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**The Indian Anomaly:
Rethinking Credit Rating Agency Regulation from the
Economic Perspective of Hyman Minsky**

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Abstract

Policymakers have blamed the credit rating agencies for the recent financial crisis – but they could be wrong. India can aid in understanding whether the agencies can still be relied upon as private “gatekeepers” in financial markets, or whether public institutions must take primary responsibility. The economist, Hyman Minsky, advocated for robust public regulation and a limited role for private actors. India can be seen as an example of his theories. If India’s agencies cannot prevent speculative credit from causing future economic problems, the problems could suggest that more structural measures are necessary to counter instability, as Minsky predicted. Analyzing India and the credit ratings agencies through the frame of Minsky’s economic theories offers insights into how best to reform financial regulation to prevent future economic collapse.

INTRODUCTION

Recent developments in India lend themselves to two diverging forecasts of its future.¹ The first predicts sustained growth: the narrative begins with the country liberalizing its economy, continues to its strong performance during the peak of the recent global financial crisis, and anticipates an accelerating trajectory that will eventually overtake the West.² The second story ends differently: the economic bubble bursts, as India's financial indicators reverse and its development slows.³

At the intersection of the two, opposing visions are six Indian credit rating agencies ("CRAs").⁴ They earned large profits in recent years, and grew more influential.⁵ As India's debt markets have grown and diversified, the CRAs have provided positive ratings to increasingly risky financial products.⁶

The accuracy of the Indian CRAs is relevant to a debate that has gained intensity in the West.⁷ One side has blamed the recent financial crisis on the payment model that domestic CRAs employ,⁸ in which the agencies charge the issuers of the products for the ratings.⁹ The arrangement misaligns incentives, by this argument, and causes the agencies to raise their ratings in order to attract and retain new clients.¹⁰ U.S. and European regulators have in large part accepted this explanation of unreliable credit ratings, some resulting in bank failures,¹¹ and they

¹ See Section I, below.

² See Section I.A., below.

³ See Section I.B., below.

⁴ See Section IV.A., below.

⁵ See Section IV.A.1., below.

⁶ See Section IV.B.3., below; Tarun Jain and Raghav Sharma, *Credit Rating Agencies in India: A Case of Authority without Responsibility*, 3 *Company Law Journal* 89, 106 (2008), available at <http://ssrn.com/abstract=1111553> ("the Indian CRAs have made their foray into rating [structured finance] products.").

⁷ See, e.g., Amadou N.R. Sy, *The Systemic Regulation of Credit Rating Agencies and Rated Markets*, IMF Working Paper, WP/09/129, June 2009 at 3, available at <http://www.imf.org/external/pubs/ft/wp/2009/wp09129.pdf>.

⁸ Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifan Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 *B.F.L.R.* 361, 376 (2010); [payment model]

⁹ Claire Hill, *Limits Of Dodd-Frank's Rating Agency Reform*, 31 *No. 5 Banking & Fin. Services Pol'y Rep.* 13, 13 (2012) ("the agencies are paid by the issuers and the issuers can threaten to take their business elsewhere if they cannot get high ratings").

¹⁰ See, e.g., Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 *Case. W. L. Rev.* 227, 243 (2009) (describing a study that demonstrated that the CRAs became less reliable in the period following their adoption of the "issuer-pays" model); Claire Hill, *Limits Of Dodd-Frank's Rating Agency Reform*, 31 *No. 5 Banking & Fin. Services Pol'y Rep.* 13, 13 (2012) ("the agencies have let themselves be bribed into giving high ratings even when such ratings are not warranted").

¹¹ Aline Darbellay and Frank Portnoy, *Credit Rating Agencies Under The Dodd-Frank Act*, 30 *Banking & Fin. Services Pol'y Rep.* 1, 2 (2011) ("Lehman Brothers retained its investment-grade rating until a few days prior to collapsing"); House of Lords, European Union Committee, *The Future of EU Financial Regulation and Supervision* (14th Report of

have undertaken to reduce the conflict of interest.¹² Consequently, they have made few systemic changes, and they have not restricted trading of complex instruments, such as mortgage-backed securities.¹³

Others have found the response of the regulators too simplistic.¹⁴ They have put forward rival views,¹⁵ represented by the theories of the economist Hyman Minsky.¹⁶ Minsky hypothesized that unless the state imposed structural obstacles, economies would expand until they crashed.¹⁷ His writings suggested that simple – or “exogenous” – regulatory mechanisms, such as changing the way that CRAs are paid, could not substitute for robust public interventions on a structural – or “endogenous” level.¹⁸

Observing developments in India offers insights for resolving this tension.¹⁹ It helps to illuminate whether private actors such as CRAs can be relied upon to regulate financial markets, so long as their incentives are aligned correctly,²⁰ or if public institutions must instead retain primary responsibility for governance.²¹

Session 2008–09 Vol 1) HL Paper 106–I, at 17 (“DG Markt explained that the regulation of rating agencies is a necessary reaction to their ‘massive failures’ revealed by the financial crisis. They described the conflicts of interest created when the issuers of a securitised bond pays for a rating, rather than the investor.”).

¹² See Section II.D., below.

¹³ See, e.g., Timothy J. Sinclair, *Credit Rating Agencies and the Global Financial Crisis*, 12 *Economic Sociology*, 2010 at 4, available at http://econsoc.mpifg.de/archive/econ_soc_12-1.pdf (“Although criticism of conflicts of interest may serve a useful political purpose, too much attention to issues at this level will produce complacency about the inherent volatility of global finance”); further Section III, below.

¹⁴ See, e.g., R. Michael Gadbow, *Systemic Regulation of Global Trade and Finance: a Tale of Two Systems*, 13 *J. Int'l Econ. L.* 551, 552-55 (2010).

¹⁵ See, e.g., Justin Lahat, *In Time of Tumult, Obscure Economist Gains Currency*, WALL ST. J., Aug. 18, 2007. Academic economists including C.J. Whalen, L. Randall Wray, Paul Davidson, Riccardo Bellofiore and Joseph Halevi, along with other practitioners and journalists, have called the crisis a “Minsky moment,” see Alessandro Vercelli, *A Perspective on Minsky Moments: The Core of the Financial Instability Hypothesis in Light of the Subprime Crisis*, Levy Economics Institute Working Papers No. 579, Oct. 9, 2009 at 2.

¹⁶ Minsky, a Harvard-trained economist, taught on the faculties of Brown University, University of California at Berkeley, and Washington University in St. Louis, see Dimitri B. Papadimitriou and Randall Wray, *The Economic Contributions of Hyman Minsky: Varieties of Capitalism and Institutional Reform*, The Jerome Levy Economics Institute, Working Paper No. 217, 1997 at 1-3.

¹⁷ See Section III.A., below.

¹⁸ See Section III.C., below. Further, Jan Kregel, *Is This the Minsky Moment for Reform of Financial Regulation?*, Levy Economics Institute Working Paper No. 586, Feb. 25, 2010 at 3 (“regulation of the system cannot be effective if it is simply based on measures produced to remedy and reverse the conditions generated by the current ‘moment.’ It needs to reformulate the structure of the financial system. . . . the current approach . . . [applies] cosmetic changes.”).

¹⁹ See Section IV, below.

²⁰ See, e.g., Howell E. Jackson, *Variation In The Intensity Of Financial Regulation: Preliminary Evidence And Potential Implications*, 24 *Yale J. on Reg.* 253, 254-55 (2007) (discussing potential “capacity of market mechanisms to police certain activities more efficiently than government oversight.”).

²¹ Harry McVea, *Credit Rating Agencies, the Subprime Mortgage Debacle and Global Governance: the EU Strikes Back*, 59 *Internat'l and Comp. L. Quarterly* 701, 702 (2010) (the CRAs “became ‘important private makers of global public policy’ and were widely seen as key drivers of global governance.”).

This paper presents India as a case study in order to contribute to the existing literature on the Western debate, identifying the CRAs not simply as private actors, but as “gatekeepers” that participate in regulation.²² The agencies controlled the flow of information about the quality of financial instruments and could influence public awareness of fraud.²³ Section I begins by describing the precarious position of modern-day India, with its past economic growth poised either to continue or to decline. The paper then establishes the role that CRAs have played in Western markets and the reasons for blaming their payment model for the recent financial crisis. Section III rebuts the argument and explains how an economist such as Hyman Minsky would have interpreted the causes of the crisis. Section IV introduces the Indian CRAs and points out both their similarities to Western agencies and their differences. It then sets out the proposal that India’s expanding debt markets and increased use of high-risk financial instruments can be seen as an example of Minsky’s theories. The theories would portend that the regulation of the Indian CRAs would not protect the country from future economic weakening.

The story of India awaits an ending. Though many variables interact, and diverse, legal, political, and cultural contexts shape the effects that rules have in different countries, India’s future could nevertheless offer some guidance.²⁴ If the economy rebounds, the growth could suggest that private “gatekeepers” such as CRAs can effectively regulate markets, rendering the destabilizing effects of India’s increased debt levels and use of complex financial products inconsequential. If so, then perhaps the West has correctly focused on “exogenous” reforms, such as mitigating conflicts of interest among CRAs, rather than seeking more systemic solutions. If, however, the Indian economy contracts, the reversal could suggest the need for the state to participate more meaningfully to counter behaviors that increase credit supplies and contribute to instability, as Minsky proposed.²⁵ Studying India’s future thus contributes answers to three overlapping questions: 1) how intensively financial markets should be regulated and by

²² See, e.g., Statement of Eric Stein, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies*, Hearings before the U.S.

Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess. (April 22, 2008) at 18. (“The ratings industry became ‘the de facto watchdog over the mortgage industry.’”).

²³ See, e.g., Lynne L. Dallas, *Short-Termism, The Financial Crisis, And Corporate Governance*, 37 J. Corp. L. 265, 331 (2012).

²⁴ For a discussion of the embeddedness of rules, see, e.g., Dan Danielsen, *Economic Approaches To Global Regulation: Expanding The International Law And Economics Paradigm*, 10 J. Int’l Bus. & L. 23, 68 (2011).

²⁵ See, e.g., Harry McVea, *Credit Rating Agencies, the Subprime Mortgage Debacle and Global Governance: the EU Strikes Back*, 59 International and Comparative Law Quarterly 701, 702 (2010) (“the use (and abuse) of credit ratings . . . has today cast a long shadow over the ability of these ‘gatekeepers to provide reliable signals upon which parties – investors, financial institutions and regulators – can make informed decisions.”); Jan Kregel, *Is This the Minsky Moment for Reform of Financial Regulation?*, Levy Economics Institute Working Paper No. 586, Feb. 25, 2010 at 3 (“Effective proposals can only emerge from analysis of the longer-term structural changes from the point of view of Minsky’s financial fragility hypothesis.”).

whom; 2) whether policing by private actors provides an efficient substitute for government oversight; and 3) the extent to which market forces discipline financial actors.

I. SETTING THE SCENE: WHAT'S NEXT FOR INDIA

This section presents evidence for two possible scenarios of India's future. Over the past twenty-one years, the country has developed rapidly and integrated its economy with global markets.²⁶ More recently, however, its progress has appeared to slow, and a more pessimistic outlook has taken hold.²⁷ India's future economic path remains uncertain.²⁸

A. Phase I: India as "Firmly On the Growth Expressway"²⁹

Financial reforms have transformed India.³⁰ Between 2004 and 2008, the economy grew by close to 10% each year.³¹ Analysts at the investment bank Goldman Sachs predicted that the country would surpass the US in GDP before 2050.³² Its upward trajectory has promised to lift millions out of poverty,³³ and their increased consumption has seemed likely to integrate the country more closely with international markets.³⁴

India's economic leadership has extended along with its growth, as other countries have studied its strong performance during the financial crisis.³⁵ During the peak of the crisis in 2009, its GDP continued to increase by 7%,³⁶ as companies listed themselves on Indian stock exchanges³⁷ and the capital markets posted record highs.³⁸ By 2010, the economy resumed a

²⁶ Afra Afsharipour, *Rising Multinationals: Law and the Evolution of Outbound Acquisitions by Indian Companies*, 44 U.C. Davis L. Rev. 1029, 1035-36 (2011).

²⁷ See, e.g., *India's Economy: A Bric Hits the Wall*, THE ECONOMIST, May 31, 2012.

²⁸ See, e.g., Victor Mallet, *India Struggles to Restore its Fortunes*, FINANCIAL TIMES, Aug. 7, 2012.

²⁹ Goldman Sachs, *BRICs and Beyond* 12 (2007).

³⁰ Afra Afsharipour, *Rising Multinationals: Law And The Evolution Of Outbound Acquisitions By Indian Companies*, 44 U.C. Davis L. Rev. 1029, 1054-55 (2011).

³¹ Id. at 1035-36.

³² Goldman Sachs, *BRICs and Beyond* 11 (2007).

³³ *Rolls-Royces and Pot-Holes*, THE ECONOMIST, Oct. 22, 2011.

³⁴ K. G. Viswanathan, *The Global Financial Crisis And Its Impact On India*, 9 J. Int'l Bus. & L. 41, 46-47 (2010).

³⁵ Id. at 46.

³⁶ Afra Afsharipour, *Rising Multinationals: Law And The Evolution Of Outbound Acquisitions By Indian Companies*, 44 U.C. Davis L. Rev. 1029, 1035-36 (2011); Erik Wulff and Kiran Lingam, *Franchising In India: A Brave New Frontier*, 29 Franchise L.J. 248, 248 (2010).

³⁷ K. G. Viswanathan, *The Global Financial Crisis And Its Impact On India*, 9 J. Int'l Bus. & L. 41, 47 (2010).

³⁸ Shardul Shroff, *Outlook on India 2010: Delivering on the Promise in Turbulent Times*, 1815 PLI/Corp 63, 65 (2010).

growth rate of close to 10%.³⁹ By contrast, the American economy shrunk by 3.5% in 2009 and grew by only 3% in 2010.⁴⁰ The Indian central bank, the Reserve Bank of India (“RBI”), had loaned equity to private banks, relaxed their capital requirements, and delayed collecting on loans, while countering declines in the rupee, India’s currency, by allowing expatriate Indians to maintain domestic deposits.⁴¹

This success underscored the accomplishments of two decades of economic liberalization.⁴² Beginning in 1991, India unshackled its closed economy by lowering trade tariffs and boosting exports.⁴³ Tariffs fell from 200% to 15%, exports rose by a factor of 14, and trade increased by 25%.⁴⁴ The state retreated from many industries, increasing competition.⁴⁵ The stock markets rose as resurgent Indian companies sold shares to diverse international investors.⁴⁶

A unique and seemingly successful brand of capitalism has emerged.⁴⁷ Some state influence over the private sector has persisted, and politically-connected family firms predominate.⁴⁸ Resource limitations have propelled the companies to improvise affordable products, and Western competitors have sought to learn their techniques.⁴⁹ PepsiCo established a center in India to study their methods of “frugal innovation”.⁵⁰ Indian engineers won a contest sponsored by Renault-Nissan to contribute ideas for cutting costs.⁵¹

Ultimately, Indian companies have demonstrated their new strength by acquiring Western firms, and many observers have predicted a prosperous future both for them and for the broader Indian economy.⁵² In 2007, the Indian metals company Hindalco acquired

³⁹ World Bank database of GDP growth, available at <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG>.

⁴⁰ *Id.*

⁴¹ See, e.g., *Pulling Every Lever*, THE ECONOMIST, Feb. 4, 2012.

⁴² K. G. Viswanathan, *The Global Financial Crisis And Its Impact On India*, 9 J. Int'l Bus. & L. 41, 46-47 (2010)

⁴³ Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 New Eng. J. Int'l & Comp. L. 231, FN 15 (2006).

⁴⁴ K. G. Viswanathan, *The Global Financial Crisis And Its Impact On India*, 9 J. Int'l Bus. & L. 41, 48 (2010).

⁴⁵ See, e.g., *The Power and the Glory*, THE ECONOMIST, Oct. 22, 2011.

⁴⁶ See, e.g., Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 New Eng. J. Int'l & Comp. L. 231, 236 (2006).

⁴⁷ See rest of paragraph, below.

⁴⁸ See, e.g., *The Power and the Glory*, THE ECONOMIST, Oct. 22, 2011; *The Bollygarchs' Magic Mix*, THE ECONOMIST, Oct. 22, 2011; *Adventures in Capitalism*, THE ECONOMIST, Oct. 22, 2011; Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 New Eng. J. Int'l & Comp. L. 231, 235 (2006).

⁴⁹ The Hindi slang word, *jugaad*, is used to refer to the technique. See, generally, Reena Jana, *India's Next Global Export: Innovation*, BLOOMBERG BUSINESSWEEK, Dec. 2, 2009, available at http://www.businessweek.com/innovate/content/dec2009/id2009121_864965.htm; Karl Moore, *The Best Way to Innovation? - An Important Lesson from India*, FORBES, May 24, 2011, available at <http://www.forbes.com/sites/karlmoore/2011/05/24/the-best-way-to-innovation-an-important-lesson-from-india/>; Tim Ferguson, *Can 'Jugaad' Get to Core U.S. Problems?*, FORBES, Apr. 5, 2012, available at <http://www.forbes.com/sites/timferguson/2012/04/05/can-jugaad-get-to-core-u-s-problems/>.

⁵⁰ *Asian Innovation*, THE ECONOMIST, Mar. 24, 2012.

⁵¹ *Id.*

⁵² See rest of paragraph, below.

American-Canadian Novelis for \$6 billion.⁵³ In 2008, Tata Motors paid \$2.3 billion to buy Jaguar and Land Rover from Ford.⁵⁴ The beverage arm of the Tata Group, Tata Tea, acquired the iconic British brand Tetley Tea,⁵⁵ and India's Mahindra & Mahindra undercut the American market leader John Deere in sales of small tractors to American farmers.⁵⁶

B. *Phase II: India as "Gasping Elephant"*⁵⁷

Other observers, however, have not expected the accomplishments to last.⁵⁸ Despite economic growth and increased prosperity, indications of future problems have emerged.⁵⁹

The Indian economy has no longer appeared to be insulated from the downturn in global markets.⁶⁰ In 2012, its growth fell to 5.3%, the lowest rate in seven years.⁶¹ Its dependence on borrowing foreign capital and on exporting to developed markets has left the country vulnerable to decreases in the supply of global credit and foreign demand.⁶²

Other financial indicators have also begun to change direction⁶³. Inflation has risen to more than 7%, leading to predictions of stagflation.⁶⁴ The rupee hit record lows against the dollar, shedding a fifth of its value in the past year.⁶⁵ Defaults by rated corporations hit a ten-year high,⁶⁶ and recent studies predicted that India could switch places with Indonesia in growth statistics for the emerging market economies.⁶⁷

⁵³ Chidanand Rajghatta, *Novelis Acquisition Puts Indian Stamp on Every Coke, Budweiser Can*, TIMES OF INDIA, Feb. 14, 2007, available at http://articles.timesofindia.indiatimes.com/2007-02-14/international-business/27870627_1_novelis-hindalco-share-holders-customers-on-four-continents.

⁵⁴ Heather Timmons, *Ford Sells Land Rover and Jaguar to Tata*, N.Y. TIMES, March 26, 2008.

⁵⁵ *Tetley Bagged by India's Tata*, BBC NEWS, Feb. 27, 2000, available at <http://news.bbc.co.uk/1/hi/business/658724.stm>.

