Testimony of Alex J. Pollock

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Of the Committee on Financial Services

September 14, 2004

Good morning, Mr. Chairman and Members of the Subcommittee. It is a pleasure to present my views on the unintended cartel-like effects of the SEC's regulation of rating agencies through its "NRSRO" designation, and what steps might be taken to reduce government-created barriers to competition and create a more competitive rating agency sector.

I am Alex Pollock, a Resident Fellow at the American Enterprise Institute in Washington, D.C. These are my personal views. The focus of my work is to examine ways to inject greater economic efficiency and market choice into situations in which the government, in one way or another, has created non-competitive structures. An example well known to this Subcommittee is the GSE duopoly in the secondary mortgage market, but the rating agency sector is equally pertinent.

Competitive markets, as it is unnecessary to say, lead to economic growth, efficiency, innovation and customer choice. But what do we find in the rating agency sector? As Professor Larry White of New York University has written:

> The problem concerns the SEC's regulation of the bond rating industry… incumbent bond rating firms are protected, potential entrants are excluded, and new ideas and technologies for assessing the riskiness of debt (and therefore the allocation of capital) may well be stifled. This entry regulation is a perfect example of good intentions gone awry…. ("The SEC's Other Problem," Regulation, Winter 2002-03)

The fundamental source of the problem is that the designation "Nationally Recognized Statistical Rating Organization" or "NRSRO" has become embedded in the rules of various regulators as an essential restriction in investment, financial market and capital regulations. The only way to get to be an NRSRO is to be designated as one by the SEC, and this involves, as many commentators have pointed out, a practically insuperable "Catch 22."

The SEC's own Concept Release on the subject states that in order to become a recognized NRSRO:

> The single most important criterion is that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings. ("Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws," 2003)

You cannot be widely accepted by the predominant users unless you are an NRSRO, but you cannot become an NRSRO unless you are already widely accepted! The same SEC Release says, "Some commenters believe that the NRSRO designation acts as a barrier to entry into the credit rating business." There seems to be no doubt that these commenters,

which include the Department of Justice, are correct.

If you think back to the position of the SEC at the time of its first NRSRO regulation in 1975, it is easy to see why as a first designation of acceptable sources for ratings, it would be attractive to ask which rating agencies had met the market test and were widely accepted or already "nationally recognized." At that point, the concept was an endorsement of the results of market evolution of the past. But going forward, when market evolution would always thereafter be constrained by the regulatory restriction, the logic no longer holds.

Simply consider that when John Moody published his first ratings in 1909, or when Poor's Publishing Company published its first ratings in 1916, or the Fitch Publishing Company its first ratings in 1924, they were not yet "widely accepted by the predominant users." They all had to fill a market need and compete their way into becoming "nationally recognized."

As a matter of corporate strategy, the rating agency business has significant barriers to entry in any case, including the need to establish reputation, reliability and integrity; the prestige factor involved in the purchase of opinions and judgements; and natural conservatism in risk management policies. To add to this a "distortionary entry restriction regime," to use Professor White's phrase, insures a non-competitive outcome.

<u>What Could Be Done?</u>

I suggest four possible actions to move in a pro-competitive direction:

1. It is clear that what "NRSRO" really means is "SEC Approved Rating Agency." The term "NRSRO," with its implication that it represents some sort of a market test (as it did 30 years ago but no longer does) should be dropped altogether. If the SEC continues to require its own approval of rating agencies for regulatory purposes, the designation should express "SEC Approved."

2. If the SEC continues to require its approval of rating agencies, the criterion of having to be "nationally recognized" in advance should be eliminated.

3. The approval of rating agencies for specialized purposes, as the SEC has sometimes done in the past, should be encouraged. Such specialization might be an industry, for example, financial institutions; a country, for example, Japan; or any other logical domain defined by competence and knowledge. This would allow new entrants to add competition where they are best able, to demonstrate their value to the market,and to grow organically if they succeed.

4. In the best case, not only the term "NRSRO," but also the requirement of designation by the SEC, would be dropped. Instead, the responsibility to choose among rating agency services should belong to investors, financial firms, securities issuers and other users—in short, the market. Every firm should have among its financial and risk management policies its approved policies for how it uses credit ratings and whose ratings can be used for what. These policies need to be appropriately disclosed (and could be examined by any relevant regulators). Under these circumstances, which rating agencies turn out to be "nationally recognized" would reflect a true competitive market test, and competition would provide its normal benefits of innovation, choice and efficiency.

Mr. Chairman, thank you for the opportunity to testify today.