briefing paper

Reforming the Rating Agencies:
A Solution that Fits the Problem

"We've got to deal with the conflicts. If I hire S&P or Moody's to be my consultant and show me how I can do this and that to get an investment-grade rating or [an] even higher rating, they obviously have a conflict of interest there."

"That's right. I think the compensation model… where the issuer pays for the rating is really at the heart of the conflict problem…"

Exchange between Sen. Richard Shelby (R-AL) and SEC chair-designate Mary Schapiro
at her confirmation hearing, Jan. 15, 2009

Overview: A Fundamentally Flawed Business Model

The major credit rating agencies, Moody's, Standard & Poors, and Fitch, bear a heavy burden of responsibility for the financial meltdown. It was their seal of approval that enabled Wall Street to develop a multi-trillion-dollar market for bonds resting on a foundation of tricky loans and bubbly housing prices. Institutional investors around the world were seduced into buying these high-risk securities by credit ratings that made them out to be as safe as the most conventional corporate and municipal bonds.

Investors, economists, and political leaders across the spectrum have identified the ratings process as a key breakdown point. And one critic after another has zeroed in on the same basic explanation for the breakdown: the financial dependence of the ratings agencies on the issuers and underwriters of the securities they rate. Yet the remedies so far proposed by the White House, the Securities and Exchange Commission, and committee leaders in the House and Senate would not fundamentally alter the current business model—one that Sen. Charles Schumer (D-NY) has compared to "allowing students to pay for their grades."[1]

The measures under consideration would require more disclosure of the information behind ratings, strengthen the government's regulatory authority over the rating agencies, and give investors more legal recourse. These steps are sensible and needed; but they should be ancillary. The first imperative of reform is to end the practice of letting securities issuers pick their raters.

The most promising way to accomplish this is by establishing an independent office, funded through a securities-transaction fee, to act both as a ratings watchdog and as a clearinghouse, assigning securities offerings to ratings agencies at random. Conflict of interest lay at the heart of the problem; it should lie at the heart of the solution. Otherwise, the rating agencies will face constant tension between their avowed mission and their short-term business interests. At worst, they could end up as cheerleaders for another ruinous financial bubble.

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Historic Role of the Ratings Agencies

The credit rating agencies are for-profit companies that, over time, have been invested with gatekeeper powers by Congress, the Securities and Exchange Commission, and other federal and state authorities. Investors and fund managers use credit ratings to gauge the risk of a wide range of debt-based securities—everything from the plainest vanilla corporate bonds to the most super-complicated products of modern structured finance. Ratings play an especially crucial role in determining which bonds are considered safe enough to be purchased, in large or small amounts, by pension and money-market funds, insurance companies, and other institutions that hold money in trust.

The industry began with the publication, in 1909, of a guide to railroad securities by John Moody, who went on to found the company that bears his name. It was Moody who conceived the system of letter grades—Triple A, Double B, and so on—that is still widely used. Standard & Poors and Fitch, like Moody's, started out simply as businesses selling information, in printed form, to investors.

The quasi-official status of credit ratings has its origins in the financial reforms that followed the stock market crash of 1929 and the bank failures of the early 1930s. Investors, events had shown, lacked the resources to protect themselves against the pitfalls of the bond markets. But financial regulators came to realize that they, too, were not in a position to directly evaluate all the bonds issued by tens of thousands of companies and public agencies; and so, gradually, they wove credit ratings into their rules.

This process began in the '30s, when banks were instructed to invest only in "investment-grade" bonds as determined by the major credit rating agencies. In the 1970s, the Securities and Exchange Commission adopted similar rules and anointed the Big 3 of Moody's, Standard & Poors, and Fitch as Nationally Recognized Securities Rating Organizations, or NRSROs. Soon brokerage houses, banks, insurance companies, and pension and mutual fund managers had all become subject to investment regulations that relied on NRSRO ratings.

