Credit Rating Agencies and the Financial Crisis: Less Regulation of CRAs Is a Better Response

Lawrence J. White*

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Abstract

The central role that the three large U.S.-based rating agencies played in the subprime mortgage lending debacle and the subsequent financial crisis has led to expanded regulation of the rating agencies and political calls for considerably more regulation. The advocates of this policy route, however, ignore the history of how the rating agencies came to occupy a central place in the provision of bond creditworthiness information; and they ignore the dangers that more regulation will raise the barriers to entry into and decrease innovation in the provision of bond creditworthiness information. A better policy route would be to reduce the regulation of the rating agencies while reforming the prudential regulation of financial institutions' bond portfolios, by eliminating regulatory reliance on ratings. This would allow financial institutions to obtain their bond creditworthiness information from a wider range of sources, which would encourage new methodologies, new technologies, new procedures, and possibly even new business models. Since the transactors in bond markets are predominantly institutional bond managers, less regulation of the information providers would be appropriate.

Key words: Credit rating agency; nationally recognized statistical rating agency (NRSRO); financial crisis; regulation

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* Lawrence J. White is Professor of Economics, Stern School of Business, New York University. A.B., Harvard University (1964); M.Sc. (Econ.), London School of Economics (1965); Ph.D., Harvard University (1969).

"…an insured state savings association…may not acquire or retain any corporate debt securities not of investment grade." 12 Code of Federal Regulations § 362.11

" …any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision." The usual disclaimer that is printed at the bottom of Standard & Poor's credit ratings

I. Introduction

When the histories are written of the U.S. subprime residential mortgage debacle of 2007-2008, and the world financial crisis that followed, the three large U.S.-based credit rating agencies – Moody's, Standard & Poor's (S&P), and Fitch – will surely be seen as central parties to the debacle; and rightly so. Their initially favorable ratings on the bonds that were securitized from subprime residential mortgages and other debt obligations were crucial for the successful sale of these bonds to various categories of institutional investors. In turn, the sale of these bonds provided an important underpinning for the U.S. housing boom of 1998-2006 and the self-reinforcing housing price bubble.

When U.S. house prices ceased rising in mid-2006 and then began to fall, many mortgage borrowers (who were relying on a continuation of house price increases) could not repay their mortgages and began defaulting. The initial assumptions of the rating agencies proved to be overly optimistic – especially for the bonds that were based on mortgages that were originated in 2005 and 2006. The prices of the mortgage bonds collapsed (and were duly downgraded by the rating agencies), with disastrous consequences for the financial institutions that had invested in those bonds and for the larger U.S. financial system as well as many other countries' financial systems.

The credit rating agencies have received a great deal of media, political, and regulatory attention since the early summer of 2007. The political urge seems to be (figuratively) to want to grab the rating agencies by the lapels, shake them, and shout at them: “Do a better job!” Further, the current business model of all three of the major rating agencies – an “issuer pays” model, whereby the rating agencies are paid by the same entities whose bonds the agencies are rating – has also attracted a considerable amount of attention, since the potential conflicts of interest in this model are clear.

Although this political urge and the focus on the issuer pays business model are understandable, they are misguided. They ignore the seven decades of history of the prudential regulation of financial institutions’ bond holdings, which helped propel the rating agencies into the center of the U.S. bond markets and virtually assured that when they did make mistakes, those mistakes would have serious consequences for the financial system of the U.S. The critics of the issuer pays model have largely ignored the history of the issuer pays model: It was adopted by the major credit rating agencies in the early 1970s, yet didn’t “blow up” until four decades later.

The political pressures have already led to some regulations – and are likely to lead to considerably more – that will raise the costs of providing ratings and thus raise barriers to entry, which in turn will tend to discourage new ideas, new methodologies, new technologies, perhaps new business models; in short, they will discourage innovation. This added regulation will tend to stultify the credit rating business and entrench and encrust current practices. Ironically, it is likely to make the incumbent large credit rating agencies more important, not less.

There is a better way. That way involves less regulation of the credit rating agencies, as well as a reformulation of the prudential regulation of financial institutions’ bond portfolios. The result would be more entry and more innovation in the provision of information for the bond markets and greater efficiency in those markets.

The argument for this better way requires an understanding of the history of the bond rating industry, the history of the prudential regulation of financial institutions' bond portfolios, and the intertwining of those two histories that began over seven decades ago. It also requires an understanding that the bond markets are overwhelmingly an institutional market, where the buy and sell decisions are made by bond managers at financial institutions and not by retail investors.

Laying out this argument will be the goal of this article. The orientation of this article will be on the U.S. experience;[1] but the lessons surely carry over to how credit rating agencies are or are not regulated in other countries.

II. The Role of Credit Rating Agencies

A central issue in finance – perhaps the central issue in finance – is the uncertainty of a lender as to whether a borrower will repay a loan. The critical problem is one of asymmetric information: The borrower usually knows more about the prospects for repayment than does the lender. As a consequence, before extending a loan, lenders will gather extensive information about prospective borrowers, so as to try to determine which are the more creditworthy

