COMPETITION POLICY INTERNATIONAL

CPI Antitrust Chronicle
November 2013 (2)

Is There Misdiagnosis and Mistreatment in the Market for Credit Ratings?

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Rosa M. Abrantes-Metz[1]

I. INTRODUCTION

Credit Rating Agencies ("CRAs") were at the center of the recent financial crisis, with some critics going so far as to blame them for the crisis itself. A number of proposals have been made to reign in the CRAs and recently we have seen the creation of a new CRA in Europe, welcomed by many as the first step to solving the problem generated by a supposed lack of competition in this market.[2] But we must first define the problem accurately before we can find an appropriate solution.

First, let's take a look at the historical facts. In the recent financial crisis, the problem with ratings was largely contained to structured finance.[3] Corporate ratings performed within typical recessionary levels, and municipal ratings performed quite well, despite concerns for a time that they could become the next crisis. Within structured finance, the problem was largely contained to U.S. Residential Mortgage Backed Securities ("RMBS") and related derivatives, as the CRAs (along with most everyone else) underestimated the potential for catastrophic price declines in the U.S. housing market.

With this history in mind, I argue that the underlying problem is "rating shopping," combined with monopsony power unique to the structured finance market. The structured finance market is characterized by a few large financial institutions who issue these securities and who have the market power to possibly influence CRAs to at least adopt more liberal analytics—if not outright compromise them. (It should be noted that some equate "rating shopping" with the "Issuer Pays" model—the debt issuer pays for the rating—but they are distinct. "Issuer Pays" is probably necessary but is not sufficient for rating shopping.)

If rating shopping in structured finance is indeed the problem, rather than the lack of competition, then policies must solve that problem. Calls for "more competitors" could actually exacerbate rating shopping, as having more CRAs increases the likelihood that there exists some

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[2] *Big 3 Ratings Firms Facing Competition*, FOXBUSINESS, (November 18, 2013), *available at* Http://Www.Foxbusiness.Com/Markets/2013/11/15/Big-3-Ratings-Firms-Facing-Competition/.

[3] Structured finance generally refers to the use of complex transactions to create non-conventional financial instruments for entities with special financing needs. Examples of the instruments used in structured finance are collateralized debt obligations, commonly known as "CDOs".

CRA that will rate a paper "AAA" without merit, in an effort to hold on to or expand its market share. Take this situation to an extreme: Why not open a CRA and rate everything that comes in AAA. At some point some (or many) of the assets will default and, as a response, the new CRA will go out of business, wait for some time, and then re-open under a different name!

Similarly, calls for "market share caps" would not address rating shopping either. All else being equal, a rating system becomes more valuable the more of the universe it applies to, and restricting market share diminishes this value by decreasing the consistency of relative risk measures. Furthermore, the credit analysis of issuer A often requires a credit analysis of issuer B (banks and sovereigns, parents and subsidiaries). In order to do a proper analysis of issuer A, the CRA may need to do a proper analysis of issuer B. What if it is not allowed to rate B, meaning it is not compensated for its analysis of B but, at the same time, it still needs to rate A? The CRA may forego the analysis of B, leading to a diminished analysis of A, or it may raise its price for rating A.

If, instead, it can be guaranteed that the CRAs will have some part of the market, then they will be unconstrained (or at least significantly less constrained) to adopt what they think are appropriate analytics. This may in fact promote competition on ratings quality—isn't that the objective?

Some have also argued that ratings are too important in financial and regulatory systems. The CRAs themselves have publicly argued in favor of reducing the regulatory reliance on ratings. But at the end of the day, what is the alternative to some kind of private sector CRA? The options are either "nothing"—no CRAs—or government-sponsored CRAs. As regards the first alternative (no CRAs), it would seem difficult to argue that nothing is preferable to something, however flawed that something may be. After all, one always has the choice of ignoring ratings, but it is clear that many voluntary arrangements are made which refer to ratings in some form. That reveals a preference for ratings.

As regards the second alternative (government-sponsored CRAs), it would seem difficult to argue that a government-sponsored CRA would be credibly free of "conflicts of interest." Would an officially sanctioned CRA ever downgrade its own sovereign's debt, or the debt of its allies, or the debt of systemically (or merely politically) important corporate or financial institutions, or, say, too-big-to-fail corporations? Would the "U.S. Department of Credit Ratings" ever downgrade the United States, or General Motors, or Bank of America, or England, or China? And if it didn't, wouldn't doubts always persist that the decision was political and not analytical?

