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## **The Credit Rating Agencies: How Did We Get Here? Where Should We Go?**

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# The Credit Rating Agencies: How Did We Get Here? Where Should We Go?

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## I. INTRODUCTION

The three major credit rating agencies—Moody’s, Standard & Poor’s (“S&P”), and Fitch—have attracted an increasing amount of media attention over the past five years. They were clearly central players in the housing bubble and collapse of the late 1990s through the mid 2000s and the financial debacle that followed, and they have more recently gained notoriety in downgrading the debt of various European countries—with S&P even downgrading the United States in August 2011.

So, who are these guys? What do they do? Why are they so important? Why did they err so badly with respect to mortgage bonds in the United States in the mid 2000s? In what direction should public policy go? And, since there are only three major rating agencies, is there a role for competition policy?

## II. WHAT DO THEY DO?

A central question of finance—arguably, the central question—that any lender must ask is: “Will I be repaid? Will I get my money back?”

To try to answer this question, lenders—whether they are banks or bond investors (who, by buying bonds, become lenders to the bond issuer) or even the local loan shark—collect information about prospective borrowers that the lenders believe will help them determine who are the creditworthy borrowers and who are not. Further, even after making the loan, lenders typically want to continue to monitor the borrower, so as to ascertain that the borrower is still in a good condition to repay the loan and to get an early warning if the borrower’s creditworthiness begins to deteriorate.

Large, specialized lenders—such as large banks or large investment funds—are often able to collect and analyze the data and do the subsequent monitoring on their own. But smaller and less specialized lenders may lack the expertise or volume to justify dealing with the data themselves. And so they will turn to third-party information specialists.

Enter the credit rating agencies: What credit rating agencies do is provide judgments—they prefer the word “opinion,” because that makes them sound more like an entity that should be protected by the First Amendment<sup>2</sup>—about the creditworthiness (specifically, the likelihood of

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<sup>2</sup> Bond ratings were described as “the world’s shortest editorials” by Gregory Husisian, *Note: What Standard of Care Should Govern the World’s Shortest Editorials? An Analysis of Bond Rating Agency Liability*, 75 CORNELL L.R. 411-461 (1990).

default) of bonds and their issuers: corporations, governments, and (most recently) securitizers. This judgment is in the form of a letter rating: The most familiar of these letter-rating systems is that of S&P: AAA, AA+, AA, AA-, A+, etc., all the way down to D (as in “default”).

Although the big three rating firms dominate the formal rating process—their approximate shares during the 2000s were 40 percent, 40 percent, and 15 percent for Moody’s, S&P, and Fitch, respectively—they are not the only sources of such creditworthiness judgments. There are smaller firms that call themselves credit-rating firms (and often use letter grades). There are smaller firms that may not use the phrase “credit ratings” or the letter grades but that nevertheless provide creditworthiness judgments about bonds and their issuers. Further, the major securities firms employ “fixed income analysts” who provide such judgments for their firms’ “buy side” customers (and who are potential sources of entry if they were to decide to “hang out their own shingle”).

There’s also an important characteristic of the bond markets that is worth keeping in mind: The dominant participants are financial institutions: banks, insurance companies, pension funds, mutual funds, hedge funds, etc. Some of these institutions are large enough to be able to do their own research; others are more likely to want the help of third parties, such as rating firms. But, in either case, the bond “investor” is overwhelmingly a financial institution, with a professional manager who oversees its bond portfolio.

### III. SOME HISTORY

Letter-grade ratings of bonds have been publicly available since 1909, when John Moody first published ratings on railroad bonds. At least three other rating firms entered the business over the next few decades. A few things about this era (prior to 1936) are worth noting:

- a) Their business model was “investor pays.” The ratings were sold to investors in thick ratings manuals.
- b) This was an era before the establishment of the Securities and Exchange Commission (“SEC”) and its regime of mandatory disclosure by publicly traded companies. In this pre-SEC era bond investors faced greater difficulties in gathering the relevant information on their own. The rating firms were clearly meeting a market test, as was indicated by the entry of the firms that followed Moody.
- c) No one was required to use the ratings that were provided by these firms. Again, they were meeting a market test.

A major change occurred in 1936, when national bank regulators told U.S. banks that they would not be allowed to buy/invest in companies’ and governments’ bonds that were “speculative” (which today would have the descriptor “junk”); banks could buy/hold only “investment grade” bonds. (On the S&P letter grade scale, BBB- or better is “investment grade.”)

