

## Chapter 3: Executive Summary

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# The Rating Agencies: Is Regulation the Answer?

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### Background

Credit rating agencies — the three major ones being Moody's, Standard & Poor's, and Fitch—are firms that offer judgments about the creditworthiness of bonds. Specifically, the agencies measure the likelihood of default on debt issued by various kinds of entities, such as corporations, governments, and (most recently) securitizers of mortgages and other loan obligations. The lenders in credit markets, including investors in bonds, are always trying to ascertain the creditworthiness of borrowers. Credit rating agencies are one potential source of such information—but they are far from the only potential source. Starting in the 1930s, financial regulators have required that their financial institutions heed the judgments of the rating agencies with respect to these institutions' bond investments. These regulations, motivated by the desire for safety in bond portfolios, have played a major role in thrusting the agencies into the center of the bond markets. By creating a category ("nationally recognized statistical rating organization", or NRSRO; in 1975) of rating agency that had to be heeded, and then subsequently maintaining a barrier to entry into the category, the Securities and Exchange Commission (SEC) further enhanced the importance of the three major rating agencies.

The three major rating agencies in the U.S. played a central role in the recent housing bubble and then in the subprime mortgage debacle of 2007-08. The successful sale of the mortgage-related debt securities that had subprime residential mortgages and other debt obligations as their underlying collateral depended crucially on these agencies' initial ratings on these securities. When house prices stopped going up, and began to decline instead, these initial ratings proved to be excessively optimistic -- especially for the mortgages that were originated in 2005 and 2006. Mortgage bonds collapsed, bringing the rest of the U.S. financial sector crashing down as well.

### Issues

Most market participants now agree that the quality of the ratings of collateralized debt obligations, even *ex ante*, was poor. The question is why, and whether changes in regulation can forestall future such behavior. The answer lies in the nature of the competition across the NRSROs. In theory, competition among rating agencies should be a good thing, leading to innovation and higher quality research. There is, however, a problem when this competition is put into practice. On the one hand, in the "issuer pays" model followed by the three major players, competition can lead to inflated ratings because the company chooses who should rate them. On the other hand, in the "investor pays" model where one might expect the incentives to be better aligned, there is a free rider problem, and it is not clear how the free market can solve it. Business models aside, financial regulation may itself be the root cause of the problem since the basis of the NRSRO's authority as the central source of information about the creditworthiness of bonds decreases competition and incentives to innovation.

Appropriate public policy actions depend importantly on what one perceives as the fundamental problem vis-à-vis the credit rating agencies, and also on one's confidence in the ability of regulators to devise effective remedies. We propose two possible models.

## Policy Recommendations

With respect to the rating agency's business model of "issuer pays," the SEC should create a department that houses a centralized clearing platform for ratings agencies.

1. A company that would like its debt rated goes to the centralized clearing platform. Depending on the attributes of the security (i.e., type of debt, complexity of firm and issue, whether other debt outstanding is already rated, etc...), a flat fee would be assessed.
2. From a sample of approved rating agencies, the centralized clearing platform chooses which agency will rate the debt. While this choice could be random, a more systematic choice process could enhance beneficial competition. The choice would be based on the agency's experience at rating this type of debt, some historical perspective on how well the agency rates this type of debt relative to other ratings agencies, past audits of the rating agency's quality, and so forth.
3. For a fee, the rating agency would then go ahead and rate the debt.

This model has the advantage of simultaneously solving (i) the free rider problem because the issuer still pays, (ii) the conflict of interest problem because the agency is chosen by the regulating body, and (iii) the competition problem because the regulator's choice can be based on some degree of excellence, thereby providing the rating agency with incentives to invest resources, innovate, and perform high quality work. It does, however, put tremendous faith in the ability of the regulator to monitor and evaluate the rating agencies' performance.

Alternatively, a 180-degree turn would be to withdraw the financial regulations that thrust the rating agencies into the center of the bond markets.

1. The regulatory goal would still be for financial institutions to have safe bond portfolios, but those institutions would have more latitude and flexibility with respect to where they could seek advice.
2. Therefore, regulated financial institutions would be free to take advice from sources that they considered to be most reliable - based on the track record of the advisor, the business model of the advisor (including the possibilities of conflicts of interest), the other activities of the advisor (which might pose potential conflicts), and anything else that the institution considered relevant.
3. Again, the institution would have to justify its choice of advisor to its regulator. But, subject to that constraint, the bond-advisory information market would be opened to new ideas - about business models, methodologies, and technologies - and new entry in a way that has not been true since the 1930s.