And without a third party CRA, how can I, as an investor, solve the principal-agent problem of constraining my portfolio manager? Today I can say "invest only in investment-grade instruments," as defined by someone other than my portfolio manager. Furthermore, how can I compare the "riskiness" of one bank's portfolio against another? Today I can compare the ratings (from the same CRA) of one bank against another. In the end, will I not require *some* third party to provide objective risk assessments of all types of credits, all on a broadly comparable scale?

The private CRA industry may need reform, though it is unlikely that it can be replaced. But to properly reform the industry, we must first correctly diagnose the underlying problems. If the complaint against the major CRAs is that the quality of their ratings was poor, then we must

understand why, and consider what structural changes can be made to ensure higher quality going forward.

II. CREDIT RATING AGENCIES AND THE FINANCIAL CRISIS

Blaming the CRAs for most, or at least a significant portion, of the financial crisis is a popular view.[4] A common argument is that the CRAs, either due to avarice or incompetence, inflated the ratings of securities related to residential mortgages and in so doing abetted the adoption of inadequate underwriting standards in the origination of mortgages. According to this theory, CRAs lulled market participants, including large and sophisticated banks, into a false sense of security, and when house prices fell and people began to default on their mortgages, those securities which had been deemed AAA-safe began to take losses. Banks were not adequately capitalized against their tremendous exposures to such securities, and they quickly suffered large and unanticipated losses. The rest, as they say, is history.

With hindsight it is very tempting to accept some or all of this explanation. After all, securities the CRAs stamped AAA have taken losses—what more proof is needed that those initial ratings were "wrong?" However, the truth is far more complicated. Rating Agencies required that to be rated AAA, Residential Mortgage Backed Securities ("RMBS") tranches be protected against levels of default not witnessed since World War II, which seemed an appropriate requirement prior to the crisis. They did not require that RMBS tranches be protected against a 40 percent national decline in house prices, which is what ended up happening.[5]

It is easy to say with hindsight that such protection should have been required, but it is worth remembering the absence of widespread *contemporaneou*s accusations that U.S. RMBS securities, including even subprime securities, were obviously under-rated. Moreover, this argument raises the question of why protection against a 40 percent decline is enough; suppose housing prices were to drop by a 60 percent decline?

Let's, for example, take a look at the Case-Schiller's index for real estate futures prices presented in Figure 1 below, representing prices for four futures contracts with delivery dates of November 2007, and February, May, and August of 2008. Futures prices represent the market's best forecast of what spot prices will be at the delivery date (though some discounting may exist between the two). It is clear from these price evolutions that in 2006 and at least until November of 2007 (after the "official beginning of the financial crisis" on August 9, 2007), the market did not anticipate any meaningful decrease in housing prices. And from then, throughout February of 2008 (well into the crisis), there continued to be no anticipation of significant future housing prices decreases, but only a relatively moderate decrease. Only after February 2008 did the market start to anticipate significant decreases in real estate prices.

Now, if the entire market was unable to anticipate the drastic decrease in national housing prices before the crisis, why would it expect the rating agencies to magically have been