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[1] Other discussions of this experience can be found in: Lawrence J. White, "The Credit Rating Industry: An Industrial Organization Analysis," in Richard M. Levich, Carmen Reinhart, and Giovanni Majnoni, eds., Ratings, Rating Agencies, and the Global Financial System, Kluwer (Boston, 2002), pp. 41-63; Lawrence J. White, "The SEC's Other Problem," Regulation, 25 (Winter 2002-2003), pp. 38-42; Lawrence J. White, "Good Intentions Gone Awry: A Policy Analysis of the SEC's Regulation of the Bond Rating Industry," Policy Brief #2006-PB-05, Networks Financial Institute, Indiana State University, 2006; Lawrence J. White, "A New Law for the Bond Rating Industry," Regulation, 30 (Spring 2007), pp.48-52; Lawrence J. White, "The Credit-Rating Agencies and the Subprime Debacle," Critical Review, 21, Nos. 2-3, 2009, pp. 389-399; Matthew C. Richardson and Lawrence J. White, "The Rating Agencies: Is Regulation the Answer?" in Viral Acharya and Matthew C. Richardson, eds., Restoring Financial Stability: How to Repair a Failed System. New York: Wiley, 2009, pp. 101-115; Richard Cantor and Frank Packer, "The Credit Rating Industry," Journal of Fixed Income, 5 (December 1995), pp. 10-34; Herwig Langohr and Patricia Langohr, The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They Are Relevant, Wiley (Chichester, 2008); Frank Partnoy, "The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies," Washington University Law Quarterly, 77 No. 3 (1999), pp. 619-712; Frank Partnoy, "The Paradox of Credit Ratings," in Richard M. Levich, Carmen Reinhart, and Giovanni Majnoni, eds., Ratings, Rating Agencies, and the Global Financial System, Kluwer (Boston, 2002), pp. 65-84; Timothy J. Sinclair, The New Masters of Capital: American Bond Rating Agencies and the Politics of Creditworthiness, Cornell University Press (Ithaca, 2008); and Richard Sylla, "An Historical Primer on the Business of Credit Ratings," in Richard M. Levich, Carmen Reinhart, and Giovanni Majnoni, eds., Ratings, Rating Agencies, and the Global Financial System, Kluwer (Boston, 2002), pp. 19-40.

borrowers and which are the less creditworthy;[2] and even after extending a loan, the lender will usually want to monitor the borrower's actions, so as to be reassured that the borrower's actions are not putting repayment in jeopardy.[3]

For the remainder of this article, it will be important to keep in mind that bonds are just another form of a loan. Although the terminology (e.g., "investors", "investing", "purchasing"; "issuers", "issuing", "selling") of bonds may make them sound different, a bond is fundamentally a loan:[4] The bond issuer is the borrower; the bond buyer (or investor) is the lender.[5] Accordingly, that central question of finance – will I get repaid? – applies just as importantly to bonds.

Credit rating agencies are one potential source of help for piercing the fog of asymmetric information for bonds. After collecting information about bond issuers, they offer judgments – they prefer the word "opinions"[6] – about the creditworthiness of bonds that are issued by corporations, governments (including state and local governments, as well as national – "sovereign" – issuers), and securitizers of mortgage (and other) loans.[7] These judgments are in

[2] In addition, lenders may take other protective actions, such as requiring collateral as the security for the loan or requiring a co-signer or guarantor. Lenders may also place restrictions in the lending agreement (or covenants in a bond indenture) that limit the actions of the borrower during the period of the loan.

[3] Even the act of requiring a fixed monthly payment on a loan (as compared with waiting for a "balloon" repayment at the end of the loan period) is a form of monitoring. If a borrower fails to make a monthly payment, this failure is an early signal that further repayment may be in jeopardy.

[4] The major difference is that a bond is usually considered to be a security and hence is tradable, whereas a loan usually is not considered to be a security (although it may be sold from one party to another, as has been increasingly true for mortgage loans and other loans originated by banks).

[5] And if a subsequent investor buys a bond from its original investor, that subsequent investor is now in the role of lender, to whom the issuer (borrower) owes the repayment.

[6] The rating agencies prefer that word because it allows them to portray themselves as "publishers", akin to the publishers of newspapers, and thereby gain the protection of the First Amendment of the U.S. Constitution when they are sued by unhappy investors (e.g., who claim that they were injured by ratings that were subsequently shown to be overly optimistic) or by issuers (e.g., who claim that they were injured by overly pessimistic ratings).

[7] The judgment may apply solely to a specific bond issuance or more broadly to the issuer as well. In the case of a specific bond issuance, the judgment may be solely about the prospects for default, or it may also include a prediction about the likely losses that a bond holder will suffer in the event of default.

the form of "ratings," the best known symbols of which are those used by S&P and a number of other rating agencies: AAA, AA, A, BBB, etc., with pluses and minuses as well.[8]

It is important to emphasize that the credit rating agencies are not the only potential source of such creditworthiness information. Many financial institutions are capable of doing their own research. There are smaller financial services firms that may not describe themselves as "rating agencies" but that nevertheless provide advice about creditworthiness to (institutional) bond investors. Further, many financial services companies, including large investment banks and commercial banks, employ "fixed income analysts" whose recommendations with respect to bond investments (based on their judgments about those bonds' creditworthiness) are provided to those companies' (institutional) clients.[9]

How then did the three large credit rating agencies gain their prominence at the center of the bond markets? It is to the history of the credit rating agencies, and their entwinement with the prudential regulation of many financial institutions' bond portfolios, to which we now turn.