By this time, frays had developed in the original investor-pays business model of the rating agencies. Now that an investment-grade rating had become a kind of license to sell or hold certain securities, big institutional investors tried to use their clout to forestall—or get advance warning of—downgrades. Meanwhile, modern photocopying machines made it increasingly easy for investors to obtain ratings materials without paying for them. Thanks to the new importance conferred on them by regulators, however, the three NRSROs realized that their ratings had become crucially important to the securities industry. One by one, they turned a problem into an opportunity by shifting from an investor-pays to an issuer-pays business model.[2]

Playing Games with Risk

In the early 1990s, the collapse of the savings and loan industry created an opening for a new generation of aggressive mortgage specialty companies. The nonbank lenders, as they became known, gradually enlisted the help of the big investment banks in the enterprise of transforming their loans into securities in order to generate capital for additional lending. Mortgage securitization itself was not new: the government-sponsored housing agencies Fannie Mae and Freddie Mac had been doing it for decades. Wall Street put a new spin on the practice, though, by asserting the ability to generate low-risk bonds out of high-risk loans.

This private-label brand of securitization involved gathering thousands of loans together and transferring ownership to a legal shell. Then the underwriter would carve out rights to the repayment stream in the form of tiers, or "tranches," of bonds, each representing a different place on line in the event of repayment trouble.[3]

The nonbank lenders had jettisoned many of the traditional rules of the mortgage lending industry. Rarely did they (or the big banks that soon adopted their practices) insist on significant down-payments or financial documentation from borrowers. Most of their mortgages involved teaser interest rates and other short-term lures, encouraging people to take on more debt than they could handle.[4] Nevertheless, the issuers sought and obtained Triple-A ratings for the vast majority of the roughly $3.2 trillion in mortgage-backed securities sold between 2002 and 2007.[5]

Invoking complex mathematical formulas, issuers claimed that the senior bondholders—those with the higher-tranch bonds, in other words—had been doubly insulated, first by a cushion of extra collateral, and second by the knowledge that losses above that level would be borne by the junior bondholders.[6] The investment world accepted the issuers' and underwriters' arguments because the ratings agencies did.

Left unsaid, and not widely understood, was the fact that the rating agencies, in order to validate the reassuring conclusions of the issuers and underwriters, also had to go along with their decision to largely ignore one of the biggest and most obvious risk factors in the equation: the fragility of the housing market. In a year or two, millions of borrowers would be called on to make mortgage payments that would be beyond their means, unless they could refinance into lower-cost loans. Their ability to do so depended, in turn, on continued increases in housing prices, which already stood at unprecedented heights relative to other prices. Any significant downturn in the market was bound to cause massive defaults and foreclosures. The rating agencies, like their clients, dismissed such an eventuality as simply too unlikely (or "unprecedented") to be worthy of inclusion in their models.[7]

Relaxed Standards Amid a "Market-Share War"

In testimony before the House Committee on Oversight and Government Reform in October 2008, the chief executives of the three rating agencies adopted essentially the same line of defense, lamenting that like others in the financial world, they had failed to see the warning signs of an unprecedented cataclysm.[8] But the evidence tells a different story—not of a failure to see, but of a determined refusal to look at facts that threatened an enormous new stream of revenue.

Historically, most of the work of these companies had been with straightforward bonds issued directly by corporations and public agencies. By the beginning of the current decade, the balance of the ratings business (and of the debt issuance business) had shifted toward mortgage-backed securities and other structured-finance products.[9] The new securities were far more complicated and, at the same time, far more lucrative. Thanks to the growing volume of mortgage-backed securities and collateralized debt obligations (the next level up in both complexity and danger), the profits of the major rating agencies rose from a combined $3 billion in 2002 to more than $6 billion in 2007.[10] During that time, their CEOs earned a collective $80 million.[11]

Top executives claimed to have taken strong measures to protect the ratings process from the influence of clients angling for higher ratings. Email and instant-message evidence suggests the opposite: As the temptations mounted, the rating agencies worked more closely than ever with securities issuers and underwriters, often charging separately for advice that helped their clients achieve—just barely—the ratings they were after. In this atmosphere of intense financial pressure and continual back-and-forth communication, issuers found it easy to complain about a particular rating, and sometimes they got it raised. At Standard & Poors, this is reported to have happened repeatedly with securities issued by Countrywide Home Loans, one of the most notorious of the big subprime lenders.[12]