Although this directive made a good deal of sense from a prudential regulatory perspective—after all, a major goal of bank regulation is to keep banks solvent and prevent them from making risky investments that might turn out badly and yield losses—it fundamentally changed the nature of the creditworthiness information marketplace: U.S. bank regulators had effectively “outsourced” or delegated to a small set of third-party rating firms the decision as to what constituted the safe bonds that banks could hold. Effectively, those firms’ judgments had

the force of law. Concomitantly, there were now a major group of bond investors—banks—that were a captive audience for the ratings of these firms.

In subsequent decades the state regulators of insurance companies imposed a similar requirement on their regulated entities—again, in the name of enhancing the safety of the insurance companies. When pension funds came under federal regulation in the 1970s, similar requirements were extended to them. The mandated audience for the credit rating agencies was growing.

In 1975, while imposing a similar mandate on broker-dealers, the SEC became concerned that the existing regulatory references to “recognized rating manuals” were unduly vague. So, to provide more specificity, the SEC created a new category of information providers—nationally recognized statistical rating organization (“NRSRO”)—the ratings of which would need to be heeded by broker-dealers. The SEC immediately grandfathered Moody’s, S&P, and Fitch into the category. Other U.S. financial regulators soon used the NRSRO category for their mandates as well (and in the early 1990s the SEC required money market mutual funds to heed NRSRO ratings, and other countries’ financial regulators adopted similar mandates for their financial institutions).

The SEC subsequently became a major barrier to entry into the ratings business: Over the next 25 years, the SEC designated only four new NRSROs; but mergers among the four and with Fitch collapsed the actual number of NRSROs back to the original three by December 2000. The SEC was also phenomenally opaque in its dealings with applicants for the NRSRO designation: The SEC never established the criteria or an orderly application process for becoming a NRSRO.

Not having a NRSRO designation was clearly a barrier to entry for a firm that was considering entering the bond-rating business. Since major financial institutions’ bond purchases would be guided by NRSRO ratings, issuers and investors would likely be uninterested in the ratings of a firm that wasn’t a NRSRO.

Only after the Congress prodded the SEC to be more transparent, and then mandated greater transparency in 2006 legislation,<sup>3</sup> did the number of NRSROs expand. As of early 2012, there were nine NRSROs; but the legacy of the decades of dominance by the big three raters has persisted.

There is one other important piece of history: In the late 1960s and early 1970s, the credit rating industry converted its business model from the “investor pays” model that had prevailed since 1909 to an “issuer pays” model, whereby the bond issuers hire the raters and pay for the ratings and the rating firms subsequently broadcast the ratings to the general public. Although there is no definitive study of why this occurred, the circumstantial evidence points to the industry’s fears that the nascent high-speed photocopy machine (and the free riding that could accompany it) would limit its ability to expand revenues under the investor-pays model. The issuer-pays model faced no comparable constraint from the photocopy machine.

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<sup>3</sup> The Credit Rating Agency Reform Act of 2006, Pub. L. 109-291, 120 Stat. 1327-1339.

#### IV. WHY DID THE MAJOR RATING FIRMS MISJUDGE MORTGAGE SECURITIES?

The issuer-pays model of paying for bond ratings presents an obvious potential conflict of interest: The threat by an issuer to take its business to a different rater may cause a rating firm to accede to the issuer's desire for a higher-than-justified rating for its bonds.

The general solution to this kind of potential conflict is the concern by the rater about its long-run reputation: When bond investors eventually discover that the rater has been acceding to the issuers' desires, they will then cease to trust that rater's ratings, and issuers will no longer bring their business to that rater.

Recall that the major rating firms had transitioned from the investor-pays model to the issuer-pays model by the early 1970s for the corporate and municipal bonds that provided virtually all of the rating firms' revenues. For the next three decades the major rating firms did not succumb to the conflicts in the issuer-pays model; it appears that their concerns about their long-run reputations were sufficiently strong, although there were periodic complaints that the major rating firms were slow to respond to new information. For example, all three raters were slow to recognize the problems that were related to the Asian debt crisis of the late 1990s, and all three had "investment grade" ratings on Enron's debt until five days before that company declared bankruptcy in November 2001. However, this sluggishness was a cultural characteristic of the raters, which had been present at least back to the 1920s, and not a systematic consequence of the issuer-pays model.

