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Highlights

Highlights of GAO-10-782, a report to congressional committees

September 2010

SECURITIES AND EXCHANGE COMMISSION

Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures

Why GAO Did This Study

In 2006, Congress passed the Credit Rating Agency Reform Act (Act), which intended to improve credit ratings by fostering accountability, transparency, and competition. The Act established Securities and Exchange Commission (SEC) oversight over Nationally Recognized Statistical Rating Organizations (NRSRO), which are credit rating agencies that are registered with SEC. The Act requires GAO to review the implementation of the Act. This report (1) discusses the Act's implementation; (2) evaluates NRSROs' performance-related disclosures; (3) evaluates removing NRSRO references from certain SEC rules; (4) evaluates the impact of the Act on competition; and (5) provides a framework for evaluating alternative models for compensating NRSROs. To address the mandate, GAO reviewed SEC rules, examination guidance, completed examinations, and staff memoranda; analyzed required NRSRO disclosures and market share data; and interviewed SEC and NRSRO officials and market participants.

What GAO Recommends

SEC should identify the additional time frames and authorities it needs to review NRSRO applications, develop a plan to help ensure the NRSRO examination program is sufficiently staffed, improve NRSROs' performance-related disclosure requirements, and develop a plan to approach the removal of NRSRO references from its rules. SEC generally agreed with these recommendations.

View GAO-10-782 or key components.
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What GAO Found

SEC's implementation of the Act involved developing an NRSRO registration program and an examination program. As currently implemented and staffed, both programs require further attention.

- The process for reviewing NRSRO applications limits SEC staff's ability to fully ensure that applicants meet the Act's requirements. While SEC had registered 10 of 11 credit rating agency applicants as of July 2010, some staff memoranda to the Commission summarizing their review of applications described concerns that were not addressed prior to registration. According to staff, the 90-day time frame for SEC action on an application and the lack of an express authority to examine the applicants prior to registration prevented the concerns from being addressed prior to approval. Unlike other registration application programs that have built in greater authority and flexibility for their staff to clarify outstanding questions regarding applications before approval, the NRSRO registration program requires SEC to act within 90 days of receiving the application. As a result, staff recommended granting registration with ongoing concerns about NRSROs meeting the Act's requirements.
- With its current level of staffing for NRSRO examinations, SEC's Office of Compliance Inspections and Examinations (OCIE) would likely not have been able to meet its routine examination schedule of examining the three largest NRSROs every 2 years and others every 3 years. OCIE has requested additional resources to fully staff the NRSRO examination program. While the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires SEC to establish an Office of Credit Ratings to conduct annual examinations of each NRSRO and staff the office sufficiently to carry out these examinations, SEC may face challenges in meeting the required examination timetable and providing quality supervision over NRSROs unless it develops a plan that clearly identifies staffing needs, such as requisite skills and training.

While SEC has increased the amount of performance-related data NRSROs are required to disclose, the usefulness of the data is limited. First, SEC requires NRSROs to disclose certain performance statistics, increasing the amount of performance information available for some NRSROs. However, because SEC does not specify how NRSROs should calculate these statistics, NRSROs use varied methodologies, limiting their comparability. Second, SEC issued two rules requiring NRSROs to make certain ratings history data publicly available. However, the data sets do not contain enough information to construct comparable performance statistics and are not representative of the population of the credit ratings at each NRSRO. Without better disclosures, the information being provided will not serve its intended purpose of increasing transparency.

In July 2008, SEC proposed amendments that would have removed references to NRSRO ratings from several rules. While SEC removed references from six rules and two forms, it retained the use of the ratings or delayed further action on two rules. These rules govern money market fund investments and the amount of capital that broker-dealers must hold, and use NRSRO references as risk-limiting measures. GAO reviewed SEC's proposals to remove NRSRO references from these two rules and identified concerns with how SEC examiners would have evaluated compliance with the proposed alternative credit standards and whether it had staff with the requisite skills. Going forward, the Dodd-Frank Act requires SEC to remove NRSRO ratings from its rules. SEC's previous experience with proposals to remove credit rating references highlights the importance of developing a plan to help ensure that (1) any adopted alternative standards of creditworthiness for a particular rule facilitate its purpose and (2) that examiners have the requisite skills to determine that the adopted standards have been applied. Without such a plan, SEC may develop alternative standards of creditworthiness that are not effective in supporting the purpose of a particular rule.

Since the implementation of the Act, the number of NRSROs has increased from 7 to 10; however, industry concentration as measured by NRSRO revenues, the number of entities rated, and the dollar volume of new asset-backed debt rated remains high. Several factors likely have contributed to the continued high concentration among NRSROs. First, relatively little time has passed since SEC implemented the NRSRO registration program and NRSRO rulemaking. Second, the three new NRSROs have not had much time to build market share. Finally, the recent financial crisis occurred soon after the Act's implementation, substantially slowing certain sectors of the securitization markets. Moreover, there are barriers to entering the rating industry and to becoming an NRSRO. For example, establishing a reputation as a credible provider of credit ratings can take years. The reference to specific NRSROs in private contracts and investment guidelines also acts as a barrier.

As part of an April 2009 roundtable held to examine oversight of credit rating agencies, SEC requested perspectives from users of ratings and others on whether it should consider additional rules to better align the raters' interest with those who rely on those ratings, and specifically, whether one business model represented a better way of managing conflicts of interest than another. GAO identified five unique alternative models for compensating NRSROs that have been proposed by roundtable participants and others, although they vary in the amount of detail available. To assist Congress and others in assessing these proposals, GAO created an evaluative framework of seven factors that any compensation model should address to be effective. By applying these factors, users of the framework can identify the potential benefits of the model consistent with policymakers' goals as well as any tradeoff.

Framework for Evaluating Alternative Models for Compensating NRSROs

Factors		Description
✓	**Independence**	The ability for the compensation model to mitigate conflicts of interest inherent between the entity paying for the rating and the NRSRO. Key questions include: What potential conflicts of interest exist in the alternative compensation model and what controls, if any, would need to be implemented to mitigate these conflicts?
✓	**Accountability**	The ability of the compensation model to promote NRSROs' responsibility for the accuracy and timeliness of their ratings. Key questions include: How does the compensation model create economic incentives for NRSROs to produce quality ratings over the bond's life? How is NRSRO performance evaluated and by whom?
✓	**Competition**	The extent to which the compensation model creates an environment in which NRSROs compete for customers by producing higher-quality ratings at competitive prices. Key questions include: To what extent does the compensation model encourage competition around the quality of ratings, ratings fees, and product innovation? To what extent does it allow for flexibility in the differing sizes, resources, and specialties of NRSROs?
✓	**Transparency**	The accessibility, usability, and clarity of the compensation model and the dissemination of information on the model to market participants. Key questions include: How transparent are the model's processes and procedures for determining ratings fees and compensating NRSROs? How would NRSROs obtain ratings business?
✓	**Feasibility**	The simplicity and ease with which the compensation model can be implemented in the securities market. Key questions include: What are the costs to implement the compensation model and who would fund them? Who would administer the compensation model? What, if any, infrastructure would be needed to implement it?
✓	**Market acceptance and choice**	The willingness of the securities market to accept the compensation model, the ratings produced under that model, and any new market players established by the compensation model. Key questions include: What role do market participants have in selecting NRSROs to produce ratings, assessing the quality of ratings, and determining NRSRO compensation?
✓	**Oversight**	The evaluation of the model to ensure it works as intended. Key questions include: Does the model provide for an independent internal control function? What external oversight does the compensation model provide to ensure it is working as intended?

Source: GAO.