More typically, the process of lowering standards took the form of changes in rating procedures. During the boom years of 2004 to '06, S&P and Moody's engaged in what S&P director Richard Gugliada recalled as a "market-share war where criteria were relaxed." (Gugliada himself ordered some of the relaxing. "I knew it was wrong at the time," he would testify, adding, "It was either that or skip the business.")[13] In August 2004, Moody's made methodology changes that led to higher ratings on subprime mortgage-backed securities. A week later, S&P altered its standards at the urging of an executive who spoke of the "threat of losing deals."[14]

By late 2006, home prices had began to decline, and there was mounting evidence of fraud (involving brokers, lenders, and appraisers as well as borrowers) resulting from a system of up-front commissions that allowed parties up and down the financial chain to profit whether loans ultimately got repaid or not. Even so, another six months passed before the first downgrades of mortgage-backed securities.[15] At Moody's, "analysts and executives who warned of trouble" were demoted, reassigned, or fired, employees later told reporter Kevin Hall of the McClatchy's newspapers chain.[16]

Looking back on this period at a confidential meeting with top managers in October 2007, Moody's CEO Raymond McDaniel talked about the "very tough problem" of market pressure for higher ratings. "Analysts and [managing directors] are continually pitched by bankers, issuers, and investors," and sometimes "we drink the Kool-Aid," he said. McDaniel presciently added that "unchecked competition on this basis can place the entire financial system at risk."[17]

The Key to Reform: Realigning the Incentives

Why did the rating agencies understate or ignore the huge risks associated with mortgage-backed bonds and other structured-finance products? Because that was the way to attract more business from the securities issuers who paid them, picked them, and, in many cases, retained their services as advisers on how to qualify a particular set of securities for a particular rating.

The challenge of reforming the rating agencies is to break their dependency on issuers and underwriters, and help them forge a new business model that supports the quality and integrity of their work. In a January 2009 concept paper commissioned by the Congressional Oversight Panel, the economist David Raboy has outlined an elegantly simple way to do this.[18] His proposal calls for the creation of an independent clearinghouse that would receive rating applications from securities issuers, and assign each job to a rating agency in a random or unpredictable way. Payment would be based on the complexity of the securities involved. Funding could come from a financial-transaction fee, set at a level sufficient to cover the operations of the clearinghouse as well as the ratings work itself.

The clearinghouse would periodically compare the performance of the rating agencies, using simple, transparent criteria, such as the number of times that investment-grade bonds default or lose substantial value. The most accurate rating agencies could be rewarded with additional assignments. Those with the poorest records could, in extreme cases, be suspended or removed from the pool.

The clearest and most important virtue of the clearinghouse proposal is in bringing the incentives of the rating agencies into alignment with their mission. But it could have significant other advantages as well. Pointing to the record of herd-like behavior on the part of these firms, some reformers have sought to stimulate more competition by expanding the current ratings oligopoly. This was one of the major aims of the Credit Rating Agency Reform Act of 2006, a piece of legislation inspired by a series of cases (that of Enron, perhaps most notably) in which the rating agencies waited until a company was on the brink of collapse before downgrading its debt en masse.[19] As long as the business model remains unaltered, however, more competition could simply mean a livelier race to the bottom. By changing the incentive structure, the clearinghouse idea lays the foundation for a new and more fruitful form of competition, in which multiple rating agencies search for more accurate and efficient ways of predicting bond performance.

Under the current system, the rating agencies are effectively paid by the rating. The clearinghouse would compensate them for their work even if they concluded that some securities were simply too complicated rate. Up to now, that healthy possibility has not been on the table. "We rate every deal," a Standard & Poor's analyst grumbled in an instant message to a colleague. A securities offering "could be structured by cows," the analyst added, "and we'd rate it."[20]

The reform proposals put forward so far would restrict, but not altogether prohibit, the consulting arrangements that led to cases of apparent "ratings shopping," in which an issuer or underwriter solicited "preliminary ratings" from more than one source, and then retained the services of the rating agency that seemed prepared to be most generous.[21] The clearinghouse idea could solve all such problems with one blow, allowing the rating agencies to have the data and documentation they need while barring them from direct contact with issuers or underwriters.