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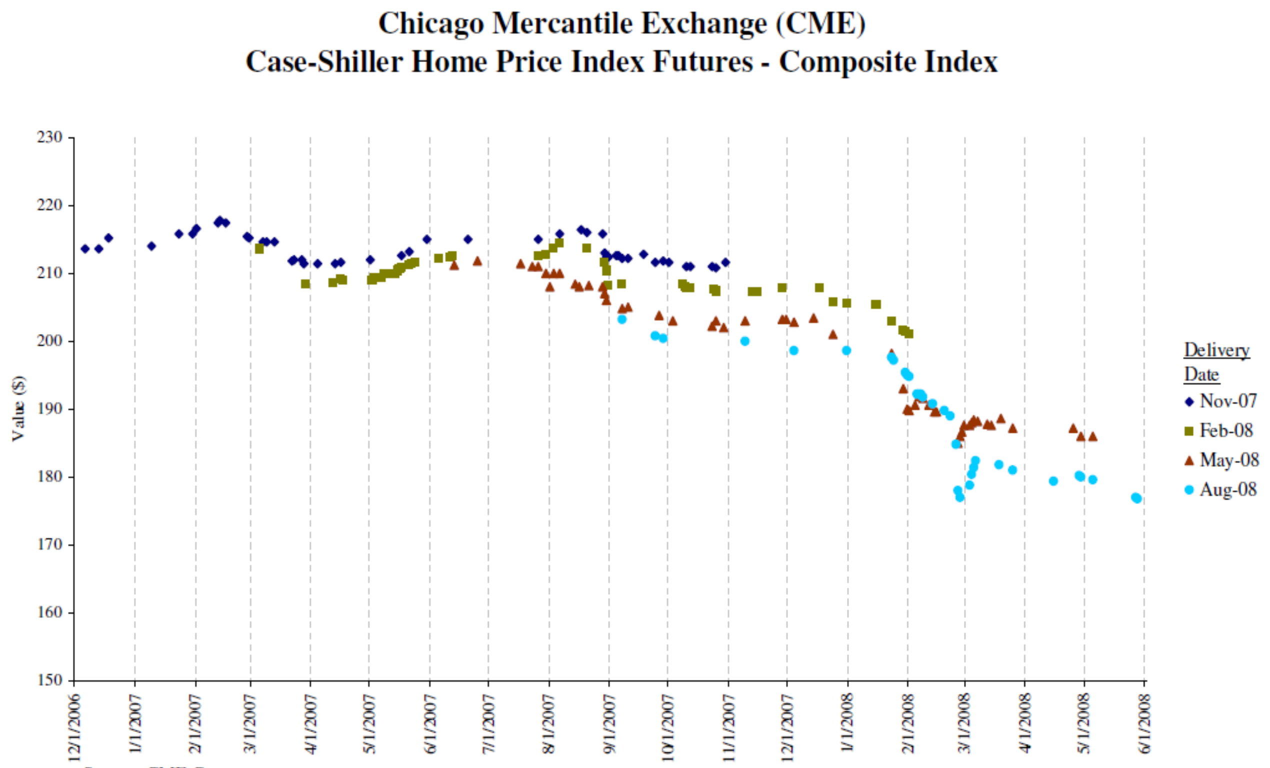
[4] *See*, for example, Alan Greenspan, *The Crisis: Comments and Discussion*, Brookings Papers on Economic Activity, pp. 201-246, (Spring 2010).

[5] Or AAA rated securities would not have defaulted when a 40 percent decline in real estate national prices did occur.

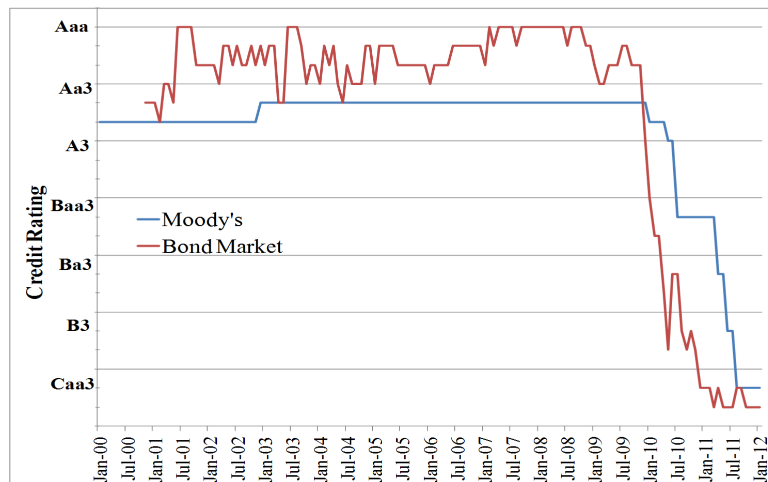
able to do so? The CRAs likely assumed only a very small probability of a 40 percent decline in housing prices, but so did the entire market. So weren't they consistent with information available at the time?

Figure 1: Drastic Decline in Housing Prices Unanticipated by The Market Well Into the Financial Crisis



Yes, with hindsight, ratings were too high for U.S. RMBS, but how about cases when CRAs have been more conservative than the market, attributing lower ratings than those implied by the respective assets' bond prices? These situations seem to go unnoticed. As just one example, Figure 2 presents Moody's ratings for Greek sovereign debt as being more conservative than that implied by the market.

Figure 2: Two Opinions on Greek Sovereign Debt



So what really is the problem in the market for ratings of structured finance products and, further, how should it be addressed?

