

**Credit Rating Agencies and the ‘Worldwide Credit Crisis’:
The Limits of Reputation, the Insufficiency of Reform,
and a Proposal for Improvement**

Summary

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John P. Hunt

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One of the most important developments in finance over the last quarter-century is the rise of “securitization,” or the creation of “structured products,” which generally speaking can be defined as securities that represent the rights to receive cash flow from underlying pools of income-producing financial assets (such as mortgages, auto-loan or credit-card receivables) and the sale of rights to the cash flows from the pools to investors. More and more sophisticated ways of allocating the cash flows and associated credit risks have evolved over time, and ratings from major credit rating agencies such as Moody’s and Standard & Poor’s have been important in building investor acceptance of each generation of products.

In early 2007, novel structured products, including but not limited to bonds based on subprime mortgages, yielded significantly more than traditional corporate bonds carrying the same ratings. According to the major credit rating agencies, similarly rated novel and traditional products carried more or less the same default risk. This sounds too good to be true, and it was. In 2007 and 2008, many securitized products – some based on subprime mortgages, some not – turned out to be much riskier than traditional corporate bonds bearing the same ratings. The resulting loss of confidence in agency ratings on these products apparently contributed to a near-complete shutdown in markets for the affected products and may have contributed to the general fear of credit risk that characterizes the “worldwide credit crisis.”

Ratings from the major agencies, are important to some extent because investors look to them as high-quality assessments of credit risk. But they are important for two other related reasons. First, the financial regulatory system incorporates ratings issued by agencies that enjoy the government-recognized status of a “nationally recognized statistical rating organization” (NRSRO). At least 44 SEC rules and forms rely on ratings, including rules that require money-market funds to invest in instruments with high credit ratings and that exempt highly rated structured-product vehicles from the (fatal) designation as investment companies. State laws require state funds and employee pension funds to meet credit-rating requirements. Banking regulations determine regulatory capital requirements based on the credit ratings of the securities the bank owns. Judicial decisions protect fiduciaries that rely on credit ratings. Second, agency ratings -- with the agencies often identified by name -- are hardwired into the financial infrastructure through private arrangements: Investment guidelines and covenants for

all manner of fixed-income instruments are keyed to agency ratings. Indeed, many structured products are set up so that they default if they fail to meet ratings criteria, even if investors are receiving all scheduled payments.

Ironically, the latest problems for the rating agencies cropped up just as a new regulatory regime – this one designed to address the problems of the Enron-era corporate scandals – was going into effect. In the wake of Enron (which retained an investment-grade credit rating up until four days before it filed for bankruptcy) and other, similar failures, Congress and the SEC held years of hearings and ultimately alit on a strategy for rating agency reform that aimed to increase competition in the industry by reducing regulatory barriers to entry, and that included modest disclosure rules as a backup. Under legislation passed in 2006 and implementing rules the SEC adopted in 2007, the SEC was to apply substantively undemanding criteria on applications to become an NRSRO and to act on such application according to a strict timetable. Rating agencies were to disclose summaries of their rating procedures and their procedures for handling any conflicts of interest. Whatever the long-term merits of this approach, it doesn't appear to have accomplished much to date: Although the SEC now recognizes at least 10 NRSROs, it reported earlier this year that the three ones continue to have a market share in excess of 95%. The disclosure rules for their part have produced only vague, seemingly unhelpful information. For example, the officially required disclosures say a lot less about how the major agencies rate structured products than the reports they already were making available to the market.

The SEC did propose additional rules in summer 2008 in response to the crisis. The major point of these rules was to reduce what the SEC called investors' "undue reliance" on ratings by reducing its own reliance on agency ratings in its rules. Part of the problem, the SEC said, was that investors might have seen the use of ratings in the regulatory system as some sort of official endorsement of rating quality. Accordingly, the SEC proposed to revamp many of its rating-dependent rules: Money-market fund investments would not be limited by credit ratings, but by board determinations that the instruments in question were liquid and creditworthy (although the SEC expects that boards will continue to use NRSRO ratings that they conclude are "credible"). Structured-finance vehicles would no longer have the option to escape investment-company status by issuing highly rated debt (the SEC expects that they would instead rely on the sophisticated-investor exemption that most of them use already). Broker-dealers no longer would have to calculate their net capital with reference to credit ratings but would be required to assess creditworthiness on their own (although they could continue to rely on credit ratings if they wish). Although the SEC's proposal appears to be a meaningful reduction of its own reliance on credit ratings, so many other agencies and private ratings depend on credit ratings that the proposal may have only a limited effect.

The SEC also proposed new rules specifically for structured products, the most significant of which reflected the Commission's continuing faith in disclosure and competition: Agencies could not be paid by issuers to rate structured products unless the data underlying the rating were broadly distributed, permitting other agencies to issue their own, alternative ratings (albeit without pay).

The SEC stopped short of seriously taking on one obvious conflict of interest faced by rating agencies: The ratings are paid for by the issuers themselves. Although the agencies have adopted "firewall"-like approaches to dealing with this problem, rules intended to separate credit analysis from the business of building and maintaining relationships with the issuers that are the agencies' clients, it is questionable whether such rules address a conflict that exists at the level of

the agency, not just the individual analyst. Although the SEC recognizes that the issuer-pays revenue model is a conflict of interest, its existing and proposed rules on the subject, such as a ban on gifts over \$25 from issuers to individual analysts, are quite weak.

The underlying theme of Congressional and SEC action, both before and during the 2007-08 crisis, is that a competitive market with well-informed participants can produce high-quality ratings. The regulatory goals of increasing competition and transparency while reducing rating-dependent regulation clearly serve the laudable purpose of creating such a market; the decision not to address conflicts of interest seriously is an expression of faith in the power of such a market to discipline the agencies. The overall approach is consistent with the dominant academic view of the rating market, which is that rating agencies will not (or in a well-functioning market would not) risk their reputation by knowingly issuing low-quality ratings.

But in the case of a new product that requires fundamentally different analytical techniques from the agency's existing business, it's unclear that that view makes sense. Consider an agency that does not have a firm grasp on how a novel instrument, such as a structured product based on subprime mortgages, will behave over the credit cycle. If the agency goes ahead and issues ratings on the novel product, it seems unlikely that the agency is "risking its reputation" for high-quality ratings on, say, traditional corporate or municipal bonds. An agency's failure to model the subprime mortgage product correctly says little about its ability to rate the traditional debt of a corporation like General Electric – something that Moody's has been doing for literally 100 years. Rational investors will not penalize the agency on the traditional side for its failures on the novel side. Evidence from the credit crisis supports this theoretical prediction: Even as the market for novel structured products collapsed, agency revenue rose in the traditional investment-grade corporate market.

Thus, regulatory strategies based solely on reputation are of questionable value in dealing with the fundamental problem posed by ratings on novel products: agencies' incentives to issue ratings even when they do not know what they are doing. The problem is particularly acute because the chance that agencies do not know what they are doing is highest for novel products. Regulators might consider some form of ex post remedy, such as a requirement to disgorge profits on low-quality ratings, to deal with this problem.

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For further information, contact bclbe@law.berkeley.edu

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