⁵⁶ James Crabtree, *Mahindra Looks at International Acquisitions*, FINANCIAL TIMES, Apr. 15, 2012.

⁵⁷ Leif Eskesen, *India*, HSBC Global Research Report, May 31, 2012.

⁵⁸ See, e.g., *Now Finish the Job*, THE ECONOMIST, Apr. 15, 2012 (quoting the governor of the central bank stating, "We are not saying the economy is in the pink of health . . . we should be concerned. . .").

⁵⁹ See rest of section, below.

⁶⁰ See, e.g., *Losing Its Magic*, THE ECONOMIST, March 24, 2012.

⁶¹ James Crabtree, *Bollygarchs at Bay*, FINANCIAL TIMES, June 6, 2012.

⁶² See, e.g., K. G. Viswanathan, *The Global Financial Crisis and Its Impact On India*, 9 J. Int'l Bus. & L. 41, 44-45 (2010).

⁶³ See rest of paragraph, below.

⁶⁴ James Crabtree, *Bollygarchs at Bay*, FINANCIAL TIMES, June 6, 2012.

⁶⁵ See *Rupee and the Bears*, THE ECONOMIST, Nov. 26, 2011 and accompanying chart.

⁶⁶ Nupur Acharya, *Indian Corporate Default Rate at Ten-Year High*, WALL ST. J., Apr. 4, 2012.

⁶⁷ James Crabtree, *Bollygarchs at Bay*, FINANCIAL TIMES, June 6, 2012.

The efforts that the country undertook to stave off the financial crisis appear to have weakened its condition.⁶⁸ The central bank distributed money and took responsibility over portions of the economy, leaving the quality of its own assets poor.⁶⁹ Approximately 4.6% of its outstanding loans have reached the brink of default.⁷⁰

Meanwhile, poverty has persisted.⁷¹ The official numbers indicate that 29.8% of the population, or 350 million people, remain below the poverty line.⁷² India ranks as the poorest country among the emergent BRIC economies (Brazil, Russia, India, and China)⁷³ and the poorest member of the G-20.⁷⁴ Politicians appear to have struggled to promote business needs while also addressing the problems of the urban poor.⁷⁵ The economy has not expanded fast enough to support the creation of sufficient infrastructure, and many of its citizens still lack access to electricity and potable water.⁷⁶ As a demographic bulge reaches working age, ten million young people per year will need to find jobs over the next two decades.⁷⁷

Many obstacles, however, have seemed to stifle entrepreneurship and job creation.⁷⁸ State-controlled firms have accounted for close to half of corporate profits in India; family-owned companies have earned most of the rest.⁷⁹ The companies have sprawled into chains of holding companies, in order to compensate for deficiencies such as poor infrastructure, unreliable sources of labor and materials, and weak enforcement.⁸⁰ They have built their own infrastructure and supply chains and have leveraged their size to gain influence.⁸¹ Outsiders have had limited ability to compete against them.⁸²

⁶⁸ See rest of paragraph, below.

⁶⁹ *Reflections of Reality*, THE ECONOMIST, Aug. 6, 2011.

⁷⁰ *My Conflicted Heart, The Struggle for the Soul of India's Biggest Bank*, THE ECONOMIST, Apr. 21, 2012.

⁷¹ Erik Wulff and Kiran Lingam, *Franchising In India: A Brave New Frontier*, 29 SPG Franchise L.J. 248, 248 (2010)

⁷² Tripti Lahiri, *Is India Fudging Its Poverty Numbers*, WALL ST. J., May 20, 2012.

⁷³ See, e.g., *India's Economy: A Bric Hits the Wall*, THE ECONOMIST, May 31, 2012.

⁷⁴ *Economic Survey 2012-13: India poorest among G20 nations despite growth*, INDIA TODAY, Mar. 15, 2012.

⁷⁵ Erik Wulff and Kiran Lingam, *Franchising In India: A Brave New Frontier*, 29 Franchise L.J. 248, 248 (2010).

⁷⁶ See, e.g., Charles Runckel, *Infrastructure India: A Long Road Ahead*, available at http://www.business-in-asia.com/asia/infrastructure_india.html.

⁷⁷ *India's slowdown: Farewell to Incredible India*, THE ECONOMIST, June 9, 2012.

⁷⁸ See rest of paragraph, below.

⁷⁹ See, e.g., *The Power and the Glory*, THE ECONOMIST, Oct. 22, 2011; Afra Afsharipour, *Rising Multinationals: Law And The Evolution Of Outbound Acquisitions By Indian Companies*, 44 U.C. Davis L. Rev. 1029, 1083, 1085 (2011).

⁸⁰ *Building India Inc.*, THE ECONOMIST, Oct. 22, 2011; *Adventures in Capitalism*, THE ECONOMIST, Oct. 22, 2011; *The Bollygarchs' Magic Mix*, THE ECONOMIST, Oct. 22, 2011; Umakanth Varottil, *Evolution And Effectiveness Of Independent Directors In Indian Corporate Governance*, 6 Hastings Bus. L.J. 281, 288-89 (2010).

⁸¹ *Looking for the Next Infosys*, THE ECONOMIST, Oct. 22, 2011.

⁸² See, e.g., *Now Finish the Job*, THE ECONOMIST, Apr. 15, 2012; *Looking for the Next Infosys*, THE ECONOMIST, Oct. 22, 2011.

In addition, relations between the government and private companies have appeared to worsen.⁸³ Business leaders have protested burdensome regulations by investing abroad rather than in India.⁸⁴ In May 2012, heads of the largest Indian telecommunications companies met with politicians in New Delhi to complain.⁸⁵ The chief executive of the Indian steel company ArcelorMittal threatened not to initiate any domestic projects for the next five years.⁸⁶

What will the future hold? American CRAs have already cast votes against India's future.⁸⁷ In June 2012, Standard & Poor's⁸⁸ and Fitch revised their outlooks on India from stable to negative.⁸⁹ Analysts at Standard & Poor's speculated that India could become the first of the BRICs to fail.⁹⁰

II. PANNING WEST:

BLAMING CONFLICTED RATING AGENCIES FOR THE FINANCIAL CRISIS

Ironically, policymakers in America and Europe have viewed the CRAs as the villains of the most recent financial crisis.⁹¹ They alleged that these entities had conflicts of interest, because they adopted an "issuer-pays" model, in which the issuers of financial instruments paid the agencies to rate them.⁹² This model, they maintained, incentivized the agencies to award inflated scores, in order to please the issuers and retain their business.⁹³ Regulators concluded that the

⁸³ See rest of paragraph, below.

⁸⁴ James Crabtree, *Bollygarchs at Bay*, FINANCIAL TIMES, June 6, 2012.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ See, e.g., Bruce Einhorn, *India's Growth Story Dims on S&P Downgrade*, BloombergBusinessweek, Apr. 25, 2012.

⁸⁸ Penny MacRae, *S&P Downgrades India Outlook to Negative*, AGENCE FRANCE PRESS, Apr. 25, 2012.

⁸⁹ *Fitch downgrades India's outlook to 'negative'*, BBC NEWS, June 19, 2012.

⁹⁰ Joydeep Mukherji and Takahira Ogawa, *Will India Be the First BRIC Fallen Angel?*, Standard & Poor's, Global Credit Portal, June 8, 2012.

⁹¹ John C. Coffee, *Ratings Reform: The Good, The Bad, and The Ugly*, The Center for Law and Economic Studies – Columbia University School of Law Columbia Law and Economics Working Paper No. 359, Sept. 2010 at 2 ("Broad consensus exists that inflated credit ratings and conflict-ridden rating processes played a significant role in exacerbating the 2008 financial crisis."); EC Commission, *Consultation by the Commission Services on Credit Rating Agencies*, July 31, 2008, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1224&format=HTML&aged=1&language=EN&guiLanguage=fr> ("It is generally accepted that CRAs underestimated the credit risk of structured credit products and failed to reflect early enough in their ratings the worsening of market conditions"). The European Commission opened proceedings against Standard and Poor's in 2009, see Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifan Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 380-81 (2010).

⁹² See, e.g., Lynne L. Dallas, *Short-Termism, The Financial Crisis, and Corporate Governance*, 37 J. Corp. L. 265, 288 (2012) ("As for credit rating agencies, they had a conflict of interest because the issuers of securities paid their fees").

⁹³ Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: the Case for a Disclosure-Based Approach*, 2005 at 18, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=797325.

model resulted in inaccurate public information on default risk and that the inaccuracies caused the financial markets to crash.⁹⁴ This section explains why and how the regulators have focused on eliminating the conflict of interests in order to prevent a future crisis.

A. Agencies as “Gatekeepers”: The “Referee in the Debt Game”⁹⁵

In 2008, Henry Paulson, the U.S. Treasury Secretary under President George W. Bush, presented a policy statement in which he emphasized the responsibility of the CRAs for the crisis.⁹⁶ The report indicated the depth of the certainty of the regulators that the agencies were corrupt, and their reliance on the agencies to perform a “gatekeeping” role.⁹⁷ “Gatekeepers” deter fraud by monitoring financial markets and disseminating information.⁹⁸

For the last century, the CRAs facilitated financial investment by publishing assessments of the risks of buying financial products from specific issuers.⁹⁹ When issuers sell financial products to investors, the products represent promises from the issuers that they will pay back the full purchase price at fixed instalments, plus interest.¹⁰⁰ The investors therefore relied on the

⁹⁴ *Report of the Financial Stability Forum on Enhancing market and Institutional Resilience*, April 7, 2008, at 32, available at, Financial Stability Board http://www.financialstabilityboard.org/publications/r_0804.pdf, (“Poor credit assessments by CRAs contributed both to the build up to and the unfolding of recent events.”); Statement of Arthur Levitt, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies*, Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess. (April 22, 2008) (“Being able to gather and understand relevant information about a company’s financial health and performance is critical to the proper functioning of the markets.”); Lynne L. Dallas, *Short-Termism, The Financial Crisis, And Corporate Governance*, 37 J. Corp. L. 265, 331 (2012) (“the ratings on structured financial products have proven to be inaccurate . . . contribut[ing] significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy”).

⁹⁵ Arthur Levitt, *Conflicts and the Credit Crunch*, WALL ST. J., Sept. 7, 2007 at A15.

⁹⁶ Timothy J. Sinclair, *Credit Rating Agencies and the Global Financial Crisis*, 12 *Economic Sociology*, 2010, at 4, available at http://econsoc.mpifg.de/archive/econ_soc_12-1.pdf.

⁹⁷ The President’s Working Group on Financial Markets, *Policy Statement on Market Developments*, March, 2008, at 2, 4, 14-15, available at http://www.naic.org/documents/committees_e_rating_agency_comdoc_presidents_wg.pdf.

⁹⁸ Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: the Case for a Disclosure-Based Approach*, 2005 at 5, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=797325 (“these institutions have become central to the financial markets’ infrastructure through their role in rectifying information asymmetries that exist between issuers and investors”); Opening Statement of Representative Henry Waxman, Congressional Committee on Oversight and Governmental Reform Hearing, *Credit Rating Agencies and the Financial Crisis*, Oct. 22, 2008, available at <http://oversight.house.gov/story.asp?ID=2250> (“Millions of investors rely on [CRAs] for independent, objective assessments. The rating agencies broke this bond of trust . . .”).

⁹⁹ Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifen Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 370 (2010); Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: the Case for a Disclosure-Based Approach*, 2005 at 7, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=797325.

¹⁰⁰ See, e.g., Richard L. Kuersteiner, James O. Johnston, Richard L. Wynne, and Lance Miller, *Your Bond Issuer Has Filed for Bankruptcy? A Survey of the Trips, Traps, and Opportunities that Await Corporate Bondholders in a Chapter 11 Case*, 2008 Ann. Surv. Bankr. L. 6, non-paginated (2008) (“A bond represents the debtor’s promise to repay borrowed money over a specified period of time at a specified rate of interest.”).

CRAs' assessments of the likelihood that the issuers would return all of the money,¹⁰¹ in order to decide: 1) whether to buy financial products from particular issuers, and 2) how much interest to charge the issuers, in order to protect themselves against possible loss.

The CRAs carried out a quasi-regulatory role, ensuring the stability of the markets by promoting responsible behavior among issuers.¹⁰² The agencies rewarded issuers that managed their risks with high ratings, which made their financial products more marketable.¹⁰³ The agencies also increased the availability of credit for the issuers by providing accurate information to investors.¹⁰⁴ In theory, the information enabled the investors to charge lower interest rates.¹⁰⁵ If they trusted the ratings, then they did not need to add large margins of error, in order to cushion themselves against unexpected losses.¹⁰⁶ The lower interest rates made credit cheaper.¹⁰⁷

¹⁰¹ Testimony of Eric Stein, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies*, Hearings before the U.S.

Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess.. Apr. 22, 2008 at 18 (“Investors - the world financial markets – trusted the rating agencies because of their long history”).

¹⁰² Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, Council of Institutional Investors White Paper, Apr. 2009 at 3 (“rating agencies wield immense, quasi-governmental power.”). Essentially, the agencies intermediated between the issuers and investors, (see Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifen Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 363 (2010)). Economists have assumed that investors would not have gathered enough information on their own to inform themselves about the financial position of the issuers, (see Basel Committee on Banking Supervision, *Credit Ratings and Complementary Sources of Credit Quality Information*, July 2000 at 11, available at <http://www.bis.org/publ/bcbs72a.pdf>). The investors would have had to fund the full cost of an investigation, but they would not have received the full benefits. Other people could have accessed the information that they uncovered without having to pay for it. Economists have referred to the information on the issuers' risk of default as a “public good,” because of the difficulty of preventing others from sharing in it, (see Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: the Case for a Disclosure-Based Approach*, 2005 at 8, available at [http:// papers.ssrn.com/1sol3/papers.cfm?abstract_id=797325](http://papers.ssrn.com/1sol3/papers.cfm?abstract_id=797325)). CRAs have also been described as correcting “information asymmetries,” (see, e.g., Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifen Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 363 (2010)).

¹⁰³ Steven Schwarcz, *Disintermediating Avarice: A Legal Framework For Commercially Sustainable Microfinance*, 2011 U. Ill. L. Rev. 1165, 1195 (2011)

¹⁰⁴ Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifen Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 363 (2010); Basel Committee on Banking Supervision, *Credit Ratings and Complementary Sources of Credit Quality Information*, July 2000 at 11, available at <http://www.bis.org/publ/bcbs72a.pdf>.

¹⁰⁵ Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifen Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 370 (2010).

¹⁰⁶ Id.

¹⁰⁷ Id. Because the CRAs provided the service of investigating issuers when no one else would have undertaken it, economists have described them as correcting a “market failure,” (see Basel Committee on Banking Supervision, *Credit Ratings and Complementary Sources of Credit Quality Information*, July 2000 at 11, available at <http://www.bis.org/publ/bcbs72a.pdf>). The specialization and expertise of the agencies enabled them to collect the information at a lower cost. Economists have referred to their cost advantages as “economies of scale,” (see Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: the Case for a Disclosure-Based Approach*, 2005 at 9, available at [http:// papers.ssrn.com/1sol3/papers.cfm?abstract_id=797325](http://papers.ssrn.com/1sol3/papers.cfm?abstract_id=797325); John C. Coffee, *Ratings Reform: The Good, The Bad, and The Ugly*, The Center for Law and Economic Studies – Columbia University School of Law Columbia Law and Economics Working Paper No. 359, Sept. 2010 at 54).

Charging issuers to be rated earned profits for the CRAs,¹⁰⁸ provided information to investors, and enabled issuers to sell their products,¹⁰⁹ but it also introduced conflicts of interest.¹¹⁰ The agencies charged the issuers for their ratings, and then disseminated their assessments to the public for free.¹¹¹ The three dominant agencies in the West, Standard & Poor's, Moody's Investors Service, and Fitch Ratings, have depended on issuers for roughly 90% of their revenues.¹¹² "Clearly the rating agencies skewed their assessments to please their clients," Paul Krugman wrote in the New York Times in 2010.¹¹³

Others have shared Krugman's concern.¹¹⁴ In the wake of the crisis, evidence of inaccurate ratings emerged. Regulators in the U.S. and in Europe sought to remedy the conflicts, stressing that investor confidence in the financial markets depended on their belief in the accuracy of the ratings.¹¹⁵

B. Egregious Behavior: "Market Share, Market Share, Market Share"¹¹⁶

"[A] rating, which is supposed to be an honest, objective, independent assessment of the likelihood of an investment paying off . . . is not performing that function when you have this kind of pressure on people to rate a certain way in terms of their own pay," Senator Carl Levin said in April 2010, in the opening statement of a Senate Subcommittee investigation of the

¹⁰⁸ See rest of paragraph, below.

¹⁰⁹ See previous paragraph, above.

¹¹⁰ See rest of paragraph, below.

¹¹¹ Securities Exchange Commission, *2011 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization*, (2011), available at http://www.sec.gov/news/studies/2011/2011_nrsro_section15e_examinations_summary_report.pdf ("Of the ten registered NRSROs, seven—including the three larger NRSROs—operate predominantly under the issuer-pay model."); Lynn Bai, *On Regulating Conflict of Interests in the Credit Rating Industry*, 13 N.Y.U. J. Legis. & Pub. 253, 295 (2010) (explaining that CRAs generally provide the information to the public "free of charge").

¹¹² Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifan Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 373 (2010).

¹¹³ Paul Krugman, *Berating the Raters*, N.Y. TIMES, Apr. 26, 2010, at A23, available at <http://www.nytimes.com/2010/04/26/opinion/26krugman.html?dbk>.

¹¹⁴ See, e.g., Joseph E. Stiglitz, *Capitalist Fools*, VANITY FAIR, Jan. 2009.

¹¹⁵ The President's Working Group on Financial Markets, *Policy Statement on Market Developments*, March, 2008, at 2, 4, 14-15, available at http://www.naic.org/documents/committees_e_rating_agency_comdoc_presidents_wg.pdf; House of Lords, European Union Committee, *The Future of EU Financial Regulation and Supervision* (14th Report of Session 2008-09 Vol 1) HL Paper 106-I, at 17 ("DG Markt explained that the regulation of rating agencies is a necessary reaction to their 'massive failures' revealed by the financial crisis. They described the conflicts of interest created when the issuers of a securitised bond pays for a rating, rather than the investor.").

¹¹⁶ Statement of Senator Carl Levin, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies*, Second Session, Volume 3, April 23, 2010, available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57321/html/CHRG-111shrg57321.htm>.

financial crisis.¹¹⁷ The testimony that followed, along with information uncovered by the Securities and Exchange Commission (“SEC”), the European Commission, and the British House of Lords, depicted an industry whose actions had jeopardized the stability of the global economy.¹¹⁸ This part examines the evidence that the agencies inflated ratings to increase their profits.

1. Senate Subcommittee Investigation

Evidence presented at the Senate investigation revealed deliberate inaccuracies in ratings.¹¹⁹ “Sold some more crap to Pursuit,” an analyst at the investment bank UBS wrote in an internal email, in reference to securities that had earned a high, “investment-grade” rating.¹²⁰ “Version 6.0 [of the ratings model] could’ve been released months ago and resources assigned elsewhere if we didn’t have to massage the sub-prime and Alt-A numbers to preserve market share,” an analyst at Standard & Poor’s wrote in another.¹²¹

Clients had appeared to assume that they could demand higher ratings, either by purchasing them outright or by providing the agencies with false information.¹²² An investment banker at Merrill Lynch implied that he expected higher fees to buy more favorable ratings: “We are okay with the revised fee . . . under the assumption that it will not be a precedent for any future deals and that you will work with us further on this transaction to try and get to some middle ground with respect to the ratings,” he said in an email to an analyst at Moody’s.¹²³ An analyst at

¹¹⁷ Senator Carl Levin, Opening Statement before the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies*, Apr. 23, 2010.