Nevertheless, the major rating firms clearly did succumb to the issuers of residential mortgage-based securities ("RMBS") in the 2000s. What was different?

There were two important characteristics of the "plain vanilla" corporate and municipal debt that served as a deterrent to succumbing to an issuer's entreaties:

- a) There were thousands of issuers, and no individual issuer represented a significant fraction of a rater's revenue stream; the gain from acceding to any individual issuer's threats would be relatively small, relative to the risk of damage to the rater's reputation; and
- b) The information base that was the basis for the ratings was relatively transparent and widely available (e.g., the quarterly and annual financial reports of publicly traded companies, and the annual budgets of municipalities); this was a deterrent to any temptation to favor an issuer, since any such "error" would likely be quickly discovered, to the potential detriment of the rater's reputation.

By contrast, for the RMBS issuers:

- a) There were just a few dozen RMBS issuers, with the largest issuers representing a significant fraction of a rater's lucrative revenue stream from this growing area that had higher profit margins than the ratings on the plain vanilla securities; any threat from a large issuer would surely involve not only the current securities that were being rated but also the issuer's future (substantial) issuances; and
- b) The information base for the ratings was opaque, since the underlying information about the mortgage borrowers was not publicly available; further, the major dispute in the rating of these securities (which were structured in tranches of cascading seniority)

usually concerned the percentage of the overall security that could be allocated to the most senior (protected) tranche and thus receive a AAA rating, which was a yet more arcane and obscure issue.

In addition, the rating of the RMBS was in the context of a housing boom and the widespread belief that housing prices would always increase. If this were the case, then mortgages would never be a problem: Even if a borrower was hit by a truck or otherwise lost her job, she could still sell the house at a profit and thereby repay the mortgage. And if mortgages would never be a problem, then RMBS would never be a problem. And thus acceding to a RMBS issuer's request that a higher percentage of a security be designated as the AAA senior tranche seemed unlikely to pose a threat to a rater's long-run reputation.

However, housing prices did cease to rise on a nationwide basis in mid 2006 and then began to fall. By the spring of 2007 it was clear that mortgage foreclosures were rising and that RMBS would soon experience losses as well, even reaching the previously AAA-rated senior tranches. Widespread rating downgrades of the RMBS were unavoidable, followed by widespread criticism of the credit rating agencies for their initial excessively favorable ratings. What was missing in this criticism of the raters and of the conflicts that were present in their issuer-pays business model was any recognition that the raters' record in the area of plain vanilla corporate and municipal debt (where the same business model applied) was still reasonably good.

## V. WHAT ABOUT EUROPE?

Since 2009, the fiscal problems of a number of countries within the Euro-zone have become increasingly clear, and the rating firms have been downgrading the government ("sovereign") debt of those weaker countries. European government leaders have widely criticized the raters for those downgrades, arguing that the downgrades were premature and exacerbated the downgraded countries' financial problems—even though the downgrades have generally lagged the financial markets in their recognition of these countries' problems (consistent with the raters' general sluggishness in changing ratings, as discussed above).

Notice, however, that these criticisms of the major rating agencies are quite different from those that were levied after the RMBS debacle. The RMBS problem was that the raters had initially been excessively lenient; but the Europeans' criticism has been that the raters have been excessively harsh (despite the fact that the issuer-pays business model applies to most sovereigns' debt issuances).

## VI. WHAT IS TO BE DONE?

There are at least four broad directions in which public policy could go: The first direction is a natural political reaction to the rating firms' failings with respect to RMBS: The rating firms should be regulated, so as to reduce the likelihood of a similar debacle in the future. The Dodd-Frank Act of 2010<sup>4</sup> requires the SEC to regulate NRSROs so as to force the latter to deal more extensively with the conflicts that arise in the issuer-pays model and to be more transparent with respect to the bases for their rating judgments. The European Union has also

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<sup>4</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376-2223.

traveled down this path and appears to be ready to go further, including restrictions on the ability of rating agencies to rate sovereign debt.

In addition to the question of whether these regulatory efforts will actually be successful (and, for the European Union, how would investors in sovereign debt be expected to obtain their information?), there is also the issue of the additional costs that such regulation unavoidably places on the regulated entities. The added costs will likely discourage entry, as well as putting smaller raters at a disadvantage relative to larger raters. The number of NRSROs fell from ten to nine in late 2011 when a Japanese-based rating firm (Rating and Investment Information, Inc.), which had received the NRSRO designation in 2007, decided to withdraw from the designation. An ironic consequence of greater regulation could be that the three major rating firms might emerge as even more dominant.

