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Kilroy Was Here, Alas

Dodd-Frank and the credit raters.

If politicians were as accountable as CEOs, half of them would be fired for incompetence. Witness last week's land speed record for unintended consequences, as a liability provision in the Dodd-Frank financial reform brought new issues to a screeching halt in the $1.4 trillion asset-backed securities market.

These securities are bonds backed by auto loans, credit-card receivables and the like. Shutting down this entire market to new offerings was an amazing Congressional feat, given that the same federal government has put tens of billions of taxpayer dollars at risk to revive the same market.

The financial genius behind this section of Dodd-Frank is Representative Mary Jo Kilroy. The Ohio Democrat inserted a line in the bill that removes the exemption for credit raters like Standard & Poor's and Moody's from being considered "expert" advisers in judging securities offerings. This makes them closer to underwriters or accountants in vouching for an issued security, and it means that their consent is required before their ratings can be included in a registration statement filed at the Securities and Exchange Commission.

Coincidentally—and Ms. Kilroy has said this was her motivation—the provision also sharply increases the potential liability for credit rating firms. Both S&P and Moody's cited this enhanced liability in announcing that they would not consent to participating in SEC asset-backed securities registrations. Fitch, DBRS and others followed suit.

Oops. Billions of dollars of deals were scrapped, as issuers were barred from proceeding without ratings information and the raters weren't willing to participate. A June press release still appears on Ms. Kilroy's website, proudly noting that her amendment "adds teeth to Wall Street reform." Did it ever.

The market remained frozen until late on July 22nd when the SEC staff rushed out an announcement that they were suspending enforcement for six months of its rule that ratings information be part of securities offerings.

The SEC acted wisely in granting temporary relief, but pushing the uncertainty into late January is no solution. This is another excellent reason for the SEC to begin immediately to implement another but much better provision of Dodd-Frank. Under the new law, the SEC has one year to remove all references to the government's favored ratings agencies, including S&P and Moody's, from its various regulations and replace them with other standards for judging creditworthiness.

Ideally, the government would get out of the business of setting such standards entirely. But if it's going to tell, say, money market fund managers that they can hold only relatively safe securities, it's better not to outsource the decision on what "safe" is to an anointed oligopoly of private firms. This was a key contributor to the credit crisis, as the big raters earned outsize profits providing shaky ratings to a market that had no choice but to buy them.

If there is to be a standard measurement for the safety of a bond, the bond's yield and the cost of insuring it in the credit-default swap market are two good facts to consider. Making the fund manager who seeks to manage investors' money perform due diligence on the bond and judge its soundness is the best reform of all.

As for Dodd-Frank, this won't be the last of its unintended consequences, nor is it likely to be the most costly, but here's hoping that it is the last and most costly one at least for this month.