III. Some pre-2000 Financial History

John Moody is generally credited with providing the first published bond ratings. Moody's firm[10] published its first bond ratings (mostly on railroad bonds) in April 1909. That innovation was followed by the entry of Poor's Publishing Company into the provision of published ratings in 1916, by the Standard Statistics Company[11] in 1922, and by the Fitch

[8] A separate set of symbols is used for the ratings of short-term debt instruments, such as commercial paper.
[9] Fixed income analysts have a professional society – the Fixed Income Analysts Society, Inc. (FIASI) – and there is even a Fixed Income Analysts Society Hall of Fame! An analysis of these fixed income analysts as a source of information about bonds can be found in Rick Johnston, Stanimir Markov, and Sundaresh Ramnath, "Sell-side Debt Analysts," Journal of Accounting and Economics, 47 (March 2009), pp. 91-107.
[10] The Moody's company was bought by Dun & Bradstreet in 1962; subsequently, in 2000 Dun & Bradstreet spun off Moody's as a freestanding corporation.
[11] Standard and Poor's merged to form S&P in 1942; S&P was absorbed by McGraw-Hill in 1966.

Publishing Company[12] in 1924. Recall that this was the era before the establishment of the U.S. Securities and Exchange Commission (SEC, which was created in 1934) and its requirements that publicly traded companies should issue standardized financial statements. In that reduced information era, Moody and the other firms that followed his lead were clearly meeting a market demand for their information services.

These rating companies sold their ratings to bond investors, in the form of thick rating manuals. In the parlance of modern-day corporate strategy, their business model was that of "investor pays".

The relationship between the rating companies and the bond markets changed importantly in the 1930s. Thousands of U.S. banks had failed in the late 1920s and early 1930s. Major changes in the prudential regulation of banks were enacted in the 1930s. Concomitant with those legislative changes was an important set of regulatory changes, involving the use of credit ratings, that were designed to encourage banks to hold safe bonds in their portfolios. These changes culminated in 1936 with a federal regulatory prohibition on banks' being able to invest in "speculative investment securities" as determine by "recognized rating manuals". "Speculative" securities were those that were below "investment grade"; a common phrase today for such securities would be "junk bonds". Thus, if banks wanted to invest in bonds, they were restricted to investing only in "investment grade" bonds (e.g., bonds that were rated BBB or better on the S&P scale

This regulatory edict (which still applies to U.S. banks today) caused an important change in the provision of information to the bond market. Whereas banks had previously been free to act on information about bonds from any source that they had considered to be reliable

[12] Fitch merged with a British Firm (IBCA, which was a subsidiary of a French business services conglomerate, FIMILAC) in 1997.

(albeit within the constraints of the prudential oversight by bank regulators), banks were now constrained to heed the judgments of the publishers of "recognized rating manuals" – i.e., Moody's, Standard, Poor's, and Fitch – at least with respect to the categories of bonds that could be bought and bonds that could not be bought.[13] Since banks were important participants in the bond markets, other institutional buyers and sellers in the bond markets would also want to know the specifics of these rating agencies' ratings.

From a regulatory perspective, bank regulators were no longer using their own prudential judgments for what were and were not safe bond portfolios for their regulated banks. Instead, they had delegated (or outsourced) that safety judgment to these private third-party rating agencies. Equivalently, the bank regulators had endowed these third-party rating agencies' ratings with *the force of law*.

In the following decades the 48 (and later, 50) state regulators of insurance companies[14] adapted their prudential regulation in a similar direction. The state regulators wanted their regulated insurance companies to have adequate capital to support the riskiness of the bonds in their portfolios. Accordingly, the regulators established minimum capital requirements that were linked to the riskiness of the bonds in insurance companies' portfolios, with riskiness being determined by the ratings of the same small group of rating agencies. Once again, prudential regulators had delegated their safety judgments to a small set of third parties; equivalently, another set of important participants in the bond markets were being required to heed the ratings of a select group of rating agencies. In the 1970s, federal pension fund regulators followed a

[13] Bank regulators have since employed ratings for other regulatory purposes as well. For example, the capital requirements on residential mortgage-backed securities (MBS) are reduced for MBS that are rated AA or better. Also, in 1989 the prohibition on holding "speculative" securities was extended to savings institutions.
[14] In the U.S., the regulation of insurance companies is solely a function of the individual states.

similar strategy of requiring defined-benefit pension funds to heed ratings in their bond investment decisions.

This regulatory reliance on the ratings of fewer than a (literal) handful of rating firms – endowing them with the force of law – was crystallized by the SEC in 1975. The SEC wanted to revise its minimum capital requirements for broker-dealers (i.e., securities firms), so as to link those capital requirements to the riskiness of the bonds in their portfolios. Following the example of the state insurance regulators, the SEC used the rating agencies' ratings as the guide to bonds' riskiness. However, the SEC was uneasy with the vagueness of the previous references to "recognized rating manuals": A bogus rating firm might promise "AAA" ratings for the bonds of a company that paid a suitable fee (and threaten "DDD" ratings for the bonds of the companies that did not); and a broker-dealer might want to use those ratings for the determination of its capital requirements, claiming that these ratings were "recognized".

To deal with this problem, the SEC created the category of "nationally recognized statistical rating agency" (NRSRO); it immediately "grandfathered" Moody's, S&P, and Fitch into the category; and it instructed broker-dealers to heed only the NRSROs' ratings.[15] The other U.S. financial regulators soon followed the SEC's lead in this regard, adopting the NRSRO category and the rating firms within it as the source of the ratings that their regulated financial institutions must heed in their choices of bond portfolios.