¹¹⁸ See Section II.B.1, 2, 3, below.

¹¹⁹ See rest of paragraph, below.

¹²⁰ See email quoted by Senator Carl Levin, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies*, Second Session, Volume 3, Apr. 23, 2010, available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57321/html/CHRG-111shrg57321.htm>; Steven Schwarcz, *Disintermediating Avarice: A Legal Framework For Commercially Sustainable Microfinance*, 2011 U. Ill. L. Rev. 1165, 1195 (2011) (“The higher the rating, the lower the rating agency has assessed the credit risk”).

¹²¹ Email quoted by Senator Carl Levin, *Opening Statement before the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, ‘Wall Street and the Financial Crisis: The Role of Credit Rating Agencies,’* Second Session, Volume 3, April 23, 2010, available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57321/html/CHRG-111shrg57321.htm>.

¹²² See rest of paragraph, below.

¹²³ Email quoted by Senator Carl Levin, *Opening Statement before the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, ‘Wall Street and the Financial Crisis: The Role of Credit Rating Agencies,’* Second Session, Volume 3, April 23, 2010, available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57321/html/CHRG-111shrg57321.htm>.

Standard & Poor's appeared to indicate that the agency had agreed to rate fake data.¹²⁴ "The 25ish assets that they included in our closing date portfolio that were dummies were replaced in less than 24 hours with assets that would have been notched and made the portfolio worse," he wrote.¹²⁵

The agencies' compensation structures encouraged the analysts to acquiesce.¹²⁶ "Most employees owned either a lot of options or restricted stock in the company, as well as the profitability of the group did influence the size of the bonus, yes," the former head of the structured products group at Moody's, Eric Kolchinsky, testified.¹²⁷ Moreover, the importance of maintaining revenues appeared to increase over time.¹²⁸ A former vice president and senior credit officer at Moody's, Richard Michalek, described "a revision . . . where a larger percentage of our compensation [depended on] whether or not we were reaching our revenue numbers on a quarterly and annual basis which would allow us to, maximize our – or max out our bonuses."¹²⁹

The Senate testimony seemed to demonstrate that the CRAs continued to boost their ratings in order to preserve market share, even in the midst of the crisis.¹³⁰ "Despite the . . . market implosion we were witnessing, it appeared to me that my manager was more concerned about losing a few points of market share than about violating the law," the former Moody's executive, Eric Kolchinsky, said.¹³¹ He elaborated:

Managers of rating groups were expected by their supervisors to build, or at least maintain, market share. It was an unspoken understanding that loss of market share would cause a manager to lose his or her job.

¹²⁴ See, e.g., email quoted by Senator Carl Levin, *Opening Statement before the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, 'Wall Street and the Financial Crisis: The Role of Credit Rating Agencies,'* Second Session, Volume 3, April 23, 2010, available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57321/html/CHRG-111shrg57321.htm> ("The documents show how investment bankers argued with the credit rating analysts, substitute worse assets at the last minute, and pressured analysts to waive their procedures and standards.").

¹²⁵ Id.

¹²⁶ See rest of paragraph, below.

¹²⁷ Statement of Eric Kolchinsky, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies,* Second Session, Volume 3, April 23, 2010, available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57321/html/CHRG-111shrg57321.htm>.

¹²⁸ See Statement of Richard Michalek, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies,* Second Session, Volume 3, April 23, 2010, available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57321/html/CHRG-111shrg57321.htm>.

¹²⁹ Id.

¹³⁰ See rest of paragraph, below.

¹³¹ Statement of Eric Kolchinsky, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies,* Second Session, Volume 3, April 23, 2010, available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57321/html/CHRG-111shrg57321.htm>.

*Senior management would periodically distribute emails detailing their departments' market share. . . .
Colleagues have described enormous pressure when their market shares dipped.*¹³²

2. Securities and Exchange Commission Staff Examinations

The information that emerged in the Senate tracked the findings of an SEC examination of selected CRAs.¹³³ The SEC investigation suggested that analysts at the agencies knew about revenues and raised their ratings in order to increase them.¹³⁴

The SEC had observed that analysts at the CRAs participated in fee negotiations and allowed the discussions to influence the ratings that they assigned.¹³⁵ “Analysts appeared to be aware, when rating an issuer,” the Commission report stated, “of the ratings’ agency’s business interest in securing the rating of the deal.”¹³⁶ Clients that pressed for higher ratings “could influence the rating agencies’ decisions on whether to update a model when such an update would lead to a less favorable outcome,” the report continued.¹³⁷

The SEC based its findings on internal emails that emphasized the pressure to sacrifice accuracy in order to maintain profits.¹³⁸ “We are meeting with your group this week to discuss adjusting criteria for rating CDOs of real estate assets . . . because of the ongoing threat of losing deals,” one internal email said.¹³⁹ “Aspects of the firm’s ratings methodology w[ill] have to be revisited to recapture market share from the competing rating agency,” stated another.¹⁴⁰ “[L]et’s hope we are all wealthy and retired by the time this house of cards falters,” an analyst responded.¹⁴¹

¹³² *Id.*

¹³³ See rest of section, below.

¹³⁴ Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008, at 25, available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> (“Rating agencies do not appear to take steps to prevent considerations of market share and other business interests from the possibility that they could influence ratings or ratings criteria.”).

¹³⁵ See rest of paragraph, below.

¹³⁶ Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008, at 24, available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

¹³⁷ *Id.*

¹³⁸ See rest of paragraph, below.

¹³⁹ Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008, at 26, available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

¹⁴⁰ *Id.*

¹⁴¹ Quoted in Lynne L. Dallas, *Short-Termism, The Financial Crisis, And Corporate Governance*, 37 J. Corp. L. 265, 340 (2012).

3. European Studies

Evidence that conflicts of interest from the “issuer-pays” model produced inaccurate ratings also surfaced in Europe.¹⁴² A 2008 survey discussed in the European Commission indicated that 11% of the members of a professional society of financial analysts, the Chartered Financial Analysts Institute, had “witnessed a CRA changing a rating as a consequence of pressure or influence from an investor, issuer or underwriter.”¹⁴³ Members of the British House of Lords described “miscalculation” of risks because of “flaws in the methodologies of rating agencies” at a 2008 hearing.¹⁴⁴ The problems had been “exacerbated by conflicts of interests caused by the originator ... purchasing the rating,” they concluded.¹⁴⁵

C. Getting Here: “How Can You Miss So Badly”¹⁴⁶

Conflicts of interest did not always compromise the CRAs.¹⁴⁷ This part describes the agencies’ shift from charging investors to charging issuers and the power that they gained in the absence of strict regulation.¹⁴⁸ It then explains how the introduction of securitized financial products intensified their conflicts of interest.¹⁴⁹ The new products produced three changes: they offered the agencies higher profits¹⁵⁰ and less need for accuracy,¹⁵¹ as well as fewer potential clients over whom to compete.¹⁵²

¹⁴² See rest of paragraph, below.

¹⁴³ See Harry McVea, *Credit Rating Agencies, the Subprime Mortgage Debacle and Global Governance: the EU Strikes Back*, 59 *Internat’l and Comp. L. Quarterly* 701, 713 (2010).

¹⁴⁴ House of Lords, *European Union Committee, The Future of EU Financial Regulation and Supervision*, 14th Report of Session 2008–09 Vol 1, HL Paper 106–I, at 8.

¹⁴⁵ *Id.*

¹⁴⁶ Statement of Senator Kaufman, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies*, Apr. 23, 2010.

¹⁴⁷ Stéphane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: the Case for a Disclosure-Based Approach*, 2005 at 11, available at http://papers.ssrn.com/1sol3/papers.cfm?abstract_id=797325.

¹⁴⁸ See Sections II.C.1, 2 below.

¹⁴⁹ See, e.g., John C. Coffee, *Ratings Reform: The Good, The Bad, and The Ugly*, The Center for Law and Economic Studies – Columbia University School of Law Columbia Law and Economics Working Paper No. 359, September 2010 (“the conflicts were stronger and the prospects for ratings arbitrage greater in the case of structured finance.”).

¹⁵⁰ See, e.g., Lynne L. Dallas, *Short-Termism, The Financial Crisis, And Corporate Governance*, 37 *J. Corp. L.* 265, 289, 340 (2012).

¹⁵¹ See, e.g., Opening statement of Henry Waxman, Congressional Committee on Oversight and Governmental Reform Hearing, *Credit Rating Agencies and the Financial Crisis*, Oct. 22, 2008, available at

1. Adopting “Issuer Pays” Without New Regulation

Changes in technology, coupled with the rising influence of the CRAs, triggered the shift to the “issuer-pays” model.¹⁵³ At the turn of the century, investors paid the CRAs.¹⁵⁴ Cheap photocopying began to enable them to access the ratings for free.¹⁵⁵ The default of the railroad company Penn Central motivated issuers to seek ratings from the agencies, in order to reassure potential investors of their solvency.¹⁵⁶ The agencies then began to charge the issuers.¹⁵⁷

A small group of CRAs gained power but remained free of direct regulation.¹⁵⁸ In 1975, the SEC recognized the existing agencies, as official Nationally Recognized Statistical Rating Organizations (“NRSROs”).¹⁵⁹ The new status restricted entrance to the industry.¹⁶⁰ In 2001, the agencies maintained high ratings for financial products issued by Enron, even though they

<http://oversight.house.gov/story.asp?ID=2250> (“These new financial inventions were so complex that virtually no one really understood them”).

¹⁵² See, e.g., Claire Hill, *Limits Of Dodd-Frank's Rating Agency Reform*, 31 Banking & Fin. Services Pol'y Rep. 13, 16 (2012) (describing “close relational ties”).

¹⁵³ See rest of paragraph, below.

¹⁵⁴ D. Andrew Hatchett, *Sox It To 'Em: Using Sarbanes-Oxley As A Model For Regulating Conflicts Of Interest In The Credit Rating Industry*, 63 Ala. L. Rev. 407, 425 (2012). Moody's first graded railroad bonds, and the information increased the number of people that bought them, (see Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, Council of Institutional Investors White Paper, Apr. 2009 at 4). By the 1920s, Moody's charged investors for ratings of most of the bond market, (see Timothy J. Sinclair, *Credit Rating Agencies and the Global Financial Crisis*, 12 Economic Sociology, 2010 at 5, available at http://econsoc.mpifg.de/archive/econ_soc_12-1.pdf).

¹⁵⁵ Financial Economists Roundtable, *Statement on Reforming the Role of the Statistical Ratings Organizations in the Securitization Process*, Dec. 1, 2008 at 4, available at <http://fic.wharton.upenn.edu/fic/policy%20page/FER12%201%2008rev.pdf>.

¹⁵⁶ Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: the Case for a Disclosure-Based Approach*, 2005 at 11, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=797325; Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifan Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 373 (2010).

¹⁵⁷ Aline Darbellay and Frank Portnoy, *Credit Rating Agencies Under The Dodd-Frank Act*, 30 No. 12 Banking & Fin. Services Pol'y Rep. 1, 2 (2011).

¹⁵⁸ Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifan Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 363 (2010)

¹⁵⁹ Claire Hill, *Limits Of Dodd-Frank's Rating Agency Reform*, 31 Banking & Fin. Services Pol'y Rep. 13, 16 (2012).

¹⁶⁰ Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifan Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 372 (2010); Financial Economists Roundtable, *Statement on Reforming the Role of the Statistical Ratings Organizations in the Securitization Process*, Dec. 1, 2008 at 6, available at <http://fic.wharton.upenn.edu/fic/policy%20page/FER12%201%2008rev.pdf> (“From 1975 to 2002, although the SEC received numerous applications from entities in the United States and abroad, only one new general purpose NRSRO was approved.”). For the argument that barriers to entry existed even before the SEC established the NRSRO designation, see Financial Economists Roundtable, *Statement on Reforming the Role of the Statistical Ratings Organizations in the Securitization Process*, Dec. 1, 2008 at 3, available at <http://fic.wharton.upenn.edu/fic/policy%20page/FER12%201%2008rev.pdf>.

had identified weaknesses in the company's financial statements.¹⁶¹ They lowered their ratings only four days before Enron entered bankruptcy.¹⁶² The SEC imposed no new rules in response to the Senate's call for "meaningful SEC oversight,"¹⁶³ though it predicted that the "issuer-pays" model would cause the agencies to "rate issuers more liberally and temper their diligence."¹⁶⁴ In 2006, Congress reversed course and barred the SEC from regulating "the substance of the credit ratings or the procedures and methodologies" that the agencies used.¹⁶⁵

The CRAs also encountered limited regulation outside of the U.S.¹⁶⁶ The Enron scandal prompted foreign officials to review their policies, but they decided to continue their reliance on self-regulation.¹⁶⁷ The International Organization of Securities Commissions ("IOSCO") drafted a voluntary code of conduct without a mechanism for enforcement.¹⁶⁸ In 2006, the Committee of European Securities Regulators ("CESR") advised the European Commission to adopt a "wait and see" approach to regulating the agencies.¹⁶⁹ The CESR monitored compliance with IOSCO's code of conduct and reported its findings annually to the Commission.¹⁷⁰ The Commission supported the rights of companies to deviate from the code, so long as they disclosed it.¹⁷¹

¹⁶¹ Andrew Hatchett, *Sox It To 'Em: Using Sarbanes-Oxley As A Model For Regulating Conflicts Of Interest In The Credit Rating Industry*, 63 Ala. L. Rev. 407, 407-08 (2012).

¹⁶² Claire Hill, *Limits Of Dodd-Frank's Rating Agency Reform*, 31 Banking & Fin. Services Pol'y Rep. 13, 13 (2012).

¹⁶³ Quoted in opening Statement of Representative Henry Waxman, Congressional Committee on Oversight and Governmental Reform Hearing, *Credit Rating Agencies and the Financial Crisis*, Oct. 22, 2008, available at <http://oversight.house.gov/story.asp?ID=2250>.

¹⁶⁴ Quoted in D. Andrew Hatchett, *Sox It To 'Em: Using Sarbanes-Oxley As A Model For Regulating Conflicts Of Interest In The Credit Rating Industry*, 63 Ala. L. Rev. 407, 418-19 (2012).

¹⁶⁵ The Rating Agency Reform Act, enacted on Sept. 29, 2006 created a new Section 15E of the Securities Exchange Act of 1934 and provided for some new authority of the SEC, while also explicitly limiting it, *see, e.g.*, Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008, available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>. To the extent that it addressed conflicts of interest, the new Act simply required the agencies to institute written codes of conduct to manage them, *see, e.g.*, D. Andrew Hatchett, *Sox It To 'Em: Using Sarbanes-Oxley As A Model For Regulating Conflicts Of Interest In The Credit Rating Industry*, 63 Ala. L. Rev. 407, 418 (2012).

¹⁶⁶ *See rest of paragraph, below.*

¹⁶⁷ Amadou N.R. Sy, *The Systemic Regulation of Credit Rating Agencies and Rated Markets*, IMF Working Paper, WP/09/129, June 2009 at 7, available at <http://www.imf.org/external/pubs/ft/wp/2009/wp09129.pdf>.

¹⁶⁸ *IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies*, Sept. 25, 2003, available at <http://www.fsa.go.jp/inter/ios/20030930/02.pdf>; Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifan Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 369-70 (2010).

¹⁶⁹ Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifan Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 B.F.L.R. 361, 368-69 (2010).

¹⁷⁰ John C. Coffee, *Ratings Reform: The Good, The Bad, and The Ugly*, The Center for Law and Economic Studies – Columbia University School of Law Columbia Law and Economics Working Paper No. 359, Sept. 2010 at 22.

¹⁷¹ *Id.*

2. Securitization and Increased Competition

The advent of securitization seemed to exacerbate the conflicts of interest that the “issuer-pays” model produced.¹⁷² The term “securitization” refers to the process by which rights to future loan repayments were: 1) separated from the risk that the borrowers might not pay; 2) grouped together; and 3) sold to other investors in portions, or “tranches.”¹⁷³ Investment banks, the “issuers,” pooled the rights to repayment and divided them according to the underlying risk that the borrowers would default.¹⁷⁴

The issuers paid the CRAs for ratings when each tranche sold,¹⁷⁵ which encouraged the agencies to inflate scores to make them more marketable.¹⁷⁶ In 2008, 64,000 separate tranches of securitized debt earned triple-A ratings, compared to only 12 companies worldwide.¹⁷⁷ The issuers re-pooled riskier tranches with additional assets, then sought higher ratings for the new combinations.¹⁷⁸

Because the CRAs charged more to rate the securitized products than they could for traditional debt, the importance of retaining clients increased.¹⁷⁹ Agencies could earn more than \$200,000 for complex ratings.¹⁸⁰ Moody’s graded 9,029 mortgage-backed securities triple-A, the equivalent of 30 products per day, while awarding the same score to only four traditional

¹⁷² See rest of section, below.

¹⁷³ Steven Schwarcz, *The 2011 Diane Sanger Memorial Lecture Protecting Investors In Securitization Transactions: Does Dodd-Frank Help, Or Hurt?*, 72 La. L. Rev. 591, 591 (2012); *Code of Conduct Fundamentals for Credit Rating Agencies*, May 2008 at 4, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf>.

¹⁷⁴ See, e.g., Testimony of Eric Stein, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies* Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess., Apr. 22, 2008 at 17.

¹⁷⁵ Id.

¹⁷⁶ See, e.g., Statement of Raymond McDaniel, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies*, Second Session, Volume 3, April 23, 2010, available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57321/html/CHRG-111shrg57321.htm>; Steven Schwarcz, *Disintermediating Avarice: A Legal Framework For Commercially Sustainable Microfinance*, 2011 U. Ill. L. Rev. 1165, 1195 (2011).

¹⁷⁷ Remarks by Lloyd C Blankfein, Chairman and CEO, The Goldman Sachs Group, Inc., Council of Institutional Investors Spring Meeting, Apr. 7, 2009, available at <http://www2.goldmansachs.com/ideas/public-policy/speech.pdf>.

¹⁷⁸ See, e.g., Testimony of Eric Stein, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies* Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess., Apr. 22, 2008 at 17.

¹⁷⁹ See, e.g., Financial Economists Roundtable, *Statement on Reforming the Role of the Statistical Ratings Organizations in the Securitization Process*, Dec. 1, 2008 at 5, available at <http://fic.wharton.upenn.edu/fic/policy%20page/FER12%201%2008rev.pdf>.