A second direction would be to have the SEC select the first rater that any bond issuer would have to use.<sup>5</sup> The SEC would choose the rater on the basis of expertise and past performance. Such a system would retain the beneficial instantaneous dissemination of information that the issuer-pays model allows, while avoiding that model's shopping-around drawbacks.

The potential flaws in this approach are non-trivial, however: One would have to trust the SEC to be a good judge of expertise and competency, as well as trusting that the SEC would recognize good technological change in the rating business as it came along. The SEC would also have to be the arbiter of the fee for this rating.

A third direction has been mentioned especially in the European context: The Europeans should establish a European-based credit rating agency. Although the "cover story" for this kind of proposal is that there needs to be more competition among raters, the underlying tone is that the three major rating agencies are U.S.-based (even though Fitch is a subsidiary of a French financial services conglomerate) and are not sufficiently sympathetic to the needs of European countries. However, if the new agency is seen as the handmaiden of European governments, its credibility among bond market participants would suffer.

There is a fourth direction in which public policy could go: This would be to reduce the formal regulatory reliance on ratings that has existed in the United States since 1936 and that was hardened into the NRSRO system in 1975. This is a route that the Dodd-Frank legislation also pursues: That legislation removed all references to NRSRO ratings from existing laws and instructed federal financial regulators to replace reliance on NRSRO ratings in their prudential regulations. The SEC has gone farthest and fastest in this regard; federal bank regulators, unfortunately, have proceeded more slowly. And the European Union, while giving some lip service to this approach, has thus far not implemented it.

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<sup>5</sup> This idea seems to have arisen independently at least three times: see Jerome Mathis, James MacAndrews, and Jean-Charles Rochet, *Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?* 56 J. MON. ECON. 657-674 (2009); David G. Raboy, *Concept Paper on Credit Rating Agency Incentives*, Congressional Oversight Panel (2009); and Matthew Richardson and Lawrence J. White, *The Rating Agencies: Is Regulation the Answer?* in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM (Viral V. Acharya and Matthew Richardson, eds.), 101-115 (2009).

The essence of this approach is that the goal of safe bonds for the investment portfolios of banks, insurance companies, pension funds, etc., is still important for the prudential regulation of these financial institutions. But financial regulators must develop alternative mechanisms for achieving this goal, rather than continuing their blind reliance on the ratings that are provided by a handful of rating agencies.

This approach should start with the recognition that the primary bond investors are financial institutions. Their professional bond managers should be expected to be able to exercise judgment as to the sources and development of creditworthiness information. Larger financial institutions that are comfortable making internal creditworthiness judgments should be allowed to do so, while smaller financial institutions could seek third-party help. In either case, if the financial institution is prudentially regulated, it would have to justify to its prudential regulator either the basis for its internal judgments (e.g., show its research and modeling to the regulator) or its basis for choosing the third-party information provider.

With the NRSROs' ratings no longer mandated, the NRSRO category should be abolished, and the special regulation of the former NRSROs should be eliminated. Again, this is an institutional market, and professional bond managers should be expected to be able to figure out who is a reliable source of information, and who is not—subject, of course, to appropriate prudential regulatory oversight.

This approach would open up the bond rating business to the potential for new ideas, new methodologies, new technologies—perhaps even new business models—in a way that certainly has not been the case since 1975 and arguably not since 1936. New competition might occur through new entry or through financial institutions' vertically integrating into deeper analysis of bond issuers' creditworthiness. Either route would be an improvement over the rigidity of the NRSRO system.

This fourth route is one that is consistent with the goals of competition policy. It is clear that competition policy was not sufficiently considered when the NRSRO system was created in 1975, nor when the SEC subsequently became an opaque barrier to entry, nor when mergers in the 1980s and 1990s eventually returned the number of NRSROs back to their original three. Still, “better late than never” is an operative concept here.

Whether the major three rating agencies would maintain their market dominance in this more open environment—or whether upstarts could encroach significantly—would be decided by market forces and not by unneeded regulatory constraints and barriers to entry. And that approach surely is consistent with sensible competition policy.