Over the next 25 years the SEC designated only four additional firms as NRSROs.[16] However, mergers among these firms and with Fitch caused the number of NRSROs to return to the original three by year-end 2000. De facto, the SEC had become a significant barrier to entry

[15] In the early 1990s the SEC similarly mandated that money market mutual funds heed the NRSROs' ratings in choosing safe short-term bonds (i.e., commercial paper) for their portfolios.
[16] They were as follows: Duff & Phelps in 1982; McCarthy, Crisanti & Maffei in 1983; IBCA in 1991; and Thomson Bank Watch in 1992.

into the credit rating business, since the NRSRO designation was important for a potential entrant. Without the NRSRO designation, a would-be bond rater would have difficulty attracting the attention of many of the "buy-side" financial institutions (since their financial regulators had mandated that these institutions follow the judgments of the NRSROs); and without the attention of many of the buy-side institutions, bond issuers (the "sell side") would also be likely to ignore a non-NRSRO fledgling.[17]

In addition, the SEC was remarkably opaque in its handling of the NRSRO category. It never defined the criteria for becoming a NRSRO; and its decisions to approve or reject an applicant's request to become a NRSRO were never transparent; it never established a formal application or review process, and never explained its decisions.

One other important pre-2000 event is worth noting: In the early 1970s, the major credit rating firms changed their business models from the "investor pays" model that had been established by John Moody in 1909 to an "issuer pays" model, whereby the entities whose bonds were being rated would be the parties that would pay the raters. The reason for this shift in business model has never been established definitively. There are four candidate explanations:

1. The early 1970s were the period when the high-speed photocopy machine (producing relatively inexpensive photocopies) was coming into widespread use; the rating agencies were afraid that they would lose too many sales of rating manuals to investors who would instead "free ride" by obtaining photocopies of the rating information from friends. The issuer pays model would not suffer from the free-riding problem.

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[17] The absence of the NRSRO designation was not fatal, however. A few smaller non-NRSRO firms that offered ratings – notably, Egan-Jones, Lace Financial, and KMV – were able to survive. All had "investor pays" business models. KMV was absorbed by Moody's in 2002.

2. The Penn-Central Railroad's bankruptcy in 1970 shocked the bond markets and caused issuers to be willing to pay for the certification that the credit rating agencies could provide.[18]

3. The credit rating agencies belatedly (in the early 1970s) realized that their ratings were essential for issuers to be able to sell their bonds to banks and insurance companies and should be willing to pay for that access.

4. The credit rating business, like many other information businesses – e.g., newspapers and magazines; cable television broadcasting – is a "two-sided market," where payments can come from either side of the market[19] and which side will actually pay can be idiosyncratic.

In any event, the conversion of the industry to the issuer-pays model clearly opened the door to some obvious potential conflict of interest problems, since issuers might "shop around" for favorable ratings and thereby place pressure on the rating agencies to shade their ratings upward (or risk losing the issuer's business to a more pliant rating agency). The question of the potential conflicts of interest that are embedded in the issuer pays model is an important one, and we will return to it below.

IV. The Events of the Past Decade

[18] This argument is advanced in Martin S. Fridson, "Why Do Bond Rating Agencies Exist?" Extra Credit (Merrill Lynch), November/December 1999. A drawback to the argument is that, if the bond markets really were shocked by the Penn-Central's bankruptcy, then bond investors should have been willing to pay even more (than previously) for good information about the creditworthiness of bonds and their issuers. Also, if the bond markets were truly shocked by that bankruptcy, what did this indicate about the timeliness and value of the ratings that the credit rating agencies had provided for the Penn-Central's bonds?

[19] Or sometimes both sides pay. Many print publications gain revenues from advertisers and from reader subscriptions (or newsstand sales); but some publications get their revenues solely from advertisers; and a few eschew advertising and gain their revenues solely from readers. Similarly, in television broadcasting, many cable channels involve a mixture of advertising and cable subscription fees; but over-the-air broadcasting is supported solely by advertising, while some premium cable channels carry no advertising and are supported solely by viewer subscription fees.

The Enron bankruptcy of 2001 brought the NRSRO system – previously little known outside of the rating agencies themselves and the few individuals at the SEC who were responsible for administering it – to the attention of the U.S. Congress. In the aftermath of that bankruptcy, the media and then Congressional staffers discovered that the major rating agencies had maintained an investment grade on Enron's bonds as late as five days before the bankruptcy. The attention on the rating agencies then led to the "discovery" of the NRSRO system. Congressional hearings followed, in which the SEC and the rating agencies were repeatedly asked how the latter could have been so slow to recognize the deterioration of Enron's financial condition. The rating agencies were subsequently slow to downgrade WorldCom prior to its bankruptcy, and were subsequently grilled about that experience as well.

The Sarbanes-Oxley legislation of 2002 included a provision that required the SEC to send a report to the Congress on the rating agencies and the NRSRO system. The SEC duly complied; but the report simply raised a number of policy questions rather than providing any policy guidance.[20] However, the SEC apparently did feel some pressure to expand the number of NRSROs from the three that had prevailed since December 2000. In early 2003 the SEC designated Dominion Bond Rating Services, a Canadian firm, as the fourth NRSRO; and in early 2005 it designated A.M. Best, an insurance company rating specialist, as the fifth NRSRO. The SEC nevertheless continued in its opaque ways: It still had not defined the criteria for designating a NRSRO; and it had not developed any formal application or approval/denial process.

Tiring of the SEC's persistence as a barrier to entry – and an opaque one at that – the Congress passed the Credit Rating Agency Reform Act (CRARA), which President George W.

[20] See U.S. Securities and Exchange Commission, "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets," January 2003.

Bush signed into law in September 2006. The Act specifically instructed the SEC to cease being a barrier to entry, specified the criteria that the SEC should use in deciding whether an applicant should qualify as a NRSRO, and insisted that the SEC should make transparent the application process and acceptance/rejection decisions. The Act also gave the SEC limited regulatory powers with respect to NRSROs, but specifically prohibited the SEC from influencing the NRSROs' ratings themselves or the NRSROs' business models.