¹⁸⁰ Testimony of Eric Stein, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies* Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess., Apr. 22, 2008 at 18.

issuers.¹⁸¹ Within seven years, Moody's profits increased four-fold, and its stock price rose 500%.¹⁸² It had the highest net revenues of any company listed on one index of publicly-traded businesses for five consecutive years.¹⁸³

The source of the new revenues concentrated among only a few issuers, which increased their leverage over the CRAs.¹⁸⁴ Twelve issuers controlled nearly 80% of the market, and six accounted for half of it.¹⁸⁵ The complexity of the products made ratings more variable,¹⁸⁶ and the issuers appeared to shop among agencies for the highest grades.¹⁸⁷

The complexity of the products also made inaccurate ratings seem easier to conceal, and the CRAs stopped updating scores.¹⁸⁸ While public financial disclosures provided a test of the quality of traditional bond ratings, the new products had no comparable performance records.¹⁸⁹

¹⁸¹ Phil Angelides, Opening Remarks before the Financial Crisis Inquiry Commission, Hearings & Testimony, *Credibility of Credit Ratings, the Investment Decisions Made Based on those Ratings, and the Financial Crisis*, June 2, 2010 at 1.

¹⁸² Opening Statement of Representative Henry Waxman, Congressional Committee on Oversight and Governmental Reform Hearing, *Credit Rating Agencies and the Financial Crisis*, Oct. 22, 2008, available at <http://oversight.house.gov/story.asp?ID=2250>.

¹⁸³ Opening Statement of Representative Henry Waxman, Congressional Committee on Oversight and Governmental Reform Hearing, *Credit Rating Agencies and the Financial Crisis*, Oct. 22, 2008, available at <http://oversight.house.gov/story.asp?ID=2250>.

¹⁸⁴ Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008, at 32, available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> (The combination of the arrangers' influence in determining the choice of rating agencies and the high concentration of arrangers with this influence appear to have heightened the inherent conflicts of interest that exist in the 'issuer pays' compensation model.").

¹⁸⁵ John C. Coffee, *Ratings Reform: The Good, The Bad, and The Ugly*, The Center for Law and Economic Studies – Columbia University School of Law Columbia Law and Economics Working Paper No. 359, Sept. 2010 at 9; further Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008, at 32, available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

¹⁸⁶ See, e.g., Adam J. Levitin, Susan M. Wachter, *Explaining The Housing Bubble*, 100 Geo. L.J. 1177, 1236-37 (2012).

¹⁸⁷ see, e.g., Lynne L. Dallas, *Short-Termism, The Financial Crisis, And Corporate Governance*, 37 J. Corp. L. 265, 289-90 (2012); Testimony of Jerome Fons, Congressional Committee on Oversight and Governmental Reform Hearing, *Credit Rating Agencies and the Financial Crisis*, Oct. 22, 2008 at, available at <http://oversight.house.gov/story.asp?ID=2250>; House of Lords, European Union Committee, *The Future of EU Financial Regulation and Supervision*, 14th Report of Session 2008–09 Vol 1, HL Paper 106–I, at 17 ("... encouraging the issuer to go 'from one [rating agency] to another until they got the rating for the securitised product they wanted.'").

¹⁸⁸ See, e.g., Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008 at 32, available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

¹⁸⁹ Testimony of John C. Coffee, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies*, Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess., Apr. 22, 2008 at 3-4, 10-11; *Report of the Financial Stability Forum on Enhancing market and Institutional Resilience*, Apr. 7 2008 at 33, available at http://www.financialstabilityboard.org/publications/r_0804.pdf; Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008 at 35, available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

Since revenues determined bonuses,¹⁹⁰ and legal immunity protected analysts from liability,¹⁹¹ the agencies left in place models that underestimated risks.¹⁹²

The CRAs waited more than a year to revise their ratings to reflect disturbances in the mortgage markets.¹⁹³ Though the agencies warned of problems in 2006, they continued to award triple-A ratings to mortgage-backed securities.¹⁹⁴ Eventually, Moody's downgraded 83% of its triple-A scores during a six-month period,¹⁹⁵ and Standard & Poor's lowered more than two-thirds of its investment-grade ratings.¹⁹⁶

*D. Blaming the CRAs: "A Watchdog Paid By the Persons They Are to Watch"*¹⁹⁷

Blame for the recent financial crisis crystallized around the CRAs' "issuer-pays" model,¹⁹⁸ and not their role as financial "gatekeepers."¹⁹⁹ "There has got to be a way that the regulators are

¹⁹⁰ Testimony of Eric Stein, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies*, Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess., Apr. 22, 2008 at 17.

¹⁹¹ Judicial opinions have found ratings to be "opinions" protected by the First Amendment, see, e.g. *Jefferson County School District No. R-1 v Moody's Investor's Services Inc.*, 175 F.3d 848, 852-856 (10th Cir. 1999), *In re Enron Corp. Securities Derivative & 'ERISA' Litigation*, 511 F. Supp. 2d 742, 752 (S.D. Tex. 2005); The high pleading standards imposed by the Private Securities Litigation Reform Act of 1995 have also protected the CRAs from responsibility, see, e.g., Testimony of John C. Coffee, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies*, Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess. (April 22, 2008) at 1-2.

¹⁹² Testimony of John C. Coffee, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies*, Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess., Apr. 22, 2008 at 3. Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008, at 26, available at

<http://www.sec.gov/news/studies/2008/craexamination070808.pdf> ("Another rating agency reported to the Staff that one of its foreign ratings surveillance committees had knowledge that the rating agency had issued ratings on almost a dozen securities using a model that contained an error."); *Id.* at 32; Statement of Frank Raiter, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies*, Second Session, Volume 3, April 23, 2010, available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57321/html/CHRG-111shrg57321.htm> ("the order came to start doing impact analysis on the effectiveness new models had on market share."); Aline Darbellay and Frank Portnoy, *Credit Rating Agencies Under The Dodd-Frank Act*, 30 No. 12 Banking & Fin. Services Pol'y Rep. 1, 3 (2011).

¹⁹³ Testimony of Jerome S. Fons, Congressional Committee on Oversight and Governmental Reform Hearing, *Credit Rating Agencies and the Financial Crisis*, Oct. 22, 2008 at 2, available at <http://oversight.house.gov/story.asp?ID=2250>.

¹⁹⁴ See, e.g., Jules Stewart, *Subprime to the Ridiculous*, FINANCIAL DIRECTOR, Sept. 24 2007, available at <http://www.financialdirector.co.uk/financial-director/analysis/1744125/sub-prime-ridiculous>.

¹⁹⁵ Aline Darbellay and Frank Portnoy, *Credit Rating Agencies Under The Dodd-Frank Act*, 30 No. 12 Banking & Fin. Services Pol'y Rep. 1, 2 (2011).

¹⁹⁶ Opening statement of Henry Waxman, Congressional Committee on Oversight and Governmental Reform Hearing, "Credit Rating Agencies and the Financial Crisis," Oct. 22, 2008, available at <http://oversight.house.gov/story.asp?ID=2250> at 1.

¹⁹⁷ Testimony of John C. Coffee, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies*, Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess. (April 22, 2008) at 2.

going to find to eliminate this conflict of interest,” Senator Levin said when he opened the Senate investigation of the crisis.²⁰⁰ Europe and the U.S. supported regulations for neutralizing the conflicts, while leaving the agencies’ function unchanged.²⁰¹

The EU reversed its earlier decision to rely on self-regulation and drafted new mandatory rules.²⁰² “CRAs will have to comply with exacting regulatory requirements to make sure ratings are not tainted by the conflicts of interest inherent to the ratings business,” European Commissioner Charles McCreevey said.²⁰³ “The crisis has shown that self-regulation has not worked.”²⁰⁴ The legislation established a European authority over the agencies²⁰⁵ and imposed several requirements.²⁰⁶ Registered agencies must now publicize their conflicts of interest and demonstrate that they have not affected ratings. Analysts may not participate in fee negotiations²⁰⁷ or earn income based on revenues.²⁰⁸ The analysts must also rotate responsibility within their agencies for rating individual issuers.²⁰⁹

U.S. regulators restricted similar behaviors and tried, but failed, to abolish the “issuer-pays” model.²¹⁰ The new SEC Rule 17g-5 opened the ratings process to greater public scrutiny and restricted analysts from a range of conflicts-producing activities.²¹¹ The Dodd-Frank Act,²¹²

¹⁹⁸ See, e.g., Mary Schapiro, Address to Practising Law Institute's “SEC Speaks in 2009,” Program, February 6, 2009, available at <http://www.sec.gov/news/speech/2009/spch020609mls.htm> (“I hope to pursue as priorities: Improving the quality of credit ratings by addressing the inherent conflicts of interest credit rating agencies face as a result of their compensation models”).

¹⁹⁹ See, e.g., Timothy J. Sinclair, *Credit Rating Agencies and the Global Financial Crisis*, 12 *Economic Sociology*, 2010 at 4, available at http://econsoc.mpifg.de/archive/econ_soc_12-1.pdf.

²⁰⁰ Senator Carl Levin, Opening Statement before the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies*, Apr. 23, 2010.

²⁰¹ See rest of section, below.

²⁰² Douglas Wayne Arner, Kwong Wing Chau, Berry F.C. Hsu, Frederik Isak Henrik Pretorius, Lifen Pu, *Regulating Credit Rating Agencies in Hong Kong: Lessons from the Global Financial Crisis*, 25 *B.F.L.R.* 361, 379 (2010).

²⁰³ EC Commission, *Consultation by the Commission Services on Credit Rating Agencies*, July 31, 2008, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1224&format=HTML&aged=1&language=EN&guiLanguage=fr>.

²⁰⁴ *Id.*

²⁰⁵ Harry McVea, *Credit Rating Agencies, the Subprime Mortgage Debacle and Global Governance: the EU Strikes Back*, 59 *International and Comparative Law Quarterly* 701, 730 (2010); Regulation (EC) No. 1060/2009 of the European Parliament and of the Council on Credit Rating Agencies; Regulation (EU) No. 513/2011 of the European Parliament and of the Council, amending Regulation (EC) No 1060/2009 on credit rating agencies.

²⁰⁶ Harry McVea, *Credit Rating Agencies, the Subprime Mortgage Debacle and Global Governance: the EU Strikes Back*, 59 *International and Comparative Law Quarterly* 701, 724 (2010).

²⁰⁷ *Id.* at 726.

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ See rest of paragraph, below.

²¹¹ See, e.g., Claire Hill, *Limits Of Dodd-Frank's Rating Agency Reform*, 31 *No. 5 Banking & Fin. Services Pol'y Rep.* 13, 18 (2012).

a package of reforms drafted in response to the crisis, nearly included plans for a Credit Agency Review Board.²¹³ The Board would have selected agencies to rate individual products and would have limited their fees to “reasonable” amounts.²¹⁴ The proposal passed the Senate by a large majority but lost in the House.²¹⁵ The final legislation compromised by calling for the SEC to study the issue.²¹⁶ The compromise “amounts to rearranging the deck chairs on the Titanic, while ignoring the gaping hole created by the iceberg,” one law school professor remarked.²¹⁷

Could blaming the conflicts of interest, however, have diverted the regulators from addressing the more fundamental problem of their reliance on the CRAs as quasi-financial regulators?²¹⁸

III. COUNTER-NARRATIVE: HYMAN MINSKY AND THE ENDOGENEITY OF CRISES

In 2007, a member of the British Parliament that had worked as an economist at a CRA downplayed the conflicts of interest of the agencies.²¹⁹ “The real problem,” he said in an interview, was not the conflicts of interest but the fact that “financial markets fall in love. They fall in love with new things, with innovations, and . . . it is very difficult to assess [their] real riskiness.”²²⁰ The statement sounded like an endorsement of the theories of the late economist Hyman Minsky.²²¹

Minsky’s ideas about the causes of financial crises did not attract attention before he died in 1996.²²² His views paralleled those of John Maynard Keynes, in advocating for government

²¹² 12 U.S.C. §§ 1465-5641; 15 U.S.C. §§ 77z-2a to 8344; and scattered U.S.C. cites; The Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010, <http://dodd-frank.com>.

²¹³ D. Andrew Hatchett, *Sox It To ‘Em: Using Sarbanes-Oxley As A Model For Regulating Conflicts Of Interest In The Credit Rating Industry*, 63 Ala. L. Rev. 407, 425-26 (2012).

²¹⁴ John C. Coffee, *Ratings Reform: The Good, The Bad, and The Ugly*, The Center for Law and Economic Studies – Columbia University School of Law Columbia Law and Economics Working Paper No. 359, Sept. 2010 at 32.

²¹⁵ Claire Hill, *Limits Of Dodd-Frank’s Rating Agency Reform*, 31 No. 5 Banking & Fin. Services Pol’y Rep. 13, 19 (2012); Andrew Ross Sorkin, *Congress Drops Changes for Credit-Rating Agencies*, NEW YORK TIMES DEALBOOK, June 16, 2010.

²¹⁶ Lynne L. Dallas, *Short-Termism, The Financial Crisis, And Corporate Governance*, 37 J. Corp. L. 265, 341 (2012).

²¹⁷ John C. Coffee, *Ratings Reform: The Good, The Bad, and The Ugly*, The Center for Law and Economic Studies – Columbia University School of Law Columbia Law and Economics Working Paper No. 359, Sept. 2010 at 58.

²¹⁸ See, e.g., Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, Council of Institutional Investors White Paper, Apr. 2009 at 3 (“these three agencies wield immense, quasi-governmental power”).

²¹⁹ Charles J. Whalen, *The U.S. Credit Crunch Of 2007: A Minsky, Moment*, Public Policy Brief No. 92, The Levy Economics Institute of Bard College, 2007 at 15.

²²⁰ Quoted in Charles J. Whalen, *The U.S. Credit Crunch Of 2007: A Minsky, Moment*, Public Policy Brief No. 92, The Levy Economics Institute of Bard College, 2007 at 15.

²²¹ No need for footnote – analytical assertion.

²²² See, e.g., José Gabilondo, *Dodd-Frank, Liability Structure, And Financial Instability Cycles: Neither A (Ponzi) Borrower Nor A Lender Be*, 46 Wake Forest L. Rev. 469, 470 (2011)

intervention in financial markets.²²³ Minsky, however, emphasized a sequence of events that he called the “financial instability hypothesis.”²²⁴ He believed that episodes of “euphoria” inevitably followed periods of stability.²²⁵ The “euphoria” caused companies and consumers to acquire increasing amounts of debt.²²⁶ Over time they relied on more speculative financial instruments, until the economy became so fragile that it collapsed.²²⁷ To prevent the collapse, Minsky wrote, public institutions needed to restrict “pro-cyclical behavior” – the volatile behavior that increased naturally with economic growth.²²⁸

In the wake of the most recent crisis, Minsky’s writings have resurfaced, and his financial stability hypothesis has gained notice.²²⁹ This section proposes that Minsky would have found the new restrictions on the CRAs too simplistic because they left responsibility for regulating financial markets in the hands of private “gatekeepers.”²³⁰ The section first explains his theories and endeavors to predict his interpretation of the recent crisis. It then seeks to formulate an alternate response that he would have supported.

A. Minsky’s Theories: The Economy “Generates a Financial Structure ... Susceptible to Financial Crises”²³¹

Minsky theorized that economic crises resulted from volatility that was intrinsic to financial markets.²³² He viewed public regulation as necessary to contain the markets’ susceptibility to

²²³ See, e.g., Michael Syron Lawler, *Minsky and Keynes on Speculation and Finance*, 27 Soc. Sci J. 435, 439, 445 (1990) (discussing the Keynes and Minsky’s views on the necessity of intervention).

²²⁴ See generally Hyman Minsky, *The Financial Instability Hypothesis*, The Jerome Levy Economics Institute of Bard College, Working Paper No. 74, May 1992.

²²⁵ See, e.g., *The Fed Discovers Hyman Minsky*, THE ECONOMIST, Jan. 7, 2010.

²²⁶ See, e.g., Jeffrey N. Gordon and Christopher Muller, *Confronting Financial Crisis: Dodd-Frank’s Dangers And The Case For A Systemic Emergency Insurance Fund*, 28 Yale J. on Reg. 151, 171 (2011).

²²⁷ See, e.g., Id.

²²⁸ Hyman Minsky and Piero Ferri. “Market Processes and Thwarting Systems”, The Jerome Levy Economics Institute of Bard College, Working Paper No. 64, Nov. 1991 at 4 (“institutions and interventions thwart the instability breeding dynamics that are natural to market economies by interrupting the endogenous process”).

²²⁹ See, e.g., Charles J. Whalen, *The U.S. Credit Crunch Of 2007: A Minsky, Moment*, Public Policy Brief No. 92, The Levy Economics Institute of Bard College, 2007 at 17.

²³⁰ Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: the Case for a Disclosure-Based Approach*, 2005 at 14, available at http://papers.ssrn.com/1sol3/papers.cfm?abstract_id=797325. (“CRAs wield influential power over both issuers and investors.”).

²³¹ Hyman Minsky, *The Financial Instability Hypothesis: An Interpretation of Keynes and an Alternative to ‘Standard’ Theory*, CHALLENGE MAGAZINE Mar./Apr., 1977 at 25.

²³² See, e.g., Justin Lahat, *In Time of Tumult, Obscure Economist Gains Currency*, WALL ST. J., Aug. 18, 2007.

bouts of speculation.²³³ In the absence of robust regulation, he believed, collapse would punctuate finite periods of economic stability.²³⁴

The chain of events that he described began with excessive borrowing.²³⁵ Stability would breed its own destruction by encouraging too much risk-taking.²³⁶ Specifically, he predicted that profitable companies would seek new loans in order to grow.²³⁷ Initially, the investments would increase the profits that they earned.²³⁸

Next, Minsky expected that reports of the profits would fuel more widespread participation.²³⁹ Additional companies would demand loans.²⁴⁰ While the expansionary period lasted, the companies with the highest leverage would reap the biggest rewards.²⁴¹

Subsequently, Minsky predicted, the political system would adapt to validate the behavior.²⁴² Profitable borrowers would donate to sympathetic politicians, or engage lobbyists to promote their interests.²⁴³ The public would interpret profitability as evidence of expertise and vote for deregulation.²⁴⁴ As support for growth permeated the public discourse, few would question the instability that was building.²⁴⁵

In the following stage, the economy would grow more fragile as a rising “euphoria”²⁴⁶ drove more companies and households to borrow.²⁴⁷ Banks and other financial intermediaries

²³³ See, e.g., Hyman Minsky and Piero Ferri, “Market Processes and Thwarting Systems”, The Jerome Levy Economics Institute of Bard College, Working Paper No. 64, Nov. 1991 at 4 (“in a world where the internal dynamics imply instability, a semblance of stability can be achieved or sustained by introducing conventions, constraints, and interventions into the environment.”).

²³⁴ See, e.g., Jan Kregel, *Regulating The Financial System In A Minskyian Perspective*, remarks prepared for the conference “Financial Stability and Growth,” Phase 3 of the Ford Foundation project: “Growth with Financial Stability and New Developmentalism” organised by the Centre for Structuralist Development Macroeconomics of the São Paulo School of Economics of Getulio Vargas Foundation, São Paulo, Mar. 22-23, 2012 at 1, available at http://cemacro.fgv.br/sites/cemacro.fgv.br/files/Panel%204%20-%20Jan%20Kregel_0.pdf.

²³⁵ See, e.g., Lynne L. Dallas, *Short-Termism, The Financial Crisis, And Corporate Governance*, 37 J. Corp. L. 265, 294 (2012).

²³⁶ See, e.g., Justin Lahat, *In Time of Tumult, Obscure Economist Gains Currency*, WALL ST. J., Aug. 18, 2007.

