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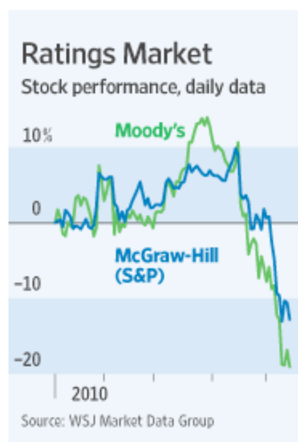
Rating Agencies Face Curbs

Senate Votes Measure to Give SEC a Role in Bond-Vetting Process; Response to Crisis

By AARON LUCCHETTI, SERENA NG and GREG HITT

The Senate approved a provision that would thrust the government into the process of determining who rates complex bond deals, in a move to end alleged conflicts of interest blamed by some for worsening the financial crisis.



The 64-35 vote Thursday represents one of the strongest moves yet by Congress to change how business is done on Wall Street. The amendment aims to resolve what's considered one of the thorniest problems in financial markets: Bond issuers choose ratings agencies and pay for ratings, meaning raters' revenues depend on the very firms whose bonds they are asked to judge.

Under the new provision, the Securities and Exchange Commission would instead establish and oversee a powerful credit-rating board that would act as a middleman between issuers seeking ratings and the rating agencies. The board would select which agency provides the "initial rating" for certain securities known as structured bonds.

Critics of the status quo say the issuer-pay model led to inflated ratings in the housing boom, particularly of securities backed by mortgages. Many bonds rated triple-A ended up getting downgraded to junk, unleashing mayhem in the financial system. Congress has drubbed ratings agencies for being too cozy with the banks that bring them business and too focused on market share rather than independent analysis.

Regulators continue to increase their scrutiny of practices during the housing boom. Last Friday, Moody's Corp. disclosed it had received notice from the SEC that its Moody's Investors Service unit may face an enforcement action for allegedly misleading regulators in a 2007 license application. Moody's has said employees broke the firm's policies but disagreed that the breach made its application misleading.

Separately, New York Attorney General Andrew Cuomo has subpoenaed large banks and ratings agencies in a probe into whether banks made misrepresentations about some mortgage securities to improve their ratings, said a person familiar with that investigation. The subpoenas were reported Thursday in the New York Times.

In the vote to approve the Senate amendment, which was offered by Sen. Al Franken (D., Minn.), 10 Republicans joined 53 Democrats and Vermont Independent Bernie Sanders. It passed over the opposition of Banking Committee Chairman Chris Dodd (D., Conn.), who worried the change could have unintended consequences.

The amendment is now part of the Senate's sweeping overhaul of financial regulation, which Democratic leaders hope to push toward final passage late next week. Once the legislation clears the Senate, a lengthy road still looms before any bill becomes law. The most likely path forward is for the House and Senate leadership and key lawmakers to negotiate a final compromise bill and then route that measure back through both chambers for final votes.

It's possible Thursday's amendment could be dropped in that process. But killing it could be difficult because the amendment received more than 60 votes, reflecting broad support. Democrats and Republicans have said they believe the bill has enough votes to pass.

Several proposals on ratings are already in the Senate legislation, including greater legal liability or penalties for bad ratings.

A majority of the members of the new board to be established would represent investors. At least one would represent issuers and one the rating agencies; another would bring an independent perspective. The board would assign rating firms only for "structured securities"—bonds that represent income streams such as auto-loan or credit-card payments.

The board would evaluate ways of assigning rating agencies, including by rotation or a lottery. But it would have to take into account agencies' accuracy and technical capacity, congressional staffers say. Some said the plan could upend incumbent raters' hold on the structured-securities market if it becomes law.

"This addresses the principal conflict of interest of the issuer-pay-and-select model," said Sean Egan, principal at Egan-Jones Ratings Co., which charges investors, rather than issuers, for its ratings.

Others were cooler to the change. A spokesman for McGraw-Hill Cos.' Standard & Poor's said the change could give investors the impression that ratings are government-sanctioned. Also, "Credit-rating firms would have less incentive to compete with one another, pursue innovation and improve their models, criteria and methodologies," said the S&P spokesman. "This could lead to more homogenized rating opinions."

A spokesman for Fitch Ratings, a unit of Fimalac SA, said, "Market participants may question whether legislation that leads to transactions having only one rating, assigned randomly, is consistent with recent regulatory efforts to promote competition in the ratings market and with the concept of greater diversity of credit opinions."

A Moody's spokesman said the firm "supports the goals of enhancing the transparency and accountability of the ratings process." He added: "We are hopeful that the final legislation will achieve these goals while avoiding unintended consequences for market participants."

—Chad Bray, Fawn Johnson and Damian Paletta contributed to this article.

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