III. IDENTIFYING THE PROBLEM

Policymakers, regulators, and academics have advanced a number of proposals aimed at fixing the problem of CRAs but without clearly identifying what the problem really is. Many of these proposals are familiar to the antitrust community. They call for "more competition," which is to be achieved by encouraging new CRAs and by limiting the actions of existing CRAs.[6]

Perhaps we can all agree on what is not the problem. Are ratings too expensive? No, that is not the problem. No one is arguing that the CRAs are colluding to raise the price of obtaining a rating. It is also not being argued that the credit markets would benefit from lower rating prices, nor is it argued, "there aren't enough ratings being issued." Critics often speak of the "oligopoly" in CRAs, but not in the context of oligopolistic pricing. Therefore, calls for "more competition" begin to appear reflexive. More competition is the solution for artificially inflated prices; but if uncompetitive pricing is not the problem, then perhaps more competition is not the solution.

If we accept that ratings were *ex-ante* inaccurate (and potentially inflated), that is a problem of quality, not price. Active oligopolies may be said to artificially raise the price per unit of quality, or lower the quality per unit of price. And introducing more competition may then lower the price per unit of quality, or raise the quality per unit of price. But that does not mean that the level of quality will increase. It simply means the available quality will be less expensive.

[6] *See*, for example, Reuters, *Euro MP seeks credit rating agency market share caps*, (February 28, 2012), *available at* http://www.reuters.com/article/2012/02/28/eu-ratingagencies-idUSL5E8DS55620120228. A possibility would be for a CRA to be required to suspend rating certain companies for a time to allow a different CRA to rate them, given that they would not be allowed to have more than a specified amount of market share, presumably significantly smaller than they currently have.

The level of quality may go up, certainly; but it may also go down. All we know for sure is that it will be less expensive.

The better explanation for inflated ratings in the structured finance market—and not in the corporate, banking, sovereign (where the complaint is exactly the opposite) or municipal debt markets—is not a lack of competition among CRAs, but rather the monopsony power in the structured finance market held by the very few and significant financial institutions issuing these products; a power which leads to "rating shopping." Such monopsony power does not exist in any of the remaining rating segments.

So what is rating shopping, and how does it relate to monopsony power? Rating shopping occurs when the issuer of debt securities searches for, and ultimately purchases, the highest possible credit rating it can obtain from a reputable agency. We should not be surprised that issuers would have an incentive for rating shopping. Indeed, what is surprising is that rating shopping is not more prevalent. Evidence for limited rating shopping is that issuers often pay for two different ratings from major CRAs—which, many times, are not at the same level. For example, an issuer may pay for a AAA rating from S&P and a lower Aa1 rating from Moody's. That would not happen in a market characterized by pure rating shopping.

Rating shopping, coupled with monopsony power, may nevertheless be significant enough to lead to inflated ratings in the credit market—even if the CRAs hold true to their best possible analytics—due to concerns by CRAs of losing very significant portions of the market precisely because of monopsony power by the issuers. When issuers engage in rating shopping, the observed credit rating will always be the maximum rating, since any ratings below the maximum will not be purchased and therefore never known to the market. Thus, the market may see an opinion that is scrupulously honest but is still an outlier, the most optimistic credit opinion. However, if the issuer in question represents a large share of the market, then a large share of the market may be represented by only the most optimistic credit assessment.

An example of how rating shopping may affect CRAs comes from the commercial mortgage backed securities ("CMBS") segment of the structured finance market. A few years ago, Moody's raised its standards in that segment, and rapidly saw its market share of new CMBS ratings drop from nearly 90 to nearly zero percent. As a consequence, with nearly zero percent share of new ratings, the market never actually heard Moody's more conservative opinion.

Rating shopping becomes more pernicious if it causes CRAs to loosen their standards. The result is, potentially, a race to the bottom. Consider ratings in structured finance. Suppose S&P requires 10 percent credit enhancement ("CE") to declare a tranche AAA, while Moody's (sincerely) believes that only 9.9 percent is required. Since the loss levels associated with the highest ratings are infinitesimal, debating the "correctness" of 10 percent versus 9.9 percent is rather like arguing about how many angels can dance on the head of the pin. Even the agency that thinks 10 percent is necessary would still agree that 9.9 percent is "very, very safe."

With rating shopping, only the Moody's rating would be purchased and heard in the market. Over time, S&P might find itself effectively excluded from this market, and all because of a 0.1 percent difference of opinion. At either level of credit enhancement, loss levels at the AAA level are likely to be infinitesimal. Thus, as time goes by, all the 9.9 percent CE tranches likely will perform well, and S&P will naturally find itself questioning its assumptions and analytics.

