs and RMBS-backed CDOs, as 95% of the eventual downgrades from 2007 to 2008 were related to these two instruments.[11] From 2006 to 2007, Moody's and S&P rated over 10,000 RMBSs and CDOs, and regularly gave these instruments AAA ratings.[12] Investors, who lacked access to information about the underlying mortgages, relied on these ratings heavily when purchasing these risky securities.[13] Ironically, these investors preferred instruments backed by risky mortgages as these instruments also received AAA ratings and paid higher returns, a function of being backed by risky mortgages.[14] In early 2007 RMBSs and CDOs

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http://www.economics.harvard.edu/faculty/benmelech/files/MacroAnnual .pdf.

[6] *Id.*

[7] *Id.*

[8] JAMES HAMILTON, SEC CREDIT RATING REFORMS DIFFERENTIATE ASSET BACKED SECURITIES PRODUCTS 3 (CCH 2009), http://business.cch.com/securitieslaw/news/nrsro.pdf.

[9] Subprime mortgages are mortgages given to a borrower with poor credit history. *See* STAFF OF SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS COMMITTEE ON HOMELAND SECURITY AND GOVERNMENT AFFAIRS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 19 (Comm. Print 2011), *available at* http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.

[10] Option-ARMs (adjustable rate mortgages) give the borrower the option to adjust the repayment rate. *See id.* at 22.

[11] Benmelech, *supra* note 5, at 177.

[12] *Wall Street and the Financial Crisis, supra* note 1, at 2.

[13] *Id.* at 3.

[14] *Id.* at 3.

began incurring huge losses, leading to the eventual mass-downgrade of these securities to junk status.[15]

Subprime RMBSs and CDOs incurred huge losses in early 2007 for a few reasons. First, home values stopped rising, thus hurting the many borrowers that depended on refinancing their mortgages before their interest rates increased substantially.[16] Secondly, an increase of predatory lenders and fraudulent borrowers in the market increased the likelihood that mortgages were fraudulent and thus were more likely to default than NRSROs assumed.[17] Thirdly, CDOs at this time contained an unusually high concentration of RMBSs,[18] making these securities very susceptible to losses once the housing market began to fall.[19]

NRSROs downgraded the AAA instruments swiftly when they began incurring huge losses.[20] In July 2007, NRSROs mass-downgraded thousands of these securities and, overnight, the market for RMBSs evaporated and the financial crisis began.[21]

C. Reasons the NRSROs' Ratings Were Wrong

NRSROs failed to correctly identify the default risk of RMBSs and CDOs because the models they used to rate these instruments were faulty. NRSROs were used to rating MBSs backed by "normal mortgages" that defaulted 1-2% of the time.[22] NRSROs understood that the subprime RMBSs would be more likely to default, but did not know how much more likely. NRSROs woefully underestimated the default risk of these riskier mortgages, making the models they used to rate the securities incorrect.[23]

In addition to faulty models, NRSROs failed to verify faulty information about the value of the underlying assets that the

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[15] *Id.* at 4 (stating 91% of 2007, and 93% of 2006, AAA subprime RMBS were downgraded to junk).
[16] *Id.* at 3.
[17] *Id.* at 3.
[18] Benmelech, *supra* note 5, at 189 (explaining that CDOs contained both CMBSs and RMBSs, which created diversification and thus reduced the risk that all of the assets would perform poorly at once).
[19] *See id.*
[20] *Wall Street and the Financial Crisis, supra* note 1, at 4.
[21] *Id.*
[22] *Id.* at 4.
[23] *Id.* at 5.

mortgage originator provided.[24] Without accurate information about the underlying assets, a model cannot accurately rate a security.[25]

Once the securities began incurring unexpected losses, at least S&P updated their rating model to reflect the new conditions; however, S&P wanted to avoid downgrades and refused to apply the new model to existing securities.[26] Although this does not explain why the initial ratings were incorrect, it does explain why downgrades occurred all at once rather than gradually.