²³⁷ See, e.g. Víctor A. Beker, *Rethinking Macroeconomics In The Light Of The Financial Crisis*, Oct. 20, 2011 at 7, available at <http://ssrn.com/abstract=1946867>.

²³⁸ See, e.g., Id.

²³⁹ See, e.g., Michael Syron Lawler, *Minsky and Keynes on Speculation and Finance*, 27 Soc. Sci J. 435, 439, 445 (1990).

²⁴⁰ See, e.g., Id.

²⁴¹ See, e.g., Lynne L. Dallas, *Short-Termism, The Financial Crisis, And Corporate Governance*, 37 J. Corp. L. 265, 294 (2012).

²⁴² See, e.g., Jeffrey N. Gordon and Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers And The Case For A Systemic Emergency Insurance Fund*, 28 Yale J. on Reg. 151, 178 (2011).

²⁴³ Id.

²⁴⁴ Id.

²⁴⁵ Id.

²⁴⁶ See, e.g., Hyman Minsky, *STABILIZING AN UNSTABLE ECONOMY* xxi (1986); Louis Uchitelle, *H. P. Minsky, 77, Economist Who Decoded Lending Trends*, N.Y. TIMES, Oct. 26, 1996.

would create speculative financial products in order to satisfy the demand.²⁴⁸ “The introduction of additional layering of finance, together with the invention of new instruments . . . is evidence . . . of the increased fragility of the system,” Minsky wrote.²⁴⁹

Eventually, the amount of outstanding debt would push the system towards collapse. Those intent on maximizing their leverage would not save enough money to repay the loans.²⁵⁰ “A reduction in the margins of safety means that much more debt than before can be carried by an expected cash flow,” Minsky explained.²⁵¹ The companies and households would raise money to cover payments due on their debts through additional borrowing.²⁵² They would “increase [their] outstanding debt in order to meet [their] financial obligations,” he wrote.²⁵³

In the end, the sequence of meeting obligations with new debt would break down.²⁵⁴ “After an initial interval, the basic disequilibrating [sic] tendencies of capitalist finance will once again push the financial structure to the brink of fragility,” Minsky wrote.²⁵⁵ Ultimately, it would become apparent that some of the borrowers had overextended themselves.²⁵⁶ Lenders would cease offering them credit, and they would have to sell assets to raise money to pay back their outstanding loans.²⁵⁷

The cycle would then progress to a crisis.²⁵⁸ As more borrowers had to sell assets, too many assets would flood the market, and the oversupply would depress prices.²⁵⁹ As Minsky explained, “units with cash flow shortfalls will be forced to try to make position by selling out

²⁴⁷ See, e.g., Jan Kregel, *The Natural Instability of Financial Markets*, The Ideas Working Paper Series, Paper No. 04/2009, 2009 at 3, available at http://www.networkideas.org/working/jun2009/04_2009.pdf; see also John Cassidy, *The Minsky Moment*, THE NEW YORKER, Feb. 4, 2008 (“As boom leads to euphoria, Minsky said, banks and other commercial lenders extend credit to ever more dubious borrowers, often creating new financial instruments to do the job.”).

²⁴⁸ See, e.g., Lynne L. Dallas, *Short-Termism, The Financial Crisis, And Corporate Governance*, 37 J. Corp. L. 265, 294 (2012).

²⁴⁹ Hyman Minsky, *STABILIZING AN UNSTABLE ECONOMY* 97 (1986).

²⁵⁰ See, e.g. See, e.g. Víctor A. Beker, *Rethinking Macroeconomics In The Light Of The Financial Crisis*, Oct. 20, 2011 at 7, available at <http://ssrn.com/abstract=1946867>.

²⁵¹ Hyman Minsky, *The Evolution of Financial Institutions and the Performance of the Economy*, 20 J. Econ. Issues 345, 350 (198).

²⁵² See, e.g. Víctor A. Beker, *Rethinking Macroeconomics In The Light Of The Financial Crisis*, Oct. 20, 2011 at 7, available at <http://ssrn.com/abstract=1946867>.

²⁵³ Hyman Minsky, *Banking and a Fragile Financial Environment*, Paper prepared for the American Economics Association meetings, Sept. 16, 1976 at 5.

²⁵⁴ See rest of paragraph, below.

²⁵⁵ Hyman Minsky, *Stabilizing an Unstable Economy* 370 (1986).

²⁵⁶ See, e.g., Charles J. Whalen, *Rethinking Economics For A New Era Of Financial Regulation: The Political Economy Of Hyman Minsky*, 15 Chap. L. Rev. 149, 154 (2011).

²⁵⁷ See, e.g., Charles J. Whalen, *Rethinking Economics For A New Era Of Financial Regulation: The Political Economy Of Hyman Minsky*, 15 Chap. L. Rev. 149, 154 (2011).

²⁵⁸ See, e.g., Justin Lahat, *In Time of Tumult, Obscure Economist Gains Currency*, WALL ST. J., Aug. 18, 2007.

²⁵⁹ See, e.g., Id.

position. This is likely to lead to a collapse of asset values."²⁶⁰ In time, the assets would not be worth enough to pay back the loans, and the central bank would have to decide whether to intervene on behalf of the lenders.²⁶¹

B. Predicting Minsky's Reaction to Regulating Credit Rating Agencies: "No Simple Answer to the Problems of our Capitalism"²⁶²

Minsky's theories offered an alternate explanation for the crisis.²⁶³ The "financial instability hypothesis" seemed to suggest that focusing on a discrete shortcoming of the CRAs failed to address the systemic tendency towards collapse.²⁶⁴ Eliminating conflicts of interest may have achieved accuracy in ratings.²⁶⁵ It would not, however, prevent volatility, because it left the agencies in charge of regulating the markets.²⁶⁶ This part extrapolates from his writings a possible interpretation of recent events.

Viewed through the lens of Minsky's hypothesis, the CRAs did not have the capacity to prevent the crisis.²⁶⁷ Their failings appeared to be symptomatic of deeper problems.²⁶⁸ "The tendency to transform doing well into a speculative investment boom is the basic instability in a capitalist economy," he wrote.²⁶⁹ A period of growth that resembled the "euphoric" phase in his

²⁶⁰ Hyman Minsky, *The Financial Instability Hypothesis*, Working Paper No. 74, May 1992 at 8.

²⁶¹ See, e.g., Justin Lahat, *In Time of Tumult, Obscure Economist Gains Currency*, WALL ST. J., Aug. 18, 2007.

²⁶² Quoted in Steven Mihm, *Why Capitalism Fails*, BOSTON GLOBE, Sept. 13, 2009.

²⁶³ See following section, below.

²⁶⁴ See, e.g., José Gabilondo, *Dodd-Frank, Liability Structure, And Financial Instability Cycles: Neither A (Ponzi) Borrower Nor A Lender Be*, 46 Wake Forest L. Rev. 469, 483 (2011) ("If we believe, as did Minsky, that capitalist market systems could be enhanced by mitigating leverage cycles, then we judge the [Dodd Frank] Act by whether it does so.").

²⁶⁵ See, e.g., Timothy J. Sinclair, *Credit Rating Agencies and the Global Financial Crisis*, 12 Econ. Sociology, 2010 at 4, available at http://econsoc.mpifg.de/archive/econ_soc_12-1.pdf.

²⁶⁶ See, e.g., Zachary Gubler, *Regulating In The Shadows: Systemic Moral Hazard And The Problem Of The Twenty-First Century Bank Run*, 63 Ala. L. Rev. 221, 260 (2012).

²⁶⁷ See, e.g., Jan Kregel, *Is This the Minsky Moment for Reform of Financial Regulation?*, Levy Economics Institute Working Paper No. 586, Feb. 25, 2010 at 2 ("The fact that the subprime crisis was able to spread to the rest of the financial system and set off a full-scale bout of systemic instability and debt deflation is, however, the result of a Minsky process of sustained and increasing financial fragility in the rest of the financial system.").

²⁶⁸ See, e.g., Nicholas Dorn, *The Governance Of Securities*, 50 Brit. J. Criminology 23, 30-31 (2010) ("blaming' the ratings agencies is merited insofar as it points to a conflict of interest; however, such blaming could also function as a diversion--like blaming a servant for carrying out one's instructions. If the subprime phenomenon was driven from above (by the capital markets), then it is hardly surprising that there was immense pressure upon a gatekeeper in the connecting chain.").

²⁶⁹ Hyman Minsky, *The Financial Instability Hypothesis: An Interpretation of Keynes and an Alternative to 'Standard' Theory*, CHALLENGE MAGAZINE Mar./Apr., 1977 at 24.

cycle seemed to infect the CRAs, along with the other participants in the system.²⁷⁰ The agencies applied the same principles they had used to rate traditional corporate debt and graded the new products highly.²⁷¹ Because the new securities did not trade on transparent markets and had no similar precursors, the agencies sustained an impression that they were worth more than their constituent parts.²⁷² The agencies' "gatekeeping" function broke down.²⁷³

Minsky appealed to policymakers to empower market regulators that could address the causes of fragility, and to reject "exogenous" responses such as tinkering with the incentives of the CRAs.²⁷⁴ "We need a theory that makes instability a normal result in our economy and gives us handles to control it," he wrote.²⁷⁵ "Unless we understand what it is that leads to economic and financial instability, we cannot . . . eliminate it."²⁷⁶

Minsky's conception of economic cycles bore a resemblance to the recent crisis.²⁷⁷ A period of stability seemed to generate increases in the accumulation of debt and the use of speculative financial instruments.²⁷⁸ In the early 2000s, the Federal Reserve lowered interest rates to 1% and set in motion a boom in the housing market.²⁷⁹ The market relied on increasingly unstable sources of credit.²⁸⁰

From Minsky's perspective, the cycle began as consumers acquired more debt.²⁸¹ Low interest rates made mortgages cheaper, and more people sought loans to buy homes.²⁸² As

²⁷⁰ See, e.g., Amadou N.R. Sy, *The Systemic Regulation of Credit Rating Agencies and Rated Markets*, IMF Working Paper, WP/09/129, June 2009 at 3, available at <http://www.imf.org/external/pubs/ft/wp/2009/wp09129.pdf> ("ratings increased systemic risk and may be pro-cyclical, helping fuel investments in 'good times'").

²⁷¹ See, e.g., Jan Kregel, *The Natural Instability of Financial Markets*, The Ideas Working Paper Series, Paper no. 04/2009, 2009 at 17-18, available at http://www.networkideas.org/working/jun2009/04_2009.pdf.

²⁷² See, e.g., Anastasia Nesvetailova, *The Crisis Of Invented Money: Liquidity Illusion And The Global Credit Meltdown*, 11 *Theoretical Inquiries L.* 125, 144 (2010).

²⁷³ See id. At 136-37.

²⁷⁴ See, e.g., Hyman Minsky and Piero Ferri, "Market Processes and Thwarting Systems", The Jerome Levy Economics Institute of Bard College, Working Paper No. 64, Nov. 1991 at 4 ("in a world where the internal dynamics imply instability, a semblance of stability can be achieved or sustained by introducing conventions, constraints, and interventions into the environment.").

²⁷⁵ Hyman Minsky, *Stabilizing an Unstable Economy*, 2008 at 111.

²⁷⁶ Id.

²⁷⁷ See rest of paragraph, below.

²⁷⁸ See, e.g., Charles J. Whalen, *Rethinking Economics For A New Era Of Financial Regulation: The Political Economy Of Hyman Minsky*, 15 *Chap. L. Rev.* 149, 164 (2011).

²⁷⁹ See, e.g., José Gabilondo, *Dodd-Frank, Liability Structure, And Financial Instability Cycles: Neither A (Ponzi) Borrower Nor A Lender Be*, 46 *Wake Forest L. Rev.* 469, 473-74 (2011).

²⁸⁰ See, e.g., Philip Arestis and Elias Karakitsos, *Subprime Mortgage Market and the Current Crisis*, Cambridge Centre for Economic and Public Policy, Working Paper No. 08-09, Feb. 2009 at 6.

²⁸¹ My own assertion – no footnote necessary.

²⁸² See, e.g., Antony Davies and James R. Harrigan, *Why the Education Bubble Will Be Worse Than the Housing Bubble*, U.S. NEWS, June 12, 2012, available at <http://www.usnews.com/opinion/blogs/economic-intelligence/2012/06/12/the-government-shouldnt-subsidize-higher-education>.

demand increased, property values rose, and the buyers had to obtain larger loans.²⁸³ “The fundamental instability of a capitalist system is upwards,” Minsky wrote.²⁸⁴

The expansion he predicted seemed to continue as the increase in prices made selling property more profitable.²⁸⁵ Other consumers entered the housing market and sought additional loans.²⁸⁶ The lucrative home sales they observed appeared to justify the size of the mortgages they required.²⁸⁷ Lenders worried less about the potential for default and demanded less security from borrowers.²⁸⁸ In 2004, for example, 42% percent of first-time home buyers paid no down payment.²⁸⁹

Lenders seemed to engage in risky practices free from regulatory constraints.²⁹⁰ As Minsky anticipated, finance was the main driver of wealth creation, and political policies supported innovation.²⁹¹ “In a world of businessmen and financial intermediaries who aggressively seek profit,” he wrote, the “innovators” “outpace[] regulators.”²⁹² In time, the lenders realized that they could earn more money through leveraging their loans than they could in fees from originating mortgages.²⁹³ Financial institutions began to purchase and pool the mortgages, then sell individual tranches to downstream investors.²⁹⁴ “Innovations in financial practice are a feature of our economy,” Minsky wrote.²⁹⁵

²⁸³ See, e.g., *Id.*

²⁸⁴ Hyman Minsky, *The Financial Instability Hypothesis: An Interpretation of Keynes and an Alternative to ‘Standard’ Theory*, CHALLENGE MAGAZINE Mar./Apr., 1977 at 24.

²⁸⁵ See, e.g., Philip Arestis and Elias Karakitsos, *Subprime Mortgage Market and the Current Crisis*, Cambridge Centre for Economic and Public Policy, Working Paper No. 08-09, Feb. 2009 at 6.

²⁸⁶ See, e.g., William Lang and Julapa Jagtiani, *The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance*, 38 Atlantic Economic Journal, 123, 127 (2010).

²⁸⁷ See, e.g., L. Randall Wray, *Money Manager Capitalism and the Global Financial Crisis*, Levy Economics Institute, Working Papers No. 578, Sept. 25, 2009 at 9.

²⁸⁸ See, e.g., William Lang and Julapa Jagtiani, *The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance*, 38 Atlantic Economic Journal, 123, 127-28 (2010).

²⁸⁹ Charles J. Whalen, *Rethinking Economics For A New Era Of Financial Regulation: The Political Economy Of Hyman Minsky*, 15 Chap. L. Rev. 149, 153 (2011).

²⁹⁰ See, e.g., Testimony Of Honorable Eugene A. Ludwig, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies*, Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess., Apr. 22, 2008 at 1 (“The paradigm of the last decade has been the conviction that un- or under-regulated financial services sectors would produce more wealth”).

²⁹¹ See, e.g., Jane Kelsey, *The Conundrum Of Shifting Orthodoxies: Ftas And Korea's Currency Controls*, 14 J. Int'l Econ. L. 845, 848 (2011).

²⁹² Hyman P. Minsky, *Stabilizing an Unstable Economy* 281 (1986).

²⁹³ See, e.g., Jan Kregel, *Is This the Minsky Moment for Reform of Financial Regulation?*, Levy Economics Institute Working Paper No. 586, Feb. 25, 2010 at 6.

²⁹⁴ See, e.g., L. Randall Wray, *Money Manager Capitalism and the Global Financial Crisis*, Levy Economics Institute, Working Papers No. 578, Sept. 25, 2009 at 7.

²⁹⁵ Hyman Minsky, *The Financial Instability Hypothesis: An Interpretation of Keynes and an Alternative to ‘Standard’ Theory*, CHALLENGE MAGAZINE Mar./Apr., 1977 at 24.

The growing demand for securitization of new mortgages increased instability in the economy.²⁹⁶ “That which can be securitized, will be securitized,” Minsky wrote.²⁹⁷ Lenders offered nonconforming mortgages and rolled back qualification standards.²⁹⁸

Soon, the system depended on a continuous supply of new home buyers.²⁹⁹ The new buyers’ demand for houses kept prices high, and the rising property values justified the acquisition of large mortgages.³⁰⁰ The large mortgages provided raw materials to securitize, and the strong performance of the housing market validated the high ratings that the CRAs awarded to the securitized products.³⁰¹ The high ratings also made trading in the products more profitable.³⁰²

Eventually, the chain broke, and the crisis started.³⁰³ Two Bear Stearns hedge funds that had invested heavily in mortgage-backed securities failed.³⁰⁴ As lenders became aware of the potential for widespread defaults,³⁰⁵ they stopped extending short-term credit, and housing prices began to fall.³⁰⁶ In the first quarter of 2008, the American economy contracted more than 6%, and 8 million jobs disappeared.³⁰⁷

²⁹⁶ See, e.g., Philip Arestis and Elias Karakitsos, *Subprime Mortgage Market and the Current Crisis*, Cambridge Centre for Economic and Public Policy, Working Paper No. 08-09, Feb. 2009 at 7-8.

²⁹⁷ Hyman Minsky, *Securitization*, The Levy Economics Institute of Bard College, Policy Note, 2008/2 at 2, quoting participants of a conference of the Chicago Federal Reserve Bank in May, 1987; further Hyman Minsky, *Securitization Outline*, 1987, Hyman P. Minsky Archive. Paper 188, available at http://digitalcommons.bard.edu/hm_archive/188.

²⁹⁸ See, e.g., Jan Kregel, *The Natural Instability of Financial Markets*, The Ideas Working Paper Series, Paper no. 04/2009, 2009 at 17-18, available at http://www.networkideas.org/working/jun2009/04_2009.pdf.

²⁹⁹ See, e.g., Jan Kregel, *The Natural Instability of Financial Markets*, The Ideas Working Paper Series, Paper no. 04/2009, 2009 at 18, available at http://www.networkideas.org/working/jun2009/04_2009.pdf.

³⁰⁰ See, e.g., *The Fed Discovers Hyman Minsky*, THE ECONOMIST, Jan. 7, 2010.

³⁰¹ See, e.g., Amadou N.R. Sy, *The Systemic Regulation of Credit Rating Agencies and Rated Markets*, IMF Working Paper, WP/09/129, June 2009 at 3, available at <http://www.imf.org/external/pubs/ft/wp/2009/wp09129.pdf> (stating that high ratings exacerbated “herding behaviour” before the crisis).

³⁰² See, e.g., Jan Kregel, *The Natural Instability of Financial Markets*, The Ideas Working Paper Series, Paper no. 04/2009, 2009 at 18, available at http://www.networkideas.org/working/jun2009/04_2009.pdf.

³⁰³ See rest of paragraph, below.

³⁰⁴ Barbara Kiviat, *Bear Stearns Is Gone; Now Comes The Trial*, TIME, Sept. 15, 2009, available at http://www.time.com/time/specials/packages/article/0,28804,1923203_1923201_1923189,00.html#ixzz23c7P5pDy.

³⁰⁵ See, e.g., Mark Pittman, *Bear Stearns Fund Collapse Sends Shock Through CDOs (Update2)*, BLOOMBERG, June 21, 2007, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ahWfhEJ7dra4>.