In response to the CRARA, the SEC designated three new NRSROs in 2007[21] and another two in 2008.[22] There are currently ten NRSROs.

Lurking in the background from the late 1990s until the spring of 2007 – and then in the foreground from the summer of 2007 onward – was the boom in subprime residential mortgage lending and the three large credit rating agencies' role in it – and then the collapse.

There is little question that the three major credit rating agencies were central parties in the subprime mortgage lending boom. Subprime lending was fueled importantly by the ability of the mortgage originators to sell their loans to "packagers" (or securitizers), who pooled the loans into securities and sold the securities to institutional investors, or who combined the securities with other debt instruments into yet-more-complicated securities, such as collateralized debt obligations (CDOs) or the "asset-backed commercial paper" (ABCP) that was issued by "structured investment vehicles" (SIVs), that were sold to institutional investors. And crucial to the ability of these packagers to sell the securities was the process of obtaining favorable ratings on the securities.

These favorable ratings were important to the securitizers for at least three reasons: First, as was discussed above, many of the financial institutions that were the likely buyers of these

[21] They were Japan Credit Rating Agency, Rating and Information, Inc. (of Japan), and Egan-Jones (a small U.S.-based firm).
[22] These were two small U.S.-based firms: Lace Financial, and Realpoint.

securities were under prudential regulatory mandates to heed the ratings of the NRSROs (which, as was discussed earlier, numbered only three in the early years of the decade). Having higher ratings on a larger fraction of the securities that were issued from any given pool of mortgages meant that more of these securities could be bought by these prudentially regulated financial institutions. Second, even for financial institutions that were not prudentially regulated,[23] the generally favorable reputations that the major credit rating agencies had established in their corporate and government bond ratings meant that many institutional bond purchasers – whether prudentially regulated or not – were inclined to trust the agencies' ratings on these securities.[24] Finally, higher ratings meant that the securitizers would be able to pay lower interest yields to the investors, leaving higher profits (for any given stream of interest payments received from the mortgage borrowers) for the securitizers.

V. The "Perfect Storm"

The three large U.S.-based credit rating agencies clearly did not attain their central place in the bond information process solely on their merits. Starting in the 1930s, the specific form of prudential regulation that applied to institutional bond portfolios – first for banks and then subsequently for a number of other important categories of financial institution – mandated that many of the major institutional transactors in the bond markets heed the ratings of a small group of rating agencies. In essence, these agencies' ratings had the force of law, and the agencies had a guaranteed market for their ratings.

[23] E.g., state and local government pension funds, mutual funds that invest in bonds, and hedge fund; non-profit institutions' endowment funds (including university endowments) are also important investors in bonds.
[24] That these securities might have higher yields than comparably rated corporate bonds would have been a plus for most of the institutional investors – a point to which we will return below.

The SEC's creation of the NRSRO category in 1975 crystallized this centrality, and the SEC's subsequent behavior in maintaining a high barrier to entry into the NRSRO category reinforced it. As was discussed above, at the end of 2000 – a crucial time, since the housing boom and the subprime lending/securitization that fueled it were just beginning – there were only the three NRSROs (Moody's, S&P, and Fitch) from which the securitizers of those subprime mortgages could obtain the all-important ratings that would allow the securities to be sold to those prudentially regulated financial institutions.

When the SEC finally did begin to reduce the barriers to entry in the NRSRO category, it was far too little and far too late. The expertise that the incumbent NRSROs had developed in the late 1990s and early 2000s meant that they were the NRSROs that the mortgage securitizers would continue to seek. The advantages of incumbency by the "big three" could not possibly be overcome by the subsequent entry of seven new NRSROs – three of which were headquartered outside the U.S., one of which was an insurance company rating specialist, and three of which were small U.S.-based rating firms.

The change in business model by the large credit rating agencies in the early 1970s – from the investor pays model to the issuer pays model – opened the door to the possibilities of conflicts of interest. But, for the first thirty years of experience with the new model, the possibilities did not become actualities. The rating agencies' concerns about their long-run reputations carried the day. Contributing to this resolve were two important characteristics of the bonds that were being rated:

(a) There were thousands of issues and issuers that the agencies rated, so that any individual issuer's pressures to inflate a rating could be dismissed as not worth the risk to the rating agency's reputation; and

(b) The issues and issuers that were being rated were relatively transparent, so that ratings that were off the mark were likely to be noticed publicly by other rating agencies and/or by fixed income analysts elsewhere in the financial services sector; this ease of detection, of course, reinforced the reputation risk of succumbing to an issuer's pressures.

The issuer pays model did break down, however, in the 2000s decade of subprime mortgage securitization. Contrary to the experience with rating the "plain vanilla" corporate and municipal bonds of the previous three decades, mortgage securities (and their even more complex CDO and related offspring) provided a different and more tempting environment:

(a) There were a relatively small number of mortgage securities packagers (in essence, the issuers), so that the threat by any one of them that, unless they received the ratings that they wanted, they would take all of their business to a different rating agency, was far more potent;[25]

(b) The bonds that were being rated were far more complex than the "plain vanilla" bonds of corporations and governments, so that rating errors were far less likely to be quickly "called out" by third parties;[26] and

(c) The profit margins on rating the mortgage securities were substantially higher than on rating the "plain vanilla" bonds.