Finally, NRSROs failed because the rating organizations had more incentive to increase profits than to accurately assess risk. NRSROs competed for business and made huge profits by granting CDOs and RMBSs favorable ratings.[27] Potential revenues created a conflict of interest in the credit rating market as NRSROs are paid to rate securities by the institutions issuing the securities. The SEC found that NRSROs shifted focus from accuracy to profits and knowingly used faulty models and information to rate MBSs.[28]

D. Regulations of Credit Rating Agencies

1. The Credit Ratings Agency Reform Act of 2006

Prior to 2006 the SEC lacked power to regulate NRSROs, but in a response to the Enron collapse, Congress passed the Credit Ratings Agency Reform Act ("CRARA").[29] In accordance with the CRARA, the SEC instituted many reforms.[30] The reforms suggested by the SEC were made effective in April 2009 and therefore did not have an effect on the behavior of NRSROs prior to the 2008 financial crisis.[31]

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[24] *See id.* at 6.
[25] HAMILTON, *supra* note 8, at 3.
[26] *Wall Street and the Financial Crisis, supra* note 1, at 5.
[27] *Id.* at 2 ("[F]rom 2002 to 2007, the 3 top credit rating agencies doubled their revenues, from less than $3 billion to over $6 billion per year.").
[28] *Id.* at 5 ("The drive for market share, and the revenues from increased volumes of ratings, created pressure on both agencies to provide favorable credit ratings to the investment bankers bringing in business.").
[29] F. Phillip Hosp, *Problems and Reforms in Mortgage-Backed Securities: Handicapping the Credit Rating Agencies*, 79 MISS. L.J. 531, 559 (2010).
[30] *Id.* at 549.
[31] HAMILTON, *supra* note 8, at 1.

The SEC now requires more transparency, which makes NRSROs more accountable in the marketplace for the accuracy of their ratings.[32] NRSROs must submit reports on their own performance, and inform the SEC of the number of rating actions ("upgrades, downgrades, placements on credit watch, and withdrawals") throughout the year.[33] These new disclosure requirements are meant to provide clients of the agencies enough information to assess the NRSROs performance, which should incentivize NRSROs to care more about accuracy.[34]

In addition to the new disclosure requirements for rating accuracy, NRSROs must disclose information about the rating process and the securities themselves. First, NRSROs must provide detail on the assets backing the securities they rate.[35] This requires NRSROs to show they have: "(1) verified the loan documents of the mortgages backing the securities; (2) verified the quality of the loan originators; and (3) monitored existing ratings and applied model improvements to existing ratings."[36] Secondly, NRSROs are now required to disclose their primary assumptions, including methodologies and inputs.[37] These requirements compel NRSROs to disclose their "assumptions about the correlation of defaults across the underlying assets," and their assessment of the reliability of the information they depend on.[38] Finally, NRSROs must explain any discrepancy between the rating a model produces and the rating actually given to a security instrument.[39] Ultimately, these disclosure

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[32] *See id.*

[33] Hosp, *supra* note 29, at 560.

[34] HAMILTON, *supra* note 8, at 3.

[35] Hosp, *supra* note 29, at 561 (listing the various details about the verification of underlying assets agencies must now provide); *Securities and Exchange Commission Fact Sheet: Final Rules and Proposed Rules Relating to Nationally Recognized Statistical Rating Organizations And Credit Ratings*, 1724 PLI/CORP 495, 497-98 (Dec. 2008).

[36] Hosp, *supra* note 29, at 561.

[37] *Credit Ratings: SEC Proposes New Rules for NRSROs; Seeks Public Comment to Assist in Study on Assigned Credit Ratings*, 2011 WGL SEC ACCT. RPT. 04, 2 (2011) [hereinafter *SEC Proposes New Rules: Seeks Public Comment*] (stating that the proposed rule 17g-7 would require disclosure of assumptions and methodologies used for ratings schemes).

[38] *Id.*

[39] Hosp, *supra* note 29, at 562 (detailing Exchange Act Rule 17g-2 requirement for agencies to document discrepancies between credit rating implied by models and final credit rating issued).

requirements should give individual investors enough information to independently assess any securities they may want to buy and reduce the dependence on ratings in the market overall.