For years, financial reformers have sought to wean the investment world off its reliance on credit ratings. The more drastic proposals of this sort give investors too much credit for their ability to understand and assess complex financial instruments without a reliable system of guidance. It would be a mistake (as some on Capitol Hill have suggested) to simply mandate the removal of all references to credit ratings from federal laws and regulations. But it makes great sense to move away from the current focus on letter grades alone, and to require the rating agencies to reveal more of the underlying data and methodology. That, too, could be part of the clearinghouse's mission.

More broadly speaking, this proposal would give investors more leverage as well as responsibility. At heart, it offers a way to bring back the virtues (without the drawbacks) of the investor-pays model that sustained the credit rating agencies for many years. Under the cover of a laissez-faire ideology, regulatory policy has become increasingly tilted in recent years toward executives and insiders. By making the ratings agencies publicly accountable, Congress would strike an important and needed blow for the rights of investors.

Conclusion

During a markup session in early November of 2009, Reps. Brad Sherman and Stephen Lynch—Democrats of California and Massachusetts respectively—sought the support of the House Financial Services Committee for an amendment to create a ratings clearinghouse within the Securities and Exchange Commission. None of their colleagues challenged the plan on its practical merits. Several committee members, however, objected in the abstract to the idea of mandating such a wholesale change in the way the ratings business works.[22] But wholesale change is exactly what the ratings business needs, and in view of recent experience, it would be absurd to think of credit ratings as just another private industry.

In the runup to the financial crisis, no institution more thoroughly betrayed its mission; and no single failure had a more devastating impact. Even if we take steps to reduce investors' reliance on credit ratings, they will continue to be hugely important. In today's economy, credit ratings determine the cost of credit for cities and towns as well as businesses. They also protect us—investors and the society at large—against dangerous financial products, which, as we have seen, are at least as much of a threat as the dangerous products of the physical world. We expect government to safeguard us against crash-prone cars and airplanes; why not against crash-prone financial instruments?

The situation may not call for (as some have proposed) a public rating agency. But we surely do need a strong and independent watchdog agency to set basic ground rules for the ratings agencies, and to do spot-audits of their work. And we should surely insist that the ratings agencies be financially as well as legally motivated to do that work as thoroughly, as effectively, and as dispassionately as possible.

Many Democrats as well as Republicans hesitate to advocate anything that could be portrayed as a "big government" solution. Indeed, such concerns may help explain why a number of leading figures in the financial-reform effort have backed away from their initial enthusiasm for a remedy like this. Yet because some who feel this way are also sincerely trying to prevent a repeat of the ratings abuses that fed the housing and mortgage-securities bubble, they are propelled toward solutions that, to be workable, might have to be more intrusive in the end.

As long as the current business model is left intact, the rating agencies will be tempted to give security issuers the high ratings they want, and preventing that will be a matter of trying to anticipate, and regulate against, a whole host of specific abuses. Thus, the rating-agency reforms initially put forward in both the House and Senate involve compliance officers, director independence, systems for "managing" conflicts of interest, liability reform, and tighter SEC oversight. Compared to the long list of proposed sanctions and safeguards in these measures, the clearing-house idea offers a relatively straightforward and fairly gentle way to achieve the kind of decisive change that is needed.

Any such reform is, of course, bound to be strenuously opposed by the current top managers and major shareholders of the rating agencies. In recent years, these companies have reached fabulous new heights of profitability by dispensing something precious—an investment-grade rating—without a sense of duty to properly investigate, or even fully understand, the securities they were rating. (Moody's, whose profits quadrupled between 2000 and 2007, had during five of those years the highest profit margins of any company in the S&P 500.[23]) At the rating agencies, as at the big banks, insiders are working hard to preserve a business model that has been good for them, and bad for everybody else. That is something that our elected leaders should be working just as hard to prevent.

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