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[25] This relative fewness of issuers is discussed in U.S. Securities and Exchange Commission, "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies," July 2008, p. 32. Informed financial sector opinion that ratings shopping was occurring can be found in Mark Adelson, "The Role of the Credit Rating Agencies in the Structured Finance Market," Testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, September 27, 2007. Empirical evidence that supports the likelihood of ratings shopping can be found in Efraim Benmelech and Jennifer Dlugosz, "The Credit Rating Crisis," NBER Working Paper #15045, June 2009; and Jie He, Jun Qian, and Philip E. Strahan, "Credit Ratings and the Evolution of the Mortgage-Backed Securities Market," mimeo, November 2009. And in a similar market – rating commercial mortgage-backed securities – Moody's found that it lost market share when it tightened its ratings standards; see Kemba J. Dunham, "Real Estate Finance: Moody's Says It Is Taking Hit; Ratings Firm Loses Business as Tougher CMBS Stance Spurs Issuers to 'Rate Shop,'" Wall Street Journal, July 18, 2007, p. B-7.

[26] Also, when bonds are more complex and more difficult to rate, even "honest" raters are more likely to make errors; and if issuers can "shop around" for the most favorable rating, then there will be an optimistic bias to the resulting ratings. See Vasiliki Skreta and Laura Veldkamp, "Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation," Journal of Monetary Economics 56 (July 2009), pp. 678-695.

It is not especially surprising that a tight, protected oligopoly might become lazy and complacent. The conflicts of the issuer pays model and the special characteristics of rating these mortgage securitizations combined to create irresistible temptations to provide initial ratings that were excessively optimistic, especially for the securities that were rated in 2005 and 2006. And the centralization of the bond information process, brought about by 70 years of prudential regulation of the bond portfolios of banks and other financial institutions, ensured that when the credit rating agencies did stumble, the consequences were serious.

It was "the perfect storm."

VI. Directions for Public Policy

There are two, very different directions in which public policy toward the credit rating agencies could proceed.

A. More regulation of the credit rating agencies

One direction for public policy is the politically obvious one: more regulation of the NRSRO rating agencies. The general drift of this approach is to require the rating agencies to address the conflicts that arise from the issuer pays business model and to provide greater transparency in what they do. In the former category are measures such as forbidding the agencies to rate debt issues that they have helped structure, forbidding analysts to be involved in fee negotiations, putting limits on gifts that analysts can receive from issuers, etc.; in the latter category are requirements that the rating agencies reveal details about their methodologies and assumptions and provide detailed rating histories and track records.

The SEC has already taken some steps in these directions[27] and is considering more.[28] All of the legislative proposals that are being considered by the Congress – including H.R. 4173, which was passed by the U.S. House of Representatives in December 2009 – would require that the SEC do more.[29]

There are clear dangers to this approach. First, the mandating of greater transparency runs the risk of eroding rating firms' intellectual property and, over the longer run, discouraging the creation of future intellectual property. Next, by placing more requirements on NRSROs, this regulation will raise the costs of being a NRSRO – raise barriers to entry – and thereby discourage entry.[30] Further, because entry will be discouraged and the development of future intellectual property will be discouraged and also because regulations often have difficulties accommodating new structures, innovation in the provision of bond creditworthiness information is likely to diminish. Such innovation might otherwise encompass new methodologies, new technologies, new procedures, perhaps even new business models. Ironically, by discouraging entry, such regulatory efforts are likely to make the incumbent large NRSROs (who are best able to absorb the additional regulatory costs) more important, not less.

And it is far from clear that the regulatory efforts will have a significant net effect. The senior managements of the large rating agencies are quite aware of the damage to their firms'

[27] See Federal Register, 74 (February 9, 2009), pp. 6456-6484; Federal Register, 74 (December 4, 2009), pp. 63832-63865.
[28] See Federal Register 74 (December 4, 2009), pp. 63866-63904.
[29] See U.S. Department of the Treasury, "Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward; Credit Rating Agency Reform Legislation Sent to Capitol Hill," July 21, 2009; U.S. Senate Committee on Banking, Housing, and Urban Affairs, "Dodd, Banking Committee Democrats Unveil Comprehensive Financial Reform," November 10, 2009; and U.S. House of Representatives Committee on Financial Services, "House Approves Historic New Rules to Govern America's Financial System," December 11, 2009.
[30] The Obama Administration's legislative proposal for the regulation of rating agencies would go farther and would make the stepped-up SEC requirements apply to all "credit rating agencies", regardless of whether they are or are not NRSROs. See U.S. Department of the Treasury, "Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward; Credit Rating Agency Reform Legislation Sent to Capitol Hill," July 21, 2009. Since this broad provision would appear to apply to any entity that provides creditworthiness information and receives payment in return, it would surely discourage entry.

reputations that has occurred over the past three years and have taken corrective steps. The wave of over-optimistic ratings is unlikely to repeat itself in any event.

At the same time, the rating firms' tardiness in changing their ratings, which has been another target for criticism, seems unlikely to change much, if at all, as a consequence of the stepped-up regulation. This tardiness was exemplified by the Enron and WorldCom experiences mentioned above and was revisited more recently when the major rating agencies had "investment grade" ratings on Lehman Brothers' commercial paper on the morning that Lehman declared bankruptcy in September 2008. The rating agencies have long had a deliberate goal of "rating through the cycle" – of providing a long-term perspective – rather than providing an up-to-the minute assessment. But this attitude and approach means that these rating agencies will always be slow to identify a secular trend with respect to a bond's creditworthiness, since there will always be a delay in perceiving that any given change isn't just the beginning of a reversible cycle but instead is the initial stage of a sustained decline or improvement.