³⁰⁶ See, e.g., Lynne L. Dallas, *Short-Termism, The Financial Crisis, And Corporate Governance*, 37 J. Corp. L. 265, 295 (2012).

³⁰⁷ R. Michael Gadbow, *Systemic Regulation Of Global Trade And Finance: A Tale Of Two Systems*, 13 J. Int'l Econ. L. 551, 556 (2010).

*C. Minsky's Vision of the Crisis: "Financial Regulation is Both Indispensable and Imperfect"*³⁰⁸

What solution would Minsky have proposed? He advocated for public institutions to impose limits on credit and financial innovation in order to break financial cycles.³⁰⁹ "The problem of finance that will emerge," he wrote, "is whether the . . . institutions of national government can contain . . . financial fragility."³¹⁰ Three basic characteristics and two more specific warnings emerge from his writings.³¹¹ This part proposes the elements of a resolution that he might have supported.

First, Minsky called for robust public regulation, not reliance on private "gatekeepers."³¹² "Apt intervention and institutional structures are necessary for market economies to be successful," he wrote.³¹³ Regulators had to "constrain the impact of uncertainty."³¹⁴

Second, Minsky believed that the regulators needed to strive continuously to restrict financial innovation.³¹⁵ Regulators, he wrote, should guide "the evolution of financial practices . . . to reduce the likelihood that fragile situations conducive to financial instability will develop."³¹⁶ As new instruments entered the markets, they had to keep their rules up to date.³¹⁷

Third, Minsky wanted the regulators to impose countercyclical measures, in order to limit speculation and maintain stability.³¹⁸ "Institutions can act as the equivalent of circuit breakers," he wrote.³¹⁹ They could halt the inevitability of "euphoric" expansion.³²⁰

³⁰⁸ James K. Galbraith, Keynote Lecture to the 5th Annual Dijon Conference on Post-Keynesian Economics, Roskilde University, Denmark, May 13, 2011, audio available at <http://utip.gov.utexas.edu/> (describing Minsky's beliefs).

³⁰⁹ See, e.g., Hyman Minsky, *Longer Waves in Financial Relations: Financial Factors in the More Severe Depressions II*, 29 J. Econ. Issues 83, 93 (1995).

³¹⁰ Hyman Minsky, *Longer Waves in Financial Relations: Financial Factors in the More Severe Depressions II*, 29 J. Econ. Issues 83, 93 (1995).

³¹¹ See rest of section, below.

³¹² See rest of paragraph, below.

³¹³ Pierro Ferri and Hyman Minsky, *Market Processes and Thwarting Systems*, The Levy Economics Institute at Bard College, Working Paper No. 64 (1991) at 24, available at <http://www.levyinstitute.org/pubs/wp64.pdf>.

³¹⁴ Hyman Minsky, *Uncertainty and the Institutional Structure of Capitalist Economies: Remarks upon Receiving the Veblen-Commons Award*, 30 J. Econ. Issues 357, 359 (1996).

³¹⁵ See rest of paragraph, below.

³¹⁶ Hyman P. Minsky, *Stabilizing an Unstable Economy* 322 (1986).

³¹⁷ See, e.g., Randall Wray, *Minsky Crisis*, Levy Economics Institute, Working Papers Series No. 659, Mar. 25, 2011 at 2.

³¹⁸ See, e.g., José Gabilondo, *Dodd-Frank, Liability Structure, And Financial Instability Cycles: Neither A (Ponzi) Borrower Nor A Lender Be*, 46 Wake Forest L. Rev. 469, 489 (2011).

³¹⁹ Hyman Minsky, Domenico Delli Gatti, and Mauro Gallegati, *Financial Institutions, Economic Policy, and the Dynamic Behavior of the Economy*, The Levy Economics Institute at Bard College, Working Paper No. 126, Oct. 1994 at 2.

More specifically, Minsky called for banks to act solely as lenders, rather than participate in “capital development.”³²¹ “If the authorities constrain banks and are aware of the activities of fringe banks and other financial institutions,” he wrote, then “they are in a better position to attenuate the disruptive expansionary tendencies of our economy.”³²² He proposed that regulators should require “narrow banking,”³²³ and promote an economy of small banks financing small, local deals.³²⁴

Finally, Minsky also advocated the restriction of financial trading to tangible assets.³²⁵ He emphasized the dangers of securitization in 1992, before the practice became prevalent. “The instrument originators and the security underwriters did not hazard any of their wealth on the longer term viability of the underlying projects,” he wrote.³²⁶ “All that was required for the originators to earn their stipend was skill avoiding obvious fraud. . . .”³²⁷

The measures Minsky suggested appear more difficult to implement than moderating conflicts of interest among the CRAs.³²⁸ Public regulation that limits tendencies towards economic expansion and the dynamics that introduce instability would demand the resolution of other complex questions.³²⁹ Regulators would have to address, for example: 1) how to compensate the financial sector to attract talent but discourage excessive risk taking; 2) how to direct credit to prudent borrowers while preventing irresponsible lending; and 3) how to cultivate community values that would reject the natural inclination to maximize profit.³³⁰

³²⁰ See, e.g., John Cassidy, *The Minsky Moment*, THE NEW YORKER, Feb. 4, 2008 (the “way to break this pattern was for the government to step in and regulate the moneymen.”).

³²¹ Hyman Minsky, *Financial Instability and the Decline (?) of Banking: Public Policy Implications*, The Levy Economics Institute at Bard College, Hyman Minsky Archive, Paper 88 (1994) at 13, available at http://digitalcommons.bard.edu/cgi/viewcontent.cgi?article=1087&context=hm_archive.

³²² Hyman Minsky, *STABILIZING AN UNSTABLE ECONOMY* 281 (1986).

³²³ Hyman Minsky, *Financial Instability and the Decline (?) of Banking: Public Policy Implications*, The Levy Economics Institute at Bard College, Hyman Minsky Archive, Paper 88 (1994) at 13, available at http://digitalcommons.bard.edu/cgi/viewcontent.cgi?article=1087&context=hm_archive.

³²⁴ Hyman P. Minsky, Dimitri B. Papadimitriou, Ronnie J. Phillips, and L. Randall Wray, *Community Development Banking: A Proposal to Establish a Nationwide System of Community Development Banking*, The Levy Economics Institute at Bard College, Working Paper No. 3 (1993) at 9, available at <https://www.econstor.eu/dspace/bitstream/10419/54331/1/678660921.pdf>.

³²⁵ See rest of paragraph, below.

³²⁶ Hyman Minsky, *The Capital Development Of The Economy And The Structure Of Financial Institutions*, Working Paper No. 72, The Jerome Levy Economics Institute of Bard College (1992) at 22.

³²⁷ *Id.*

³²⁸ See, e.g., José Gabilondo, *Dodd-Frank, Liability Structure, And Financial Instability Cycles: Neither A (Ponzi) Borrower Nor A Lender Be*, 46 Wake Forest L. Rev. 469, 470 (2011) (“the idea that the government should actively intervene in the financial market faces renewed political opposition”).

³²⁹ See, e.g., John Cassidy, *The Minsky Moment*, THE NEW YORKER, Feb. 4, 2008.

³³⁰ *Id.*

Minsky, however, stressed the stakes: In the absence of policy that “assures that the economic prerequisites for sustaining the civil and civilized standards of an open liberal society exist,”³³¹ he wrote, market behavior that creates “uncertainty and extremes in income maldistribution and social inequalities [will] attenuate the economic underpinnings of democracy.”³³²

IV. SPOTLIGHT INDIA: CONFLICTED RATING AGENCIES AND DELIBERATE DEREGULATION

India provides additional insights into ways to resolve the conflict in the West.³³³ The country developed local CRAs that used the “issuer-pays” model.³³⁴ The Indian economy, meanwhile, transformed in patterns similar to those that Minsky predicted.³³⁵ The government deregulated and expanded the debt markets and fostered growth in securitization.³³⁶ Will the agencies succeed in stabilizing the Indian economy, because differences in their supervision mitigated their conflicts of interest? Or, have speculation and financial innovation been the critical concern, and will economic fragility increase without countercyclical interventions? This section first introduces the Indian CRAs and compares them to their Western counterparts. Second, it investigates parallels between recent changes in the Indian economy and Minsky’s financial instability hypothesis.

A. More Conflicts of Interest: Credit Rating Agencies in India

CRAs in India resemble agencies in the West but have significant differences.³³⁷ They have profited from charging issuers for ratings,³³⁸ an arrangement that would suggest conflicted

³³¹ Hyman Minsky, *Uncertainty and the Institutional Structure of Capitalist Economies*, The Levy Economics Institute at Bard College Working Paper No. 155 (Apr. 1996) at 15.

³³² *Id.*

³³³ See rest of section, below.

³³⁴ Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies*, Dec. 2009 at 13, available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CCRA030310_R2.pdf

³³⁵ See Section IV.B., below.

³³⁶ See, e.g., Shardul Shroff, *Outlook on India 2010: Delivering on the Promise in Turbulent Times*, 1815 PLI/Corp 63, 96 (2010); Timothy Massad, *Doing Business in India 2009: Critical Legal Issues for U.S. Companies*, 1720 PLI/Corp 33, 42 (2009).

³³⁷ See rest of section, below.

³³⁸ Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies*, Dec. 2009 at 13, available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CCRA030310_R2.pdf.

interests.³³⁹ Since 1999, however, public regulators have overseen them.³⁴⁰ New activities have also diversified their revenue sources.³⁴¹

1. Soaring Market Values

Six CRAs operate in India.³⁴² CRISIL opened first, in 1987, and now leads the market.³⁴³ In 1991, a consortium of Indian financial institutions launched a second agency, ICRA.³⁴⁴ Three Indian banks own another agency, CARE.³⁴⁵ In 2007, former bankers and regulators in Bangalore incorporated the newest agency, Brickwork.³⁴⁶

The CRAs acquired a “gatekeeping” role in the financial markets.³⁴⁷ Indian law mandated that at least one agency must evaluate every financial product.³⁴⁸ The rule increased ratings volumes, and CRISIL, for example, has graded more than 30,000 issuers.³⁴⁹ In most other countries, including the U.S., the UK, and Australia, ratings have been voluntary.³⁵⁰

³³⁹ See, e.g., Testimony of Arturo C. Fuentes, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies*, Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess., Apr. 22, 2008 at 5 (“One could make the case that that whenever a rating analyst is supervised by a manager whose compensation is determined by market share or revenue growth (rather than ratings accuracy) the objectivity of ratings is compromised.”). For a discussion of a study finding a positive correlation between the “issuer-pays” model and high ratings and more downgrades, see Lynne L. Dallas, *Short-Termism, The Financial Crisis, And Corporate Governance*, 37 J. Corp. L. 265, 341 (2012).

³⁴⁰ See Section IV.A.2., below.

³⁴¹ See Section IV.A.E., below.

³⁴² The fifth agency rates only small issuers and the other is the subsidiary of a foreign company.

³⁴³ Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies*, Dec. 2009, available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CCRA030310_R2.pdf. Standard & Poor’s purchased a controlling stake in 2005, see id.

³⁴⁴ ICRA, *Profile*, available at <http://www.icra.in/67654323.aspx?ck=pXKT5F8DI0y09YcCTjHl5ZoyuA4irn1XMUvRbEmAkRBQKECpIVZmNCoJ3VCiLt2Xfnxc5w2uaDrqRY0uEKCoCw==>. In 2001, Moody’s purchased a 29% stake in ICRA, see *Moody’s in India*, available at <http://www.moody.co.in/>.

³⁴⁵ Stephen Wells and Lotte Schou-Zibell, *India’s Bond Market - Developments and Challenges Ahead*, Asian Development Bank Working Paper Series on Regional Economic Integration No. 22, Dec. 2008 at 24, available at http://aric.adb.org/pdf/workingpaper/WP22_India%27s_Bond_Market.pdf.

³⁴⁶ *History*, <http://www.brickworkratings.com/history.html>.

³⁴⁷ See, e.g., M. T. Raju, Upasana Bhutáni, Anubhuti Sahay, *Corporate Debt market in India: Key Issues and Policy Recommendations*, SEBI Working Paper Series No. 9, July 2004 at 17 (The agencies are “well . . . regarded,” and their ratings “carry confidence in the market.”).

³⁴⁸ Tarun Jain and Raghav Sharma, *Credit Rating Agencies in India: A Case of Authority without Responsibility*, 3 Company Law Journal 89, 106 (2008), available at <http://ssrn.com/abstract=1111553>.

³⁴⁹ CRISIL, *Credit Rating List*, available at <http://crisil.com/ratings/credit-ratings-list.jsp>.

³⁵⁰ Tarun Jain and Raghav Sharma, *Credit Rating Agencies in India: A Case of Authority without Responsibility*, 3 Company Law Journal 89, 106 (2008), available at <http://ssrn.com/abstract=1111553>.

All six CRAs have performed successfully.³⁵¹ CRISIL's net profits increased by 20% between January and March, 2012,³⁵² and it attained a market value of \$1.3 billion in May.³⁵³ ICRA acquired subsidiary companies, and operates in Kuwait, the Philippines, and Indonesia, among other countries.³⁵⁴ In 2011, a shareholder deal valued CARE at \$400 million dollars, and the agency has plans for a public offering.³⁵⁵

2. Conflicts of Interest

The CRAs adopted the same “issuer-pays” model that Western governments blamed for producing conflicts;³⁵⁶ however, Indian regulators started supervising the agencies early and aggressively.³⁵⁷ The Securities and Exchange Board of India (“SEBI”)³⁵⁸ has overseen the agencies’ evaluations of most financial products since 1999.³⁵⁹ In the U.S., by comparison, the SEC began actively monitoring the CRAs in 2007.³⁶⁰ The EU recently drafted its first mandatory provisions.³⁶¹

SEBI has exercised greater power than Western regulators. Since 1999, it has required the Indian CRAs to seek its authorization to conduct business.³⁶² The agencies must renew the

³⁵¹ See, e.g., *India's Ratings Agencies Are Thriving*, THE ECONOMIST, Mar. 17, 2012.

³⁵² *Crisil Net Up 20% in First Quarter*; THE HINDU BUSINESS LINE, Apr. 16, 2012.

³⁵³ See, e.g., Moneycontrol, India Financial Portal, available at <http://www.moneycontrol.com/india/stockpricequote/miscellaneous/crisil/CRI>.

³⁵⁴ See *ICRA Over the Years: A Chronicle*, available at <http://www.icra.in/67654323.aspx?ck=fQoV5tzY6LgysX63y6bYI/G41LXpEzOjvL4hRRftR6erTJmmilVw740WKBgqhO2V0rEIR1EJ8kCWpCbftqMdg==>.

³⁵⁵ *India's Ratings Agencies Are Thriving*, THE ECONOMIST, Mar. 17, 2012.

³⁵⁶ Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies*, Dec. 2009 at 13, available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CCRA030310_R2.pdf.

³⁵⁷ See rest of section, below.

³⁵⁸ M. T. Raju, Upasana Bhutáni, Anubhuti Sahay, *Corporate Debt market in India: Key Issues and Policy Recommendations*, SEBI Working Paper Series No. 9, July 2004 at 7.

³⁵⁹ Anuradha Guru, *Concerns on the Role of Credit Rating Agencies in the Evolving Financial Regime: A Policy Perspective*, NSE NEWS, Sept. 2008 at 7, available at <http://ssrn.com/abstract=1439659>; Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies*, Dec. 2009 at 12, 24, available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CCRA030310_R2.pdf.

³⁶⁰ Himanshu Bhushan, *Credit Rating Agencies in India: Have We Done Enough*, Jan. 31, 2012 at 11, available at <http://ssrn.com/abstract=1999886>.

³⁶¹ Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies*, Dec. 2009 at 24, available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CCRA030310_R2.pdf.

³⁶² Himanshu Bhushan, *Credit Rating Agencies in India: Have We Done Enough*, Jan. 31, 2012 at 2, 12, available at <http://ssrn.com/abstract=1999886>.

licenses every three years.³⁶³ The SEC, by contrast, grants permanent recognition.³⁶⁴ SEBI can also subpoena the agencies' records and employees and conduct examinations under oath.³⁶⁵

Additional institutions complement SEBI's oversight.³⁶⁶ The central bank, the Reserve Bank of India ("RBI"), supervises ratings of securitized products³⁶⁷ and must consent before agencies can grade bank loans.³⁶⁸ Other public entities, such as the Ministry of Petroleum and the Directorate General of Shipping, also regulate the agencies' activities.³⁶⁹

In 1999, SEBI set out mandatory rules that specifically addressed conflicts of interest,³⁷⁰ and it updated them in response to the global financial crisis.³⁷¹ "Clause 11" instituted an enforceable code of conduct that restricted the CRAs from the "unfair practice of diverting the clients of other agencies on assurance of higher ratings."³⁷² It also required the agencies to "maintain an arm's length relationship between . . . credit rating . . . and any other activity" and to "refrain from creating a false market."³⁷³ In the wake of the global crisis, various governmental committees reviewed the "issuer-pays" model and concluded that it did not threaten the

³⁶³ Tarun Jain and Raghav Sharma, *Credit Rating Agencies in India: A Case of Authority without Responsibility*, 3 Company Law Journal 89, 104 (2008), available at <http://ssrn.com/abstract=1111553>.

³⁶⁴ Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies*, December 2009, available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CCRA030310_R2.pdf.

³⁶⁵ Himanshu Bhushan, *Credit Rating Agencies in India: Have We Done Enough?*, Jan. 31, 2012 at 15-16, available at <http://ssrn.com/abstract=1999886>; Tarun Jain and Raghav Sharma, *Credit Rating Agencies in India: A Case of Authority without Responsibility*, 3 Company Law Journal 89, 105 (2008), available at <http://ssrn.com/abstract=1111553>; Anuradha Guru, *Concerns on the Role of Credit Rating Agencies in the Evolving Financial Regime: A Policy Perspective*, NSE NEWS, Sept. 2008 at 7, available at <http://ssrn.com/abstract=1439659>.

³⁶⁶ Himanshu Bhushan, *Credit Rating Agencies in India: Have We Done Enough?*, Jan. 31, 2012 at 10, available at <http://ssrn.com/abstract=1999886>.

³⁶⁷ Himanshu Bhushan, *Credit Rating Agencies in India: Have We Done Enough?*, Jan. 31 at 10, 2012, available at <http://ssrn.com/abstract=1999886>.

³⁶⁸ Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies*, Dec. 2009 at 27, available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CCRA030310_R2.pdf.

³⁶⁹ *Id.* at 10.

³⁷⁰ Anuradha Guru, *Concerns on the Role of Credit Rating Agencies in the Evolving Financial Regime: A Policy Perspective*, NSE NEWS, Sept. 2008 at 7, available at <http://ssrn.com/abstract=1439659>.

³⁷¹ See rest of paragraph, below.

³⁷² Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies*, Dec. 2009 at 24, available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CCRA030310_R2.pdf; Tarun Jain and Raghav Sharma, *Credit Rating Agencies in India: A Case of Authority without Responsibility*, 3 Company Law Journal 89, 104-05 (2008), available at <http://ssrn.com/abstract=1111553>.

