New Rules Loom For Bond-Rating Firms (The Wall Street Journal)

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Bond-rating firms could face rules on new products similar to those already in place for stock and derivatives exchanges, as part of a House bill likely to be proposed Monday.

The proposed legislation by Reps. Gary Ackerman (D., N.Y.) and Mike Castle (R., Del.) would give the Securities and Exchange Commission authority to stop bond-rating firms from unilaterally putting triple-A marks on new structured-finance products. Instead, regulators would have to approve certain new products, with the SEC required to base decisions on the product's structure and underlying assets.

The requirements would apply to structured bonds backed by assets such as consumer mortgages, car payments and tuition bills, as well as newer, more-complex products that have been hit even harder recently.

The bill is another effort to bolster confidence in financial markets amid the tumult that erupted last summer. Untested, complicated products have contributed to massive write-downs by financial firms and the fire sale of Bear Stearns Cos. to J.P. Morgan Chase & Co.

Some skeptics say the limits being proposed in the House bill could stifle innovation. But Reps. Ackerman and Castle, both members of the House Financial Services Committee, counter that too many securities created when markets were climbing weren't sufficiently understood.

"I see this as being regulatory, but having the possibility of lending confidence to a market that's been badly battered," says Rep. Castle, a former Delaware governor.

The problem now, adds Rep. Ackerman, a 13-term House member representing parts of Long Island and the New York City borough of Queens, is that "there is no innovation, because there is no capital to sell any product."

Pension-fund advisers Sean Mathis and Julia Whitehead, and banking professor Joseph Mason of Louisiana State University worked on the plan.

The bill differs from an SEC rule proposed last month that would play down ratings in the federal agency's guidelines that apply to brokerage firms, money-market mutual funds and other financial institutions. The House bill likely to be proposed Monday would be more tailored, keeping the rating firms' role intact for corporate and government bonds while curtailing their influence over some structured products.

Currently, investors and financial companies use the approximately 10 SEC-recognized ratings companies to determine how their bonds are treated under various capital rules and safety and soundness guidelines. The most highly rated bonds are treated as safe, while lower-rated ones are treated as more risky. The bill would remove this system for asset-backed bonds that the SEC judges are too untested. There, even if ratings firms thought a certain asset-backed bond were safe enough to rate, the bonds wouldn't be allowed to be counted that way under the safety and soundness guidelines.

Under the plan, rating firms would still be free to give ratings on such products, but likely with a disclaimer that the ratings didn't count under the rules. Perhaps the most damaging assumption in the bill is that rating firms simply aren't capable of putting low ratings on risky products themselves. In May, an international regulators' group said rating firms should further analyze whether new bond products deserve to be rated. Throughout 2005 and 2006, subprime mortgages with unusually high default risks were stuffed into established securities structured in ways that many investors wrongly believed would shield them from losses.

Spokesmen for the SEC and McGraw-Hill Cos.' Standard & Poor's declined to comment on the legislation. A spokesman for Moody's Corp., the other large rater, said: "If market-oversight authorities feel certain instruments should be more tightly controlled in the market, the mechanism for that control shouldn't limit Moody's opinion about the instruments."