This sluggishness may be a response to their customers' preferences to avoid frequent (and costly) adjustments in their portfolios.[31] Although the sluggishness (at least on the downside) also avoids angering issuers, it has been present since long before the change to the issuer pays business model, so this doesn't seem to be a root motive. Finally, it also has the benefit (for the rating agencies) of allowing them to maintain smaller staffs.

In sum, this sluggishness in revising ratings appears to be a strong cultural phenomenon among the major rating agencies. Tougher regulation may well have little effect.

[31] See, for example, Edward I. Altman and Herbert A. Rijken, "How Rating Agencies Achieve Rating Stability," Journal of Banking & Finance, 28 (November 2004), pp. 2679-2714; Edward I. Altman. and Herbert A. Rijken, "A Point-in-Time Perspective on Through-the-Cycle Ratings," Financial Analysts Journal, 62 (January-February 2006), pp. 54-70; Gunter Loffler, "An Anatomy of Rating through the Cycle," Journal of Banking & Finance, 28 (March 2004), pp. 695-720; Gunter Loffler, "Avoiding the Rating Bounce: Why Rating Agencies Are Slow to React to New Information," Journal of Economic Behavior & Organization 56 (March 2005), pp. 365-381; and Mei Cheng and Monica Neamtu, "An Empirical Analysis of Changes in Credit Rating Properties: Timeliness, Accuracy and Volatility," Journal of Accounting and Economics 47 (March 2009), pp. 108-130.

B. Less regulation of the credit rating agencies (but better prudential regulation of bond portfolios)

This policy route begins with the recognition of four important features of the bond market that have been discussed earlier in this article:

(a) There are other sources of information about the creditworthiness of bonds and of bond issuers, in addition to the major credit rating agencies.

(b) The current dominance of the major credit rating agencies is due, at least in part, to the peculiarities of over seven decades of prudential regulation of institutional bond portfolios, which began with banks and then spread to insurance companies, pension funds, securities firms, and money market mutual funds, whereby these institutions were required to heed the ratings of a select handful of rating firms.

(c) The SEC's NRSRO system crystallized this delegation of regulators' safety judgments, as well as raising barriers to entry that discouraged entry into the rating business generally and kept the number of NRSROs as low as three at a crucial time period (the early years of the decade of the 2000s).

(d) The bond market is largely an institutional market.

Accordingly, prudential regulators should reverse course and cease relying on ratings for the determination of whether a financial institution's bond portfolio is safe – in essence, the financial regulators should withdraw the delegations of safety judgments that began over 70 years ago. Instead, regulators should place the burden directly on the institution to justify the safety of its bond portfolio to its regulator.[32] Under this approach, institutions would have a far wider choice from which they could draw information about the creditworthiness of bonds. The

[32] For banks, this is the "normal" burden that they bear with respect to their (non-bond) loan portfolios. For a justification of prudential regulation of depository institutions, see Lawrence J. White, The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation. New York: Oxford University Press, 1991.

institutions might choose to do the research themselves. Or they might rely on the market information that is yielded by the prices of credit default swaps (CDS). Or they could rely on advisors. Those advisors might be the incumbent NRSRO rating agencies; or they might be the fixed income analysts at investment banking firms (especially if those firms could erect credible "Chinese walls" to forestall conflicts of interest); or they might be upstart advisory firms (perhaps staffed by those fixed income analysts who decide to form their own advisory firms).

Because the participants in the bond markets are primarily institutional investors, they can be expected to have memories (e.g., as to bond advisors' track records) and to be able to exercise judgment as to who is a reliable advisor and who is not (e.g., based on the advisor's track record, business model, personnel, etc.). Consequently, there would be no need for the certification of the NRSRO system, and that designation – along with the growing body of regulation of the NRSROs – could and should be scrapped.[33]

Nevertheless, a review of the financial institution's source of advisory information (or a check of the institution's in-house research) is likely to – and probably should – be a part of any prudential regulatory examination process. Since these institution's senior managements usually have incentives otherwise to take excessive risks (the prevention of which is the central motive for prudential regulation), they would likely want to choose advisors who would be overly optimistic (e.g., who describe as "safe" a bond that the market believes is risky), since this would allow the institution to take on more risks while appearing to be safe.[34] Hence, there is a need for prudential oversight of the institution's choice of advisory information. But the primary

[33] By contrast, if this were a market where retail investors (i.e., households) had a substantial presence, then greater regulatory effort to maintain the quality of the advisors, so as to protect this category of investors (who tend generally to be less well informed and less capable of protecting themselves), would be appropriate.

[34] This cautionary reminder can be found in Charles W. Calomiris, "A Recipe for Ratings Reform," The Economist's Voice, 6 (No. 11, 2009), pp. 1-4.

regulatory target should be the safety of the bond portfolios themselves; oversight of the source of advisory information is secondary.

By widening financial institutions' choices of bond creditworthiness information, this policy route would open up the bond information market to new ideas – new technologies, new methodologies, new procedures, new business models – in a way that has not been possible since the 1930s.