In addition to the new disclosure requirements, the CRARA also imposes regulations that hold NRSRO employees accountable for quality of work and potential conflicts of interest in their work. CRARA prohibits NRSROs from issuing a rating when an NRSRO employee participated in a fee negotiation or received gifts from the issuer of the security being rated,[40] and sets forth new standards for NRSRO analysts, which include the level of training, experience and competence required for employees.[41]

If the SEC enforces the aforementioned regulations, many of the reasons for inaccurate ratings could be remedied. Now that the agencies must disclose reports indicating the accuracy of their ratings, the market can more accurately assess the reliability of each individual NRSRO.[42] Investors should prefer agencies that consistently rate securities correctly and will begin to require that any security they purchase be rated by an agency that performs well. Although some institutions, like financial holding companies, have incentives to buy AAA rated investments regardless of the accuracy, more accurate ratings overall will allow risk-based capital requirements to more accurately reflect risk.[43] Ultimately, these requirements may correct the rating market so that success of the agency is contingent upon the accuracy of their ratings. However, because investors still rely on NRSRO ratings—as they lack the capacity for independent investigation and under the CRARA NRSROs are still not accountable legally for false ratings—investors may continue to depend on false ratings without further regulation.

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[40] HAMILTON, *supra* note 8, at 6.

[41] *Credit Ratings: SEC Proposes New Rules: Seeks Public Comment*, *supra* note 37, at 2 ("Proposed standards of training, experience, and competence for credit analysts are set forth in proposed Rule 17g-9.").

[42] *Id.*

[43] *See* OFFICE OF THRIFT SUPERVISION, APPENDIX B: RISK-WEIGHTED ASSETS §120 RISK-BASED CAPITAL: RISK-WEIGHTED ASSETS (GENERAL RULES) (Sept. 2010) 120B.4, *available at* http://www.ots.treas.gov/_files/422020.pdf.

2. The Dodd-Frank Act

NRSROs played an integral role in the 2008 financial collapse, and Congress included regulations in the Dodd-Frank Act ("The Act") that: (1) hold NRSROs more accountable for their ratings; (2) reduce the conflict of interest in the market; (3) require additional disclosure over rating models; and (4) reduce the importance of credit ratings.[44] The Act requires the SEC to submit final regulations within one year of enactment (July 21, 2011) and also requires the SEC to establish the Office of Credit Ratings ("OCR") within the SEC.[45] The OCR will annually inspect NRSROs' management of conflict of interest, internal controls, governance and implementation of rating methodologies.[46]

The Act enhances NRSRO accountability for ratings by increasing their liability for inaccuracies. All credit rating agencies (including NRSROs) will now have to file additional information and will face liability for any "false or misleading statements of material fact."[47] Additionally, if the SEC finds that an NRSRO fails to accurately rate a class of securities, the SEC can revoke their NRSRO registration.[48] Finally, The Act removes NRSROs from the exemption as experts under the Securities Act.[49] NRSROs must now consent to use of their rating, thus guaranteeing the accuracy of the rating and therefore can be sued if the rating includes misstatements or the NRSRO fails to disclose material facts in connection with the rating.[50] Since the rule was instituted in 2009, NRSROs have refused to consent, and the SEC has suspended the requirement requiring the inclusion of ratings in registration statements.[51] If the SEC removes the suspension, it is not clear whether NRSROs will consent and be subject to expert liability or will continue the stalemate.

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[44] *Regulatory Developments 2010*, 66 BUS. LAW. 665, 679 (2011).
[45] *Id.* at 683.
[46] *Id.*
[47] *Id.* at 680.
[48] *Id.*
[49] DAVID MARTIN & MATT FRANKER, DODD-FRANK ISSUE BRIEF: REQUIREMENTS AFFECTING CREDIT RATING AGENCIES 2 (April 2011), *available at* http://cii.org/UserFiles/file/resource%20center/publications/Dodd-Frank%20-%20Requirements%20Affecting%20CRAs.pdf.
[50] *Regulatory Developments*, *supra* note 44, at 680.
[51] Martin, *supra* note 49, at 2.

The Act also reduces conflicts of interest in the credit rating market overall. A "look-back" provision requires the NRSRO to inspect an employee's ratings within the past year if that employee left the NRSRO to become an issuer of securities, and to report to the SEC if a senior NRSRO employee leaves to become an issuer.[52] In addition, the SEC will occasionally review these procedures to ensure that former NRSRO employees do not give their future employers' securities favorable ratings.[53] The Act also gives the SEC power to create additional rules that will diminish the conflicts of interest within the market.

