

## SEC Aims to Rein In The Role of Ratings

By AARON LUCCHETTI, KARA SCANNELL and CRAIG KARMIN June 24, 2008; Page C1

The Securities and Exchange Commission plans to propose rules that may diminish the longstanding importance of credit ratings across various markets, including the \$3.4 trillion money-market industry, in the latest blow to the rating business stemming from the credit crunch.

The most significant portion of the rules, to be proposed Wednesday, would make it possible for U.S. money-market funds to invest in short-term debt without regard to ratings put on those securities by firms such as Moody's Investors Service and Standard & Poor's, people familiar with the matter said. Currently, SEC rules generally require that money-market funds purchase only short-term debt with high investment-grade ratings. The new rule would put more discretion in the hands of money managers to determine whether the debt is investment grade.

The SEC also will propose rules that may diminish the importance of credit ratings in determining the amount of capital that investment banks are required to hold. In all, the proposal will put about a dozen changes on the table that could touch on the role of credit ratings for investors and banks. An SEC spokesman couldn't be reached for comment.

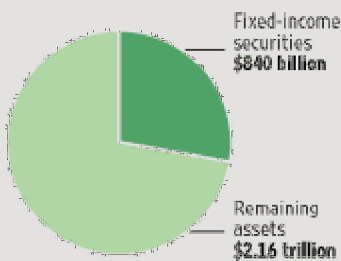
The renewed effort is part of a wide-ranging regulatory push in the U.S. and Europe amid the credit crunch that has devastated many banks and investors. Major rating services -- Moody's Corp.'s Moody's Investors Service, McGraw-Hill Cos.' Standard & Poor's and Fimalac SA's Fitch Ratings -- have been blamed by some for underestimating the risk of default on hundreds of billions of dollars of mortgage debt.

The dirty secret of some bond investors is that they simply bought securities with the highest yield for a given rating, which is why they snapped up complicated securities tied to subprime mortgages. Those securities often got high ratings but yielded more than other, more standard securities with the same rating.

In 2003, the SEC asked the industry and investors for comment on similar changes to money-market funds and capital rules, but the ideas never went anywhere and were shelved amid mixed reviews.

### A Pension for Bonds

Of the \$3 trillion in combined U.S. pension assets, 28% are invested in fixed-income securities



Source: National Association of State Retirement Administrators

As the current credit crisis has unfolded, regulators have grown concerned that the reliance on ratings in various market rules gives investors a sense of false comfort, discouraging them from doing their own research when assessing the riskiness of bonds in their portfolios. By diminishing the role of ratings, they hope to reverse that.

S&P, Moody's and Fitch declined to comment on the pending proposal.

The proposals are expected to generate divided comments from investors and also may affect a range of other SEC provisions.

"My initial reaction is, what's the alternative?" to using rating firms for the rules, said Hal Scott, a Harvard University law professor specializing in capital-markets regulation. "What we need to do is have more assurance that these ratings will be accurate."

SEC Chairman Christopher Cox said at a recent hearing on rating firms that their role in the regulatory apparatus "may have played a role in

encouraging investors' over-reliance on ratings."

Despite the backlash against rating firms, their assessments of bonds still play a central role in decisions made by banks and investors.

Last week offered the latest example, when Moody's downgraded the debt of bond insurers MBIA Inc.

and Ambac Financial Group, triggering a selloff in the companies' stocks and fears of forced sales of bonds insured by the two companies.

Regulators also depend on them. The Federal Reserve, after it arranged a sale of Bear Stearns Cos. to J.P. Morgan Chase & Co., said the Federal Reserve Bank of New York would take as collateral some illiquid, beaten-down assets from investment banks, but only if the assets were rated highly by rating firms. Other international codes such as Basel II also use ratings to determine how global banks manage their balance sheets.

Investors have had similar rules on their books for decades that require they only buy bonds the major rating firms grade at a certain level or above. Some may now expand the list of rating firms they can use for such rules to include new firms.

In an effort to create more competition in the rating industry, on Monday the SEC recognized a 10th bond-rating firm, Realpoint LLC, a former unit of GMAC.

Institutional investors such as pension funds are looking to make changes in their ratings-based rules.

The Illinois State Board of Investment, for example, recently requested more information from its money managers about their approach to buying bonds such as mortgage-backed securities. William Atwood, executive director of the \$12 billion fund, said he would be reluctant to give new money to those managers who rely heavily on the ratings firms.

"We've got to pay closer attention," said Richard Metcalf, director of corporate affairs at the Laborers' International Union of North America, which advises pension funds. "If that means creating additional levels of scrutiny of the process, we will do that."

If regulatory changes succeed, ratings would become more of a guide, but not a quasi-regulation from the government on what investors can or cannot hold.

Rating firms haven't protested this line of thinking, saying that they don't want their ratings to be misinterpreted as a catch-all recommendation to buy a security.

While many investors and large institutions say they don't rely on ratings, recent lawsuits from holders of battered mortgage-related debt show that at least some used them extensively. In a lawsuit filed this month against Deutsche Bank AG, Buffalo, N.Y.-based M&T Bank Corp. said it had written down the value of two collateralized debt obligations by more than 90%.

"The AAA and AA ratings were major considerations in M&T's determination to invest," the bank argued in its suit, "because they indicated that the notes were safe, stable, and nearly risk-free investments." M&T didn't sue the rating firms, saying they were misled. Deutsche Bank declined to comment.

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