There have been some tentative policy movements in this direction recently. The SEC has withdrawn a few regulations that required SEC-regulated financial institutions to rely on NRSRO ratings[35] and has proposed withdrawing a few more.[36] However, the SEC seems at best to be two-minded about proceeding in this direction, since it has simultaneously been promulgating the regulations discussed above that increase the burden on NRSROs to deal with disclosure and conflict-of-interest issues; and in the area of money market mutual funds – the SEC's most important prudential regulatory application of the requirement that regulated institutions heed NRSRO ratings – the SEC has proposed an enhancement of the importance of NRSROs' ratings.[37]

The financial reform legislation (H.R. 4173) that was passed by the U.S. House of Representatives in December 2009 is similarly two-minded:[38] One the one hand, the bill eliminates statutory references to the use of NRSRO ratings by financial institutions and instructs financial regulatory agencies to eliminate such references from their regulations – which, following the logic developed above, would seem to eliminate the need for the NRSRO category and all of the regulatory requirements that are being placed on NRSROs. However, on the other

[35] See Federal Register 74 (October 9, 2009), pp. 52358-52373.
[36] See Federal Register 74 (October 9, 2009), pp. 52374-52381.
[37] See Federal Register 74 (July 8, 2009), pp. 32688-32741.
[38] See U.S. House of Representatives Committee on Financial Services, "House Approves Historic New Rules to Govern America's Financial System," December 11, 2009.

hand, the bill retains the NRSRO structure and instructs the SEC to proceed farther in its requirements that the NRSROs address the transparency and conflict-of-interest issues. And, as was discussed above, the other versions of the financial reform legislation (that address the credit rating agencies) that are being considered by the Congress are focused on increasing the regulatory requirements on the NRSROs; their only nod toward the policy route of moving away from the regulatory reliance on ratings is to require studies by the Government Accountability Office (GAO) of such possibilities.[39] As of January 2010, the outcome of any of these legislative efforts is uncertain.

Two other recent developments are worth mentioning: First, in October 2009, the Federal Reserve announced that, in connection with its "Term Asset-Backed Securities Lending Facility" (TALF) program (whereby the Federal Reserve lends to financial institutions and accepts assets-backed securities as collateral), it would be more selective with respect to which NRSROs' ratings it would accept in determining acceptable collateral for the program and that it would also conduct it own risk assessment of proposed collateral.[40] Second, in November 2009 the National Association of Insurance Commissioners (NAIC) announced that it had asked the Pacific Investment Management Company (PIMCO) to assess the riskiness of the residential mortgage-backed securities that were held by the insurance companies that were regulated by the 50 state insurance regulators.[41] Both developments indicate that regulators are beginning to be wary of automatic reliance on NRSROs' ratings and are exploring alternatives.

[39] See U.S. Department of the Treasury, "Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward; Credit Rating Agency Reform Legislation Sent to Capitol Hill," July 21, 2009; and U.S. Senate Committee on Banking, Housing, and Urban Affairs, "Dodd, Banking Committee Democrats Unveil Comprehensive Financial Reform," November 10, 2009.
[40] See Board of Governors of the Federal Reserve System, "Press Release," October 5, 2009.
[41] See National Association of Insurance Commissioners, "NAIC Selects PIMCO to Model Residential Mortgage-Backed Securities," November 17, 2009.

Finally, it is worth considering whether and how the issuer pays business model might survive in an environment where there is no regulatory reliance on ratings, there is no NRSRO system, and financial institutions have a wider choice as to where they get their information about bonds' creditworthiness. So long as institutional bond managers have memories, they should be able to ascertain which advisors have provided reliable advice and should be willing to pay a higher price for (and thus accept a lower yield on) the bonds of any given underlying quality that are rated by these reliable advisors. In turn, issuers should seek to hire these recognized-to-be-reliable advisors to rate their bonds, since the issuers would thereby be able to pay lower interest rates on the bonds that they issue.[42] Of course, just because the issuer pays model could survive in this more open environment does no mean that it would survive. That outcome would be decided by the market.

VII. Conclusion

The role of the three large U.S.-based credit rating agencies in the subprime mortgage debacle and the financial crisis that followed it has focused political and regulatory attention on the three rating agencies. A widespread response has been to call for greater regulation of the rating agencies. This approach, however, ignores the history of prudential regulation of financial institutions' bond portfolios, which had the effect (since the 1930s) of forcing these institutions and the bond markets more generally to heed the ratings of only these agencies. A major danger of the policy route of greater regulation is the likelihood that it will raise barriers to entry and

[42] In essence, the incentives for accurate rating described in the text are based on the advisory firms' concerns about their long-run reputation. Similarly, a newspaper accepts advertising from companies about which it publishes news stories and reviews (e.g., cars, movies, restaurants, books) and typically establishes procedures to protect its long run reputation for being independent of the influence of the advertisers. But concerns about reputation can be overwhelmed, as apparently occurred in the case of the rating of the subprime securities. A formal modeling of this can be found in Jerome Mathis, James McAndrews, and Jean-Charles Rochet, "Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?" Journal of Monetary Economics 56 (July 2009), pp. 657-674.

discourage innovation in the provision of bond creditworthiness information. Ironically, it will likely reinforce the centrality and importance of the three large agencies.

There is a better route for public policy. That route involves less regulation of the credit rating agencies but also a major revision in the prudential regulation of institutions' bond portfolios. Instead of delegating safety judgments to the rating agencies (as has been done for over 70 years), prudential regulators would place the burden for safe bond portfolios directly on the regulated financial institutions and allow them to seek advice about the creditworthiness of bonds as they see fit (but subject to prudential oversight). Since the participants in the bond markets are primarily institutional investors, these sophisticated investors should be able (again, subject to prudential regulatory oversight) to make sensible choices with respect to the sources of their information, so that extensive regulation of those sources – the incumbent rating agencies plus smaller firms and entrants – would not be necessary.

The result should be a greater openness in the bond information process than has possible since the 1930s, with beneficial consequences for innovation in the bond information process and greater efficiency in the bond markets.