



# Commercial Mortgage Securities Association™ (CMSA)

## *Position Paper*

### *Subject: Credit Rating Agency Reform*

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**Background:** On September 29, 2006, the “Credit Rating Agency Reform Act of (CRARA) 2006” was signed into law by President Bush. CMSA was generally supportive of the goals of the Act to: 1) provide greater transparency in the credit rating process; 2) encourage competition and facilitating the entry of new credit rating agencies into the market; and 3) prohibit anti-competitive practices (such as notching) that negatively impact the market.

Prior to 2006, the Securities and Exchange Commission (SEC) designated credit rating agencies as “nationally recognized statistical rating agencies” (NRSROs) through the issuance of “no action” letters. Of the more than 130 credit-rating agencies, the SEC had designated only five as NRSROs (Moody's, S&P, A.M. Best, Dominion Bond Rating Service, and Fitch Ratings). Some Members of Congress charged that this limited competition in the industry led to abusive practices, such as sending unsolicited ratings with a bill, notching (the practice of lowering ratings on asset-backed securities unless the rating firm also rates a substantial portion of the underlying assets), and tying ratings to the purchase of additional services. Opponents argued that the bill infringes on the free speech rights of credit agencies.

CRARA abolished the SEC's authority to designate NRSROs through the “no-action” letter process. Instead, any credit-rating company with three years of experience that meets certain standards is allowed to register with the SEC as an NRSRO. Under the Act, the SEC also was required to develop regulations allowing for registration of NRSROs subject to the statutory standards. On the back-end, the Act grants the SEC authority to inspect credit-rating agencies and requires the SEC to develop regulations to prohibit certain “unfair, coercive, or abusive” practices such as notching. However, the Commission is not permitted to regulate the rating methodologies of credit agencies.

CRARA required the SEC to implement the Act, and the Commission held an open comment period on a proposed rule. CMSA met with the SEC staff and submitted several comment letters to the Commission that expressed our strong concern with portions of the proposed rule – which has a tremendous impact on our market. Specifically, one issue was with a provision in the rule that would create exemptions to the Act only for structured finance. In fact, one subparagraph of the proposed rule – 17g-6(a)(4) – permitted an SEC-registered credit rating agency to refuse to initiate a rating or withdraw an existing rating if that credit rating agency has rated less than 85% of the market value of the assets underlying the structured product. Further, under this proposal, if a credit rating agency did not rate 85% of the market value of the assets underlying the structured product, they would be exempted from anti-competitive practices (such as notching) that the statute expressly sought to prohibit. CMSA expressed concern that by creating this exemption for structure finance, the proposed rule would: 1) create barriers to entry for credit rating agencies; and 2) possibly allow for the continuation of anti-competitive practices that were intended to be banned by the Act.

On June 5, 2007, the SEC adopted final rules implementing CRARA. The rules replace the “no action” letter process with a registration process for credit rating agencies to be recognized as NRSROs. In addition, the rules implement recordkeeping, financial reporting, disclosure, and oversight requirements with respect to credit rating agencies registered as NRSROs, and maintain the congressional requirement that the SEC not regulate the substance of credit ratings or the process or methodologies used by agencies to determine them.

Since passage of CRARA, Congress has maintained a strong interest in the credit rating agencies and regulatory reform efforts, due in large part to the subprime lending crisis. Both the House Financial Services Committee and the Senate Banking Committee held hearings examining the role of credit rating agencies in the issue. The House committee examined the quality and timeliness of credit ratings, as well as role of credit rating agencies in the debt markets, including any potential conflicts of interest. The Senate hearing highlighted the apparent conflict of interest in the current “issue-to-pay” system whereby the credit rating agencies paid for the ratings that they issue. Several members have suggested moving to a system of investor funded credit rating agencies to potentially eliminate this conflict-of-interest. Although no legislation has yet to be introduced, legislation is expected in the future to propose amending the CRARA in an attempt to address these perceived problems.

**CMSA Position:** CMSA supports the concept of a revised framework to ensure that rating agencies do not engage in unfair, coercive or abusive practices. The CMBS market relies upon credit ratings in the pricing of CMBS products, so a level playing field for all rating agencies and vigorous competition in the industry will help ensure the most accurate ratings at competitive prices.

Given that credit ratings are the lynchpin of our market and the overall economy, investors need accurate and timely information to support the CMBS market and investors, and we urge Congress to be cautious not to disrupt well functioning markets when examining this area in the context of subprime lending issues.

**Status:** The SEC is currently implementing the registration, recordkeeping, financial reporting, and oversight provisions of the Reform Act. In addition, the SEC is required under the Act to report annually to Congress on: (1) applicants for NRSRO registration; (2) actions taken on such applications; and (3) the views of the SEC on the state of competition, transparency, and conflicts of interest among NRSROs. The Act also requires the Comptroller General (GAO) to study and report to Congress on the impact of reforms made under the Act upon: (1) the quality of credit ratings issued by NRSROs; (2) the financial markets; (3) competition among credit rating agencies; and (4) the incidence of inappropriate conflicts of interest and sales practices by NRSROs. The GAO report is due by 2010.

CMSA is closely monitoring implementation of CRARA by the SEC, as well as the yearly SEC reports. We have provided comments to them on specific substantive issues in the rules that affect CMBS. In addition, CMSA has asked Congress to ensure that the implementation of the Act is consistent with the underlying Congressional intent of transparency, competition and accountability. CMSA is concerned with any efforts in current or future rulemaking process to create exemptions to the Act for structured finance and that would: 1) create barriers to entry for credit rating agencies; and 2) allow for the continuation of anti-competitive practices that were banned by the Act.

With regard to the congressional examination of credit rating agencies in the context of the subprime lending issues, CMSA anticipates that Congress will continue to explore these issues. Further, we expect two separate reports on the credit rating agencies to be released in the upcoming months by the SEC and the President's Working Group on Financial Markets.