In addition to making NRSROs more accountable and diminishing conflicts of interest, The Act also requires NRSROs to disclose their rating methodologies to the SEC.[54] NRSROs now must disclose additional quantitative data (assumptions used, information on data used, information on conflict of interest) and qualitative data (factors that could change rating, information on rating and sensitivity of rating to changes in assumptions).[55] NRSROs also must report on the measures it takes to assure all employees adhere to "policies, procedures and methodologies for determining credit ratings" approved by the board of the NRSRO.[56]

Finally, The Act moves to reduce the importance of credit ratings by requiring that references to ratings be removed from federal statutes.[57] Specifically, SEC-proposed amendments would remove the "investment grade" requirement to qualify for short-form registration statements for registered securities.[58] Ultimately, the SEC believes that if references to ratings are replaced in Federal Statutes, independent investors will do their own independent investigation of ratings as well.

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[52] *Regulatory Developments*, *supra* note 44, at 682.
[53] *Id.*
[54] Martin *supra* note 49, at 3.
[55] *Regulatory Developments*, *supra* note 44, at 685 (setting out the qualitative and quantitative content of disclosures).
[56] *Id.* at 682.
[57] Martin, *supra* note 49, at 3 ("Section 939A requires all federal agencies to review their regulations and substitute alternative standards of creditworthiness in lieu of credit ratings.").
[58] *Id.* at 3-4.

E. Current State of NRSROs and Effect of Regulations Instituted

Because the CRARA regulations were only recently enacted and much of the Dodd-Frank regulations have yet to be instituted, these regulations have not had a major impact on how NRSROs interact with the market to date. However, because NRSRO failures were exposed by the crisis and subsequent government hearings and reports, the media and the public in general scrutinize NRSROs more closely. Since the crisis, S&P has been criticized for giving AAA ratings to many of Springleaf Financial Corp.'s MBSs that are backed largely with subprime mortgages, and was chastised when it had to downgrade thousands of "re-remic" securities (repackaged home-loan bonds).[59] Investors remain wary of ratings, and interest rate differentials between various AAA and AA securities suggest that many still do not trust rating scores.[60] Even if all of the regulations were in effect however, many of the problems in the rating market may not be fixed. Although regulations require NRSROs to more closely monitor employees who have additional incentives to give inflated ratings, NRSROs are still paid by the institutions that require their ratings, and therefore the conflict of interest in the market remains.

F. Conclusion

As more reforms take effect and the SEC has the opportunity to hold NRSROs responsible for their ratings, changes in the market may appear. The SEC Enforcement Division is currently investigating many of the CDO and RMBS offerings from the financial crisis and is considering taking legal action against the NRSROs who rated them. Specifically, the SEC recently served a Wells notice to McGraw Hill, owner of S&P, in regards to its rating

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[59] Zeke Faux & Jody Shenn, *Subprime Mortgage Bonds Get AAA Rating S&P Denied to U.S.*, BLOOMBERG (Aug. 31, 2011, 2:25 PM), http://www.bloomberg.com/news/2011-08-31/subprime-mortgage-bonds-getting-aaa-rating-s-p-denies-to-u-s-treasuries.html ("S&P said in December it would need to review 1,196 re-remic securities because it had "incorrectly analyzed" the debt in light of the structure of the underlying deals.").

[60] *Id.* (pointing out that Springleaf AAA bonds had 4% interest rate and AA+ U.S. Securities only have 2% interest).

of a 2007 CDO, Delphinus.[61] The SEC alleges S&P misled the investors by rating this CDO offering based on "dummy" assets, which had AAA ratings, even after these assets were replaced with low-quality assets.[62] This would be the first time that a credit rating agency is sued by the U.S. government, and this suit could be a prelude of what is to come in the market.

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[61] Jeannette Neumann & Jean Eaglesham, *SEC Eyes Ratings From S&P*, WALL ST. J. (Sept. 27, 2011) http://online.wsj.com/article/SB10001424052970204831304576595250489378880.html.

[62] *Id.*

[63] Student, Boston University School of Law (J.D. 2013).