³⁷³ Himanshu Bhushan, *Credit Rating Agencies in India: Have We Done Enough?*, Jan. 31, 2012 at 23, available at <http://ssrn.com/abstract=1999886>.

economy.³⁷⁴ SEBI tightened some provisions on disclosure and imposed new prohibitions on analyst participation in marketing, business development, and share ownership in rated companies.³⁷⁵

3. Diversification

The Indian CRAs have broadened their sources of revenue, potentially blunting some of the conflicts of interest that the “issuer-pays” model might generate.³⁷⁶ Most agencies in India have rated a diverse range of financial products and institutions, and have also provided additional services.³⁷⁷ Their enlarged pool of clients has made retaining individual customers less critical to their profits.³⁷⁸

CRISIL, for example, has earned half of its revenues from abroad by conducting a variety of ratings and undertaking several other tasks.³⁷⁹ In addition to rating standard financial products, it has assessed bank loans and real estate, and has evaluated more than 14,000 small businesses.³⁸⁰ It has developed risk-management models for banks and provided research and analysis to insurance companies.³⁸¹ It has also advised the Indian government on reforms to improve public institutions and infrastructure development.³⁸²

Other CRAs have pursued similar profiles.³⁸³ The managing director of ICRA has estimated that less than 60% of its revenues derive from credit ratings.³⁸⁴ It started rating

³⁷⁴ Shardul Shroff, *Outlook on India 2010: Delivering on the Promise in Turbulent Times*, 1815 PLI/Corp 63, 127 (2010).

³⁷⁵ Himanshu Bhushan, *Credit Rating Agencies in India: Have We Done Enough?*, Jan. 31, 2012 at 18, available at <http://ssrn.com/abstract=1999886>; Shardul Shroff, *Outlook on India 2010: Delivering on the Promise in Turbulent Times*, 1815 PLI/Corp 63, 127 (2010). (Might actually be id, and therefore not SEBI).

³⁷⁶ See rest of section, below.

³⁷⁷ See, e.g., Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies*, Dec. 2009 at 18, available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CCRA030310_R2.pdf.

³⁷⁸ This is my own thought – no footnote necessary.

³⁷⁹ Angel Broking, *CRISIL*, Jan. 10, 2010 at 2, 10, available at http://smartinvestor.business-standard.com/BSCMS/PDF/crisil_12011_01.pdf.

³⁸⁰ Id.

³⁸¹ Id.

³⁸² Id.

³⁸³ See rest of paragraph, below.

³⁸⁴ *India's Ratings Agencies Are Thriving*, THE ECONOMIST, Mar. 17, 2012.

business and engineering schools,³⁸⁵ and the newest agency, Brickwork, has graded hospitals and diagnostic labs.³⁸⁶

Regulators have directed the CRAs to offer additional services.³⁸⁷ State energy utilities have called on the agencies to rate their performance.³⁸⁸ SEBI requires companies that list on public stock exchanges to hire the agencies to rate their shares, in order to help investors evaluate them.³⁸⁹

B. Adherence to Minskyian Paradigms: Indian Market Development

The Indian CRAs, though regulated and diversified,³⁹⁰ have operated in evolving financial markets that have appeared to reflect tendencies towards “euphoria,” as Minsky forecast.³⁹¹ In 1991, India abandoned a statist economic system, characterized by government control of industry and slow growth, and began to implement a program of economic liberalization.³⁹² It actively developed its debt markets.³⁹³ It also deliberately fostered trading in securitized financial instruments,³⁹⁴ including the mortgage-backed securities at the center of the recent global financial crisis.³⁹⁵ This part observes India’s economic development through the framework of Minsky’s financial instability hypothesis.

1. Market Liberalization and Increased Cash Flow: Minsky Phase 1?

³⁸⁵ See, e.g., Prashant K. Nanda, *Now Crisil, Icra to Rate Engineering, B-Schools*, LIVEMINT.COM and WALL ST. J., May 8, 2012, available at <http://www.livemint.com/2012/05/08223213/Now-Crisil-Icra-to-rate-engin.html>

³⁸⁶ See, e.g., *Brickwork Careers*, <http://www.brickworkratings.com/careers.html>.

³⁸⁷ See rest of paragraph, below.

³⁸⁸ Deeptha Mathavan, *From Dabhol to Ratnagiri: The Electricity Act of 2003 and Reform of India’s Power Sector*, 47 Colum. J. Transnat’l L. 387, 415-16 (2009).

³⁸⁹ Timothy Massad, *Doing Business in India 2009: Critical Legal Issues for U.S. Companies*, 1720 PLI/Corp 33, 44-45 (2009); Tarun Jain and Raghav Sharma, *Credit Rating Agencies in India: A Case of Authority without Responsibility*, 3 Company Law Journal 89, 106 (2008), available at <http://ssrn.com/abstract=1111553>.

³⁹⁰ See Section IV.A., above.

³⁹¹ See rest of section, below.

³⁹² See, e.g., Afra Afsharipour, *Rising Multinationals: Law And The Evolution Of Outbound Acquisitions By Indian Companies*, 44 U.C. Davis L. Rev. 1029, 1035-56 (2011); [Bala N. Balasubramanian, Bernard S. Black, Vikramaditya S. Khanna, Firm-Level Corporate Governance in Emerging Markets: A Case Study of India](#), U of Michigan Law & Economics, Olin Working Paper 08-011, July 2, 2008 at 5.

³⁹³ See, e.g., M. T. Raju, Upasana Bhutáni, Anubhuti Sahay, *Corporate Debt Market in India: Key Issues and Policy Recommendations*, SEBI Working Paper Series No. 9, July 2004 at 10; Rajesh Chakrabarti, *Bond Markets in India*, June 21, 2008 at 2, available at <http://ssrn.com/abstract=1149322>.

³⁹⁴ See Section IV.B.3., below.

³⁹⁵ See, e.g., Steven Schwarcz, *Disintermediating Avarice: A Legal Framework for Commercially Sustainable Microfinance*, 4 Ill. L. Rev. 1165, 1178 (2011).

The period after 1992, in which the state began to reduce its role in the Indian economy has borne some resemblance to the initial growth phase of Minsky's financial instability hypothesis.³⁹⁶ Upon independence in 1949, India grew slowly.³⁹⁷ The country rejected the colonial experience for the Soviet model of state intervention.³⁹⁸ Until the early 1980s, the economy expanded by an average of only 3.5%, a situation referred to as the "Hindu rate of growth."³⁹⁹ The new leaders suppressed private competition through strict licensing requirements.⁴⁰⁰ High tariffs isolated the country from the rest of the world, and restrictions on exports suppressed corporate profits.⁴⁰¹

Government nationalization of the banks limited access to investment capital.⁴⁰² The RBI controlled interest rates and became the primary source of credit.⁴⁰³ Investors turned to government-sponsored financial institutions for finance rather than to the debt and equity markets.⁴⁰⁴ The state barred investors from trading bonds among themselves and taxed bonds purchased directly from issuers heavily.⁴⁰⁵ It forbade private firms from issuing new shares.⁴⁰⁶

³⁹⁶ See rest of section, below.

³⁹⁷ See, e.g., Afra Afsharipour, *Rising Multinationals: Law And The Evolution Of Outbound Acquisitions By Indian Companies*, 44 U.C. Davis L. Rev. 1029, 1053 (2011); Franklin Allen, Rajesh Chakrabarti, Sankar De, *India's Financial System*, Nomura Occasional Series on Contemporary Capital Markets, Oct. 27, 2007 at 2, available at <http://ssrn.com/abstract=1261244>.

³⁹⁸ Bala N. Balasubramanian, Bernard S. Black, Vikramaditya S. Khanna, *Firm-Level Corporate Governance in Emerging Markets: A Case Study of India*, Univ. of Michigan Law & Economics, Olin Working Paper 08-011, July 2, 2008 at 5.

³⁹⁹ John Armour and Priya Lele, *Law, Finance, And Politics: The Case Of India*, 43 Law & Soc'y Rev. 491, 496 (2009).

⁴⁰⁰ Afra Afsharipour, *Rising Multinationals: Law And The Evolution Of Outbound Acquisitions By Indian Companies*, 44 U.C. Davis L. Rev. 1029, 1053 (2011).

⁴⁰¹ Id.; K. G. Viswanathan, *The Global Financial Crisis And Its Impact On India*, 9 J. Int'l Bus. & L. 41, 46-47 (2010).

⁴⁰² Amelia Ames, *Foreign Institutional Investment In India: What A Portfolio Manager Needs To Know About The Past, Present, And Potential Future Of India*, 4 B.Y.U. Int'l L. & Mgmt. Rev. 143, 152 (2008).

⁴⁰³ John Armour and Priya Lele, *Law, Finance, And Politics: The Case Of India*, 43 Law & Soc'y Rev. 491, 518 (2009).

⁴⁰⁴ Suchismita Bose and Dipankor Coondoo, *A Study of the Indian Corporate Bond Market*, 2 Money & Finance 25, 30 (2003); R.H. Patil, *Broadbasing and Deepening the Bond Market in India*, Wharton Financial Institutions Center Working Paper Series 01-32 at 2, available at <http://fic.wharton.upenn.edu/fic/papers/01/0132.pdf>. In response to nationalization of the banking system, many individuals turned to commercial chit funds, which exploited a legal loophole to compete with government banks, see Jan Eeckhout and Kaivan Munshi, *Mitigating Regulatory Inefficiency: The Non-market Response to Financial Regulation in India*, Selected Working Papers, University of Pennsylvania and Brown University, June 2005 at 947-48.

⁴⁰⁵ See, e.g., R.H. Patil, *Broadbasing and Deepening the Bond Market in India*, Wharton Financial Institutions Center, 01-32, at 2, available at <http://fic.wharton.upenn.edu/fic/papers/01/0132.pdf>.

⁴⁰⁶ Bala N. Balasubramanian, Bernard S. Black, Vikramaditya S. Khanna, *Firm-Level Corporate Governance in Emerging Markets: A Case Study of India*, U of Michigan Law & Economics, Olin Working Paper 08-011, July 2, 2008 at 5.

In 1992, declines in the value of the rupee made liberalization necessary, and a period of economic growth began.⁴⁰⁷ Over the course of one summer, the country transitioned to a market-based system.⁴⁰⁸ The finance minister abolished licensing requirements, opened the economy to foreign investment, and reduced state intervention in the private sector.⁴⁰⁹ Banks privatized and tariffs and other trade barriers fell.⁴¹⁰

The capital markets became energized but succumbed to a series of scandals.⁴¹¹ Companies sold shares and used the proceeds to expand.⁴¹² Foreign institutional investors, overseas companies, and non-resident Indians invested.⁴¹³ The markets grew lawless: First, the broker Ketan Parekh and other businessmen created a stock bubble that collapsed in 2001, causing the SENSEX index of the Bombay Stock Exchange to fall by 176 points.⁴¹⁴ In subsequent “vanishing companies” scandals, rogue companies took advantage of optimistic investors and lax enforcement by selling shares to the public, then disappearing.⁴¹⁵ Substantial irregularities emerged in the financial statements of the Tata Finance company, an affiliate of the Tata Group, one of India’s largest and most prominent businesses.⁴¹⁶

Regulators enforced rules leniently.⁴¹⁷ Some market observers promoted an Indian Sarbanes Oxley Act, akin to the American legislation that followed the Enron scandal,⁴¹⁸ but the plan did not succeed.⁴¹⁹ When SEBI adopted a new listing rule mandating independent directors on corporate boards, connected directors re-designated themselves as independent directors to

⁴⁰⁷ Franklin Allen, Rajesh Chakrabarti, Sankar De, *India’s Financial System*, Nomura Occasional Series on Contemporary Capital Markets, Oct. 27, 2007 at 2, available at <http://ssrn.com/abstract=1261244>.

⁴⁰⁸ *One More Push*, THE ECONOMIST, July 23, 2011.

⁴⁰⁹ Bala N. Balasubramanian, Bernard S. Black, Vikramaditya S. Khanna, *Firm-Level Corporate Governance in Emerging Markets: A Case Study of India*, U of Michigan Law & Economics, Olin Working Paper 08-011, July 2, 2008 at 5.

⁴¹⁰ *Id.*

⁴¹¹ *See rest of paragraph, below.*

⁴¹² Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 New Eng. J. Int’l & Comp. L. 231, 236 (2006); Bala N. Balasubramanian, Bernard S. Black, Vikramaditya S. Khanna, *Firm-Level Corporate Governance in Emerging Markets: A Case Study of India*, U of Michigan Law & Economics, Olin Working Paper 08-011, July 2, 2008 at 5.

⁴¹³ John Armour and Priya Lele, *Law, Finance, And Politics: The Case Of India*, 43 Law & Soc’y Rev. 491, 503 (2009).

⁴¹⁴ *See, generally*, collection of articles published in the India Times, available at <http://articles.economicstimes.indiatimes.com/keyword/ketan-parekh/recent/3>.

⁴¹⁵ Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 New Eng. J. Int’l & Comp. L. 231, 239 (2006).

⁴¹⁶ Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 New Eng. J. Int’l & Comp. L. 231, FN 28 (2006).

⁴¹⁷ *See rest of paragraph, below.*

⁴¹⁸ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 206, 116 Stat. 745, 774 (codified at 15 U.S.C. § 78j-1 (2006)).

⁴¹⁹ Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 New Eng. J. Int’l & Comp. L. 231, 232, 250 (2006); Bala N. Balasubramanian, Bernard S. Black, Vikramaditya S. Khanna, *Firm-Level Corporate Governance in Emerging Markets: A Case Study of India*, U of Michigan Law & Economics, Olin Working Paper 08-011, July 2, 2008 at 5.

appear to meet the requirements.⁴²⁰ SEBI never delisted a company for flouting the rule, and it dropped the few enforcement actions it tried to pursue.⁴²¹

2. Deregulation and Debt Accumulation: Minsky Phase 2?

The program of market liberalization ended credit rationing,⁴²² and more consumers and companies assumed higher levels of debt, as Minsky predicted.⁴²³ Between 1994 and 2010, Indian bond markets grew by 2,000%.⁴²⁴ The increased access to credit enabled consumption and investment,⁴²⁵ but it also amplified sensitivity to variations in interest rates.⁴²⁶ Market participants became more exposed to external shocks, the more debt that they acquired.⁴²⁷

The Indian government actively supported the revitalization of the bond markets.⁴²⁸ SEBI pushed to remove regulations on pricing and limits on foreign buyers, despite recognizing the potential for instability:⁴²⁹ “In India, . . . if money starts coming in all mutual funds will get in [sic] large quantities and if it starts going out it will go in huge quantities thus creating storms in the markets,” it noted in a working paper.⁴³⁰ The Ministry of Finance established a High Level Expert Committee on Corporate Bonds to plan how to enlarge the markets.⁴³¹

⁴²⁰ Afra Afsharipour, *Directors As Trustees Of The Nation? India's Corporate Governance And Corporate Social Responsibility Reform Efforts*, 34 Seattle U. L. Rev. 995, 1005 (2011).

⁴²¹ Afra Afsharipour, *The Promise and Challenges of India's Corporate Governance Reforms*, 1 INDIAN J.L. & ECON. 33, 64-67 (2010).

⁴²² See previous section, above.

⁴²³ See rest of section, below.

⁴²⁴ Anupam Rastogi and Vivek Rao, *Product Innovations for Financing Infrastructure: A Study of India's Debt Markets*, South Asia

Working Paper Series No. 6, Oct. 2011 at 8, available at <http://www.iadb.org/intal/intalcdi/PE/2012/09645.pdf>. CRISIL predicts that credit demand will grow at a faster rate than GDP, Rajesh Chakrabarti, *Bond Markets in India*, June 21, 2008 at 2, available at <http://ssrn.com/abstract=1149322>.

⁴²⁵ See, e.g., Rakesh Mohan, *Recent Trends in the Indian Debt Market and Current Initiatives*, available at <http://www.dnb.co.in/FESConfTool/Uploads/Downloads/77/Debt%20Markets%20RM.pdf>; M. T. Raju, Upasana Bhutáni, Anubhuti Sahay, *Corporate Debt Market in India: Key Issues and Policy Recommendations*, SEBI Working Paper Series No. 9, July 2004 at 11.

⁴²⁶ See, e.g., Guy Debelle, *Household Debt and the Macroeconomy*, BIS Quarterly Review, March 24, 2004 at 51.

⁴²⁷ See, e.g., M. T. Raju, Upasana Bhutáni, Anubhuti Sahay, *Corporate Debt Market in India: Key Issues and Policy Recommendations*, SEBI Working Paper Series No. 9, July 2004 at 21 (“[A]ny default will wipe out [retails investors’] savings and security for the post retirement”); Guy Debelle, *Household Debt and the Macroeconomy*, BIS Quarterly Review, March 24, 2004 at 57, 62.

⁴²⁸ See rest of paragraph, below.

⁴²⁹ SEBI, *Developments in the Corporate Bonds and Securitization Market, An Update*, Feb. 24, 2012 at 1, available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1330492152558.pdf.

⁴³⁰ See, e.g., M. T. Raju, Upasana Bhutáni, Anubhuti Sahay, *Corporate Debt Market in India: Key Issues and Policy Recommendations*, SEBI Working Paper Series No. 9, July 2004 at 22-23.

⁴³¹ Rahul Saraogi, *Rule of Law Determines Depth of Debt Market*, India Knowledge@Wharton Series, Aug. 18, 2011, available at <http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4642>; National Institute of Securities

Regulators took deliberate steps to expand participation.⁴³² The Ministry of Finance, for example, allowed the introduction of exchange-traded corporate bonds.⁴³³ Exchange-trading enabled investors to purchase the bonds from other investors on a formal platform, rather than buying them only from the original issuers.⁴³⁴ To attract individual consumers, the Ministry also reduced the minimum size of trades⁴³⁵ and lowered income taxes on interest payments.⁴³⁶

The central bank introduced increasingly speculative products.⁴³⁷ In 2010, it reported: “There were some legal, regulatory and institutional bottlenecks impeding the development of the corporate bond market in India, many of which have been addressed in recent years.”⁴³⁸ Zero-coupon corporate bonds, for example, allowed investors to buy bonds at a discount, then receive the full value plus interest on maturity.⁴³⁹ Prices of zero-coupon bonds tend towards more volatility than those that pay out interest continuously.⁴⁴⁰

SEBI relaxed numerous regulations that controlled risk.⁴⁴¹ In 2007, it eased issuers’ mandatory disclosures to potential investors and requirements to obtain ratings.⁴⁴² It also

Markets, *Improving Indian Securitization Markets*, Nov. 2009 at 1, available at <http://www.iperitus.com/docs/IndiaSecuritizationSummit2009-WhitePaper.PDF>.

⁴³² See rest of paragraph, below.

⁴³³ See, e.g., SEBI, *Developments in the Corporate Bonds and Securitization Market, An Update*, Feb. 24, 2012 at 6, available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1330492152558.pdf. New rules also enabled institutional investors and long-term investors such as pension and provident funds to increase their participation in the bond markets, see Reserve Bank of India, *Financial Stability Report*, March 25, 2010 at 4.32, available at <http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=586>.

⁴³⁴ See, e.g., *Plan for a Unified Exchange Traded Corporate Bond Market: A Report of the Internal Committee of SEBI*, available at http://www.sebi.gov.in/commreport/corporate_bond_market.html.

⁴³⁵ Reserve Bank of India, *Financial Stability Report*, March 25, 2010 at 4.31, available at <http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=586>.