There will always be a basis for such questions. Perhaps there is a correlation parameter at the heart of S&P's analysis. Such parameters are always estimated with some error, even assuming they are based on excellent data. Without assuming anything sinister on the part of any analyst anywhere, it is perfectly reasonable to think that S&P might adapt its methodology to support a 9.9 percent CE. Then it, or some other CRA, may adopt a 9.8 percent CE, and there will be pressure to adopt that standard. In this way, standards can steadily decline until a crisis reveals the prevailing CE standards to be inadequate. This process, again without assuming avarice or deceit, will be more likely to occur where there are more CRAs.

The key to the downward spiral described above is that a conservative CRA faces exclusion from the market. In structured finance, one issuer may represent thousands of ratings, so the CRA may face a significant penalty if it disappoints one issuer. In short, there is the potential for monopsony power among structured finance issuers. This is not the case in any of the remaining ratings segments. Rating shopping, coupled with monopsony power in structured finance, will tend to drive the more conservative (not necessarily more correct) agencies from the market.

Some have identified the "issuer-pays" and the conflict of interest this practice represents as the central problem, in which the issuer of the debt pays for the rating of its own debt.[7] But while issuer-pays is necessary for rating shopping and monopsony power, it isn't sufficient. The issuer-pays model also applies to corporate ratings, and there is no evidence that corporate bond ratings have become inflated as a result. Moreover, corporate ratings held up well during the recent financial crisis. In the corporate and in the municipal bond markets, however, no one issuer represents a significant part of the market. Thus, if a single issuer is unsatisfied with a CRA's rating, that is of little concern to the CRA. In the structured market, losing only one issuer may significantly harm a CRA.

IV. PROPOSING A SOLUTION

Policy proposals should recognize existing market incentives and work within them to change or minimize undesired consequences. Rating agencies want profits, and they must be able to pay competitive wages to attract top-tier analysts. Issuers want high ratings. Ratings are needed by investors to take investment decisions. These are realities, but they also exist in other sectors besides structured finance. The difference is that issuers in the corporate sector do not have sufficient power to bring to bear against the agencies. No CRA risks exclusion from the corporate market because it holds a more conservative opinion of credit risk.

To address this problem of issuer monopsony power, there should be a guarantee for the first CRA to rate a structured finance asset that its rating will be purchased by the issuer, independently of how low such a rating may be. Of course, subsequently the issuer may seek ratings from other CRAs, which may be higher or lower than the first rating, and it may decide or not to purchase these. But they will have to keep the first rating. A structure of this type will relieve CRAs from the fear of being conservative and—as a consequence—the likelihood of losing all of the market. Since instituting such a guarantee would require that some issuers

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[7] Darcy Deryn, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It,* 605(2) COLUMBIA BUSINESS L. REV. (2009).

purchase ratings that they may not want, in practical terms it would work as a tax on issuance. It is not critical who pays the tax. It could be the issuer, or it could be the appropriate regulatory authority on behalf of the issuer. What is critical is that a CRA with a more conservative rating opinion does not risk exclusion from the structured finance rating market.

The closest analog to what I am describing is a utility. A utility is guaranteed some business in its market. There is a supervisory agency that ensures the utility does not abuse this guaranteed business, but the guarantee is there. To the extent ratings are a public good, serving a public interest, they should be supported by the public. But having the government actually pay for ratings (or operate its own rating agency) is not a solution, since governments are often some of the most interested parties in the actual rating outcome. The recent accusations that sovereign rating downgrades in Europe "plunged financial markets into a state of profound distress"[8] exemplify the possible danger of having governments responsible for paying for ratings. Governments clearly have interests in the outcome, and if the purchaser of the rating is not necessarily interested in its quality, it must follow that the problem of lower quality ratings will not be solved.

V. CONCLUDING REMARKS

The market for ratings in structured finance requires competition on the basis of quality, not price. Limiting the number of CRAs and guaranteeing them some degree of structured finance rating market participation is necessary if the more conservative credit opinions are to be revealed and the market is to be improved. Having more CRAs in a market characterized by monopsony power will likely only worsen the problem.

[8] Nicolas Petit, *Credit Rating Agencies, the Sovereign Debt Crisis and Competition Law*, 7(3) EUROPEAN COMPETITION J., pp. 587-632.