⁴³⁶ R.H. Patil, *Broadbasing and Deepening the Bond Market in India*, Wharton Financial Institutions Center, 01-32 at 2, available at <http://fic.wharton.upenn.edu/fic/papers/01/0132.pdf>; *Securitisations in India: The Story So Far and the Way Forward*, available at <http://www.dnb.co.in/Arcil2008/Securitisations%20in%20India.asp>; Stephen Wells and Lotte Schou-Zibell, *India's Bond Market - Developments and Challenges Ahead*, Asian Development Bank Working Paper Series on Regional Economic Integration No. 22, Dec. 2008 at 24, available at http://aric.adb.org/pdf/workingpaper/WP22_India%27s_Bond_Market.pdf.

⁴³⁷ See rest of paragraph, below.

⁴³⁸ Reserve Bank of India, *Financial Stability Report*, March 25, 2010 at 4.31, available at <http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=586>.

⁴³⁹ Lakshmi Iyer, *Dip Into the Debt Market*, ENTREPRENEUR, June 2010, available at <http://entrepreneurindia.in/dip-into-the-debt-market/4088>; []

⁴⁴⁰ Mark Gergen and Paula Schmitz, *The Influence Of Tax Law On Securities Innovation In The United States: 1981-1997*, 52 Tax L. Rev. 119, 131 (1997);

⁴⁴¹ See rest of paragraph, below.

⁴⁴² SEBI, *Developments in the Corporate Bonds and Securitization Market, An Update*, Feb. 24, 2012 at 9, available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1330492152558.pdf (“SEBI put in place the simplified listing agreement for debt securities . . . issuers with listed equity who are already subject to detailed disclosure requirements, now have to make minimal disclosures.”); Rajesh Chakrabarti, *Bond Markets in India*, June 21, 2008 at 10, available at <http://ssrn.com/abstract=1149322> (“the mandatory number of credit ratings for a bond issue has been reduced from two to one”).

reversed rules that restricted public bonds issues to investment-grade debt, and higher-risk bonds proliferated.⁴⁴³ The proportion of single A-graded debt rose from 9.4% in 2005 to 20.7% in 2009.⁴⁴⁴ Triple-B ratings rose from 4.4% to 23.1% over the same time frame, and non-investment grade bonds rose from 0.8% to 9%.⁴⁴⁵

More liberal regulation unleashed financial innovation.⁴⁴⁶ In 2008, the Ministry of Finance introduced a new type of bond to broaden international investment.⁴⁴⁷ The Foreign Currency Exchangeable Bond could be issued in foreign currencies and pay interest in them, as well. The Ministry also agreed with SEBI to allow repurchase agreements, or “repos,” among individual investors.⁴⁴⁸ In a “repo” transaction, one investor sells a bond to another, on the condition that the seller will repurchase the bond at an agreed price on a specific day.⁴⁴⁹ Although “repos” do not always increase risk, if one party in a sequence of “repo” transactions becomes unable to buy back the bond, the failure spreads through the chain of investors.⁴⁵⁰ This occurred in the U.S. in 2005, for example, in the wake of the collapse of the financial services company Refco.⁴⁵¹ Investors have also accused bankers of using “repos” to hide the worsening financial condition of Lehman Brothers investment bank.⁴⁵²

3. Speculative Euphoria and Fragility: Minsky Phase 3?

The deliberate process of expanding the Indian debt markets shifted from encouraging trade in traditional corporate bonds⁴⁵³ to encouraging securitization.⁴⁵⁴ Securitization increases the

⁴⁴³ Stephen Wells and Lotte Schou-Zibell, *India's Bond Market - Developments and Challenges Ahead*, Asian Development Bank Working Paper Series on Regional Economic Integration No. 22, Dec. 2008 at 24, 28, available at http://aric.adb.org/pdf/workingpaper/WP22_India%27s_Bond_Market.pdf.

⁴⁴⁴ *Id.* at 29.

⁴⁴⁵ *Id.*

⁴⁴⁶ See rest of paragraph, below.

⁴⁴⁷ See, e.g., Singh & Associates, *Foreign Currency Exchangeable Bonds*, Apr. 2008, available at <http://www.asialaw.com/Article/1988861/Channel/16958/Foreign-Currency-Exchangeable-Bonds.html>.

⁴⁴⁸ Rajesh Chakrabarti, *Bond Markets in India*, June 21, 2008 at 12, available at <http://ssrn.com/abstract=1149322>.

⁴⁴⁹ See, generally, Randall J. Pozdena, *Risk in the Repo Market*, FRBSF Weekly Letter Sept. 13, 1985.

⁴⁵⁰ See, e.g., Michael Mackenzie and Henny Sender, *Fed Seeks to Curb Repo Market Risk*, *Financial Times*, Dec. 28, 2011.

⁴⁵¹ Aaron Pressman, *What About the Rest of Refco?*, *Bloomberg BusinessWeek*, October 17, 2005.

⁴⁵² See, e.g., Michael J. de la Merced & Julia Werdigier, *The Origins of Lehman's 'Repo 105,'* *N.Y. Times DealBook*, Mar. 12, 2010, available at <http://dealbook.nytimes.com/2010/03/12/the-british-origins-of-lehmans-accountinggimmick/>; further *In re Lehman Bros. Sec. & ERISA Litig.*, 799 F. Supp. 2d 258, 264 (S.D.N.Y. 2011).

⁴⁵³ See previous section, above.

⁴⁵⁴ See following section, below.

availability of credit,⁴⁵⁵ but it also introduces instability, as Minsky predicted.⁴⁵⁶ The practice of securitizing debt severs the direct relationship between investors and issuers, which increases risk in several ways.⁴⁵⁷ First, securitization causes investors to lower their lending standards and extend more credit.⁴⁵⁸ Investors typically decide to lend to issuers based on their evaluations of the likelihood that the issuers will default, but securitization transfers the risk of default from investors to third parties.⁴⁵⁹ Because they will no longer bear the loss if issuers default, investors become less careful in their lending decisions.⁴⁶⁰ Second, securitization causes underestimation of risk.⁴⁶¹ The downstream investors who take on the risk of default have less information than the original investors.⁴⁶² They may misjudge the likelihood of default, particularly as products grow more complex.⁴⁶³ Third, securitization makes market regulation more difficult.⁴⁶⁴ As the distance between issuers and downstream investors grows, markets become more interconnected and opaque.⁴⁶⁵

In spite of these risks, the Indian government fostered trade in securitized products.⁴⁶⁶ In 2007, SEBI amended the definition of “securities” to include “securitized debt instruments,” in order to allow securitized debt to be listed and traded on Indian stock exchanges.⁴⁶⁷ Trade

⁴⁵⁵ For a discussion of securitization lowering interest rates, see Steven Schwarcz, *Disintermediating Avarice: A Legal Framework for Commercially Sustainable Microfinance*, 4 Ill. L. Rev. 1165, 1171 (2011).

⁴⁵⁶ See, e.g., Hyun Song Shin, *Securitisation And Financial Stability*, 119 *The Economic Journal*, 309, 312 (2009).

⁴⁵⁷ See, e.g., Jan Kregel, *Is This the Minsky Moment for Reform of Financial Regulation?*, Levy Economics Institute Working Paper No. 586, Feb. 25, 2010 at 5.

⁴⁵⁸ Steven Schwarcz, *Disintermediating Avarice: A Legal Framework for Commercially Sustainable Microfinance*, 4 Ill. L. Rev. 1165, 1178 (2011) (“Because lenders to subprime borrowers did not have to live with the credit consequences of their loans, the argument goes, their loan underwriting standards fell.”).

⁴⁵⁹ ⁴⁵⁹ Steven Schwarcz, *Disintermediating Avarice: A Legal Framework for Commercially Sustainable Microfinance*, 4 Ill. L. Rev. 1165, 1178 (2011).

⁴⁶⁰ Willem H. Buiter, *Lecture on Lessons From the Global Financial Crisis for Regulators and Supervisors* (June 13, 2009), available at http://eprints.lse.ac.uk/29048/1/Lessons_from_the_global_financial_crisis.pdf (“What was not well recognized was that securitization, by breaking the link between, on the one hand, the originator of the loan and the party responsible for monitoring the loan over its life-time, and, on the other hand, the principal in the investing relationship – the owner of the securitized loan – weakens the incentives for collecting information and misplaces whatever information is collected.”).

⁴⁶¹ See, e.g., Timothy Geithner, *Macroeconomic Effects of Risk Retention Requirements*, Jan. 2011 at 9, available at <http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20%28F1NAL%29.pdf>.

⁴⁶² Id.

⁴⁶³ Id.

⁴⁶⁴ See, e.g., Anastasia Nesvetailova, *The Crisis Of Invented Money: Liquidity Illusion And The Global Credit Meltdown*, 11 *Theoretical Inquiries L.* 125, 133 (2010).

⁴⁶⁵ Id.

⁴⁶⁶ See rest of paragraph, below.

⁴⁶⁷ See, e.g., Varun Vaish, *Regulations Surrounding the Listing of Securitized Debt Instruments*, National Academy of Legal Studies and Research University of Law, Aug. 17, 2011 at 3-4, available at <http://ssrn.com/abstract=2071238>.

volumes doubled within the year.⁴⁶⁸ In 2009, representatives from SEBI, RBI, and the Ministry of Finance attended a securitization summit in Mumbai with private market participants, in order to discuss how to eliminate obstacles to growth of the securities markets.⁴⁶⁹ In 2010, the Supreme Court endorsed trading in securitized debt by ruling that banks could legally transfer credit risk.⁴⁷⁰

As Minsky wrote, “anything that can be securitized will be securitized,”⁴⁷¹ and the program to increase securitization included the packaging of residential mortgages, the same financial products involved in the global financial crisis.⁴⁷² The volume of mortgage-backed securities in India increased 61% between 2009 and 2010, and the value traded rose 53% between 2011 and 2012.⁴⁷³ The National Housing Bank, the regulator of the Indian housing finance sector, pioneered their introduction in 2001 to expand property ownership through cheaper credit.⁴⁷⁴ The Indian government instituted a “Five-Year Economic Plan” that estimated the money to be earned from mortgage securitization.⁴⁷⁵ As the growing market demanded new mortgages to securitize, non-conforming mortgages with low introductory rates emerged, as they had in the West.⁴⁷⁶

⁴⁶⁸ Rajesh Chakrabarti, *Bond Markets in India*, June 21, 2008 at 13, available at <http://ssrn.com/abstract=1149322>.

⁴⁶⁹ National Institute of Securities Markets, *Improving Indian Securitization Markets*, Nov. 2009 at 2, available at <http://www.iperitus.com/docs/IndiaSecuritizationSummit2009-WhitePaper.PDF>.

⁴⁷⁰ Kalpesh Gada and Remika Agarwal, *ICRA, Update on Indian Securitisation Market*, May 2012 at 7, available at <http://www.icra.in/Files/Articles/Indian%20Securitisation.pdf>.

⁴⁷¹ Hyman Minsky, *Securitization*, The Levy Economics Institute of Bard College, Policy Note, 2008/2 at 2, quoting participants of a conference of the Chicago Federal Reserve Bank in May, 1987; further Hyman Minsky, *Securitization Outline*, 1987, Hyman P. Minsky Archive. Paper 188, available at http://digitalcommons.bard.edu/hm_archive/188.

⁴⁷² See, e.g., Timothy Geithner, *Macroeconomic Effects of Risk Retention Requirements*, Jan. 2011 at 10, available at <http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20%28FINAL%29.pdf>; Douglas W. Diamond and Raghuram Rajan, *The Credit Crisis: Conjectures About Causes and Remedies*, National Bureau of Economic Research, Working Paper No. 14739, Feb. 2009 at 4.

⁴⁷³ *Securitisation Markets in India – a Post-Crisis Perspective*, Inaugural address by Ms Shyamala Gopinath, Deputy Governor of the Bank of India, at the India Securitisation Summit 2010 hosted by the National Institute of Securities Markets (NISM), Mumbai, Aug. 10 2010 at 3; Kalpesh Gada and Remika Agarwal, *ICRA, Update on Indian Securitisation Market*, May 2012 at 5, available at <http://www.icra.in/Files/Articles/Indian%20Securitisation.pdf>.

⁴⁷⁴ See, e.g., K.C. Iyer and G.C. Tripathi, *Prepayment Analysis of Residential Mortgage Backed Securities For Indian Securitization Market*, Feb. 3, 2008, available at <http://ssrn.com/abstract=1090013>; National Housing Bank, *Credit Enhancement to Residential Mortgage Backed Securities (RMBS) of Primary Lending Institutions by way of NHB Guarantee*, available at http://www.nhb.org.in/Financial/Guarantee_NHB_website.PHP; National Housing Bank, *NHB supports 1st MBS of BOB Housing Finance Limited*, Press Release, Apr. 23, 2003, available at <http://www.nhb.org.in/Press%20Release/April28.php>.

⁴⁷⁵ Royal Bank of India, Report, available at <http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/10793.pdf> (“resource constraint confronting the housing sector. The Ninth Five-Year Plan has strongly recommended securitisation as an important source of funds for the housing sector and has envisaged Rs. 2500 crore to come by way of securitisation”).

⁴⁷⁶ Reserve Bank of India, *Financial Stability Report*, March 25, 2010 at 5.25, available at <http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=586> (“Some concerns have emerged . . . in respect of “teaser” rates for home loans offered by banks. These ‘teaser’ home loans initially have a low fixed interest rate, which in later years increases to higher levels.”).

In time, India embraced collateralized debt obligations (“CDOs”), a more complicated variety of security.⁴⁷⁷ CDOs reference underlying securitized products, such as mortgage-backed securities.⁴⁷⁸ When they do, the mortgage assets can change over time, unlike typical mortgage-backed securities which remain static.⁴⁷⁹ Investors purchase specific tranches that entitle them to different rates of return and priority of payment, so long as the holders of the original mortgages avoid default.⁴⁸⁰

Regulators encouraged investment in other new financial products, such as derivatives.⁴⁸¹ In 1996, SEBI supported legalization of derivatives trading and self-regulation by derivatives exchanges.⁴⁸² A derivative involves a contract between two parties that specifies payments based on the changes in the value of a designated variable.⁴⁸³ While investors can use derivatives to hedge against risk, they can also acquire risk by using them to speculate on future market movements.⁴⁸⁴ The complexity of derivatives trades may also make it more difficult for regulators to anticipate how the financial system will react to economic shocks.⁴⁸⁵ Interest rate swaps, in which investors bet on changes in variable interest rates, gained popularity in India.⁴⁸⁶ By 2006, the country had become the third largest market for derivatives tied to the value of

⁴⁷⁷ *Securitisation in India: The Story So Far and the Way Forward*, available at <http://www.dnb.co.in/Arcil2008/Securitisation%20in%20India.asp>

⁴⁷⁸ Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008 at 7, available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

⁴⁷⁹ *Id.* at 9.

⁴⁸⁰ *Id.* at 7, 31.

⁴⁸¹ See rest of paragraph, below.

⁴⁸² Dayanand Arora and Francis Xavier Rathinam, *OTC Derivatives Market in India: Recent Regulatory Initiatives and Open Issues for Market Stability and Development*, Indian Council for Research on International Economic Relations Working Paper No. 248, Apr. 2010 at 8, 20.

⁴⁸³ Erik F. Gerding, *Credit Derivatives, Leverage, And Financial Regulation's Missing Macroeconomic Dimension*, 8 Berkeley Bus. L.J. 29 30-31 (2011).

⁴⁸⁴ *Id.* at 37-38.

⁴⁸⁵ See, e.g., Richard Beales and Gillian Tett, *Greenspan Warns on Credit Derivatives*, FINANCIAL TIMES, May 5, 2005 (“Rapid growth in the credit derivatives market has created considerable uncertainty about how the global financial system might react to any new economic shocks,” Alan Greenspan, Chairman of the Federal Reserve warned on Thursday. “The sheer complexity of derivatives instruments, in particular, coupled with the consolidation in the financial industry, made it increasingly hard for regulators and bankers to assess levels of risk,” he said.”).

⁴⁸⁶ Dayanand Arora and Francis Xavier Rathinam, *OTC Derivatives Market in India: Recent Regulatory Initiatives and Open Issues for Market Stability and Development*, Indian Council for Research on International Economic Relations Working Paper No. 248, Apr. 2010 at 9.

gold.⁴⁸⁷ Since then, it has grown into the largest market for derivatives tied to the value of single stocks.⁴⁸⁸

CONCLUSION

The lessons that the future of India holds for the West should not be exaggerated. Indian and Western regulators and CRAs are embedded in different environments.⁴⁸⁹ What would be suitable for a less-developed economy may not be adaptable to diverse, developed economies.⁴⁹⁰

Nevertheless, watching India offers new evidence for evaluating the role that public institutions should play in regulating financial markets. To avoid instability, must they intervene to restrict increases in consumer credit and trade in speculative instruments? Can they instead delegate to private “gatekeepers,” so long as they first align the “gatekeepers” incentives?

The stakes for the Indian CRAs will rise. As the credit markets energize, they will have to make faster, more complicated judgments. Pressures on their integrity will intensify.

If their performance remains strong, and if the economy improves, it would provide some indication that the agencies can assume governance functions and keep evolving financial markets in check. That would imply that it is prudent for Western regulators to focus on “exogenous” regulatory changes to mitigate the CRAs’ conflicts of interest.

If the future does not go well—if the agencies are unwilling to downgrade a powerful Indian bank, or expose a fraud in a securitized tranche⁴⁹¹—then perhaps it confirms that private entities should not be given responsibility for financial stability. Instead, it might suggest that deeper, more meaningful structural changes are necessary to counter increasing fragility, as Minsky believed.

Substantial efforts have been expended to reform the regulation of the Western CRAs. A robust campaign tried, and failed, to eliminate the “issuer-pays” model in the American Dodd-

⁴⁸⁷ Stephen Wells and Lotte Schou-Zibell, *India's Bond Market - Developments and Challenges Ahead*, Asian Development Bank Working Paper Series on Regional Economic Integration No. 22, December 2008 at 4, available at http://aric.adb.org/pdf/workingpaper/WP22_India%27s_Bond_Market.pdf.

⁴⁸⁸ *Id.*

⁴⁸⁹ For a discussion of rule embeddedness, see Dan Danielsen, *Economic Approaches To Global Regulation: Expanding The International Law And Economics Paradigm*, 10 J. Int'l Bus. & L. 23, 37-38 (2011).

⁴⁹⁰ See, e.g., *Id.*

⁴⁹¹ For a discussion of the politics involved in ratings, see, e.g., John C. Coffee, *Ratings Reform: The Good, The Bad, and The Ugly*, The Center for Law and Economic Studies – Columbia University School of Law Columbia Law and Economics Working Paper No. 359, Sept. 2010 at 55.

Frank Act.⁴⁹² If the efforts have not been focused correctly, it is important to redirect them towards a more effective response.⁴⁹³ India provides a reference for how intensively financial markets should be regulated, and by whom.

⁴⁹² On the Franken Amendment, *see, e.g.*, Daniel Indiviglio, *Franken Amendment Would Bring Real Rating Agency Reform*, THE ATLANTIC, May 6, 2010.

⁴⁹³ For a discussion of the difficulties investors and shareholders have in securing reforms, *see* John C. Coffee, *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, Center for Law and Economic Studies, Columbia Law School, Working Paper No. 414, Jan. 9, 2012 at 3-4.