IDEAS

CREDIT RATING AGENCIES

ARE THEY REALLY TO BLAME?

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Many people have blamed the credit rating agencies for their role in the financial meltdown of 2008 but were their assessments on asset securitizations any different from the judgment of the market?

CREDIT RATING AGENCIES • RISK ASSESSMENT
ASSET SECURITIZATION • REGULATION •
ACCOUNTING AND CONTROL

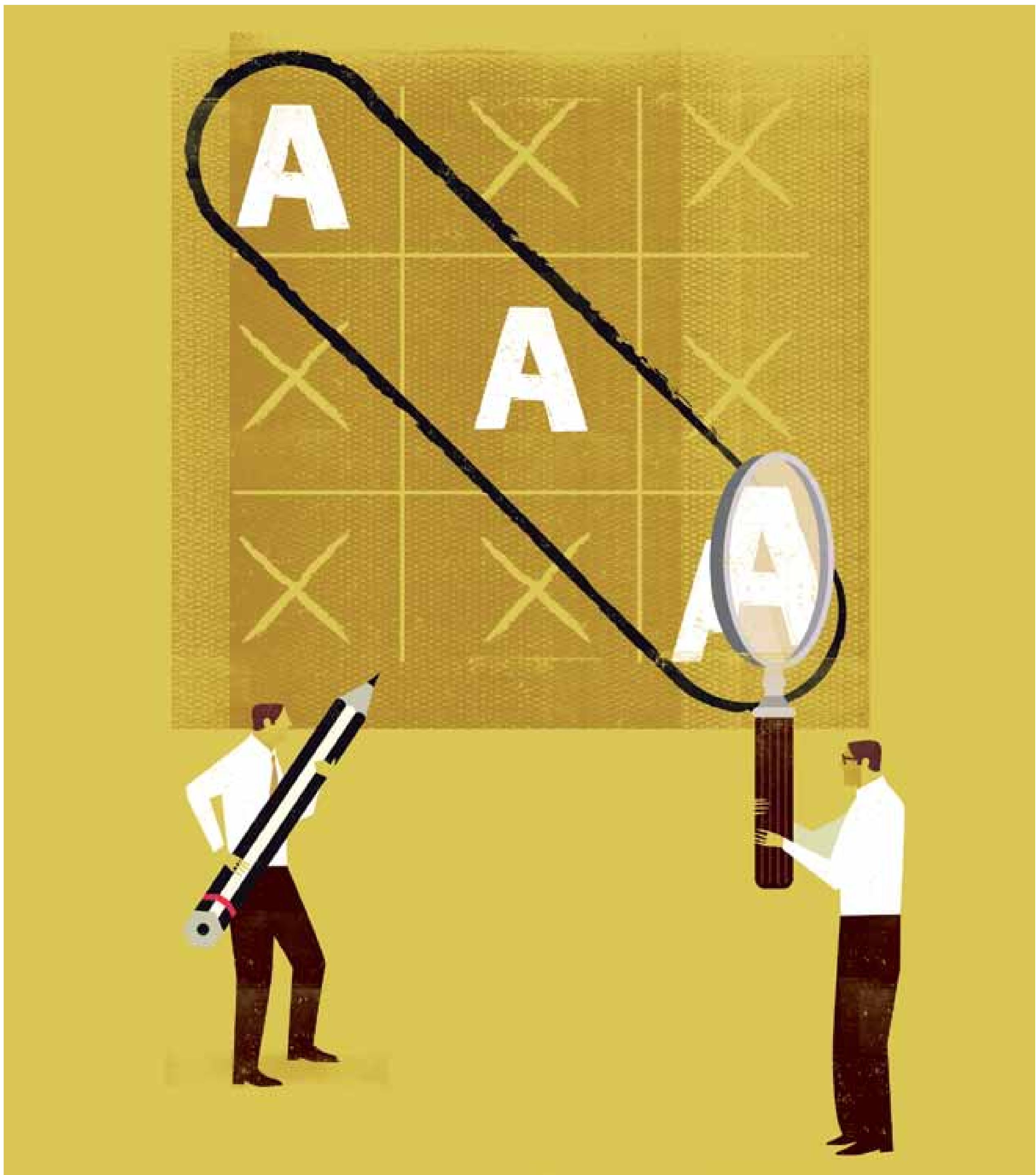
The major credit rating agencies – Moody's, Standard & Poor's and Fitch – have been widely criticized for their role in the financial crisis. It is said that they wrongly assessed the risks on billions of dollars worth of bonds backed by residential mortgages, thus allowing financial institutions to take undue risks at the expense of taxpayers. The public outcry led to regulatory initiatives such as the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, in which the regulation of rating agencies is viewed as an important mechanism to increase investor protection.

To fully understand the controversy surrounding the role of credit rating agencies in the securitization process, let us remember how this whole game works. What is an asset securitization? Do these transactions have an economic rationale or are they just a way for greedy financiers to take risky gambles knowing that if they lose, their companies will be bailed out by the government? What is the role that ratings play in this game?

In a typical securitization, a firm legally transfers assets — whether residential mortgages or credit-card debt or some other some other kind of receivables — to a special purpose entity (SPE). The SPE is a legal shell set up for the dual purpose of holding the assets and attracting investment by issuing securities based on the cash flows originated by the assets transferred to the SPE. For example, a mortgage-based security (MBS) represents a claim on the cash flows originated by a pool of mortgage loans. Cash from investors goes from the SPE to the firm that created it, and almost invariably the originating firm retains a portion of the assets for itself, generally the highest-risk portion, as an encouragement to investors. In theory, SPEs can be advantageous to investors as a protection against bankruptcy of the originating firm and as a means of diversifying risk among investors, who can have payoffs tailored to their needs and their degree of risk aversion.

One problem with these transactions is that investors know less about the quality of the securitized assets than issuers, and thus might end up overpaying for those securities. Aware that they can be fooled by issuers, investors will protect themselves by paying less money for those securities than the quality of those assets deserve. The role of credit rating agencies is to mitigate this problem by offering judgments about the likelihood of default on debt issued by the SPE.

However, some might call into question the value added by this intermediation. Why are these ratings so important if, after all, they are no more than opinions? Why should the opinion of a rating agency's research team formed by a reduced number of people be more accurate than the assessment of thousands



of sophisticated market participants that have important economic interests in those securities? Is it that the market relies more on the expert judgment of rating agencies than on their own risk assessments? Is it that rating agencies have access to information about the firm that is not publicly available to market participants?

Although this is possible, financial regulations, motivated by the desire for safety in investment portfolios, have also played a major role in thrusting the agencies into the center of the debt markets. Starting in the 1930s, financial regulators have required that their financial institutions heed the judgments of the rating agencies with respect

THE "ISSUER PAYS" MODEL GIVES THE ISSUER THE INCENTIVE TO CHOOSE THE RATING AGENCY WITH THE MOST FAVORABLE OPINION OF THE COMPANY

to these institutions' debt investments. Credit ratings determine — as a matter of law — how much capital regulated institutions such as banks or insurance companies need to have on their balance sheets. Regulated financial institutions have a regulatory limit on the risk they can take. This limit is a maximum value for the firm's capital ratio, which is computed as the ratio between the equity the firm holds in its balance sheet and a risk-weighted sum of its assets. Those weights are defined by regulators based on categories of assets and credit ratings. That is, the better the credit ratings, the higher the firm's capital ratio threshold, and thus the higher the amount of debt (leverage) the firm can take. More leverage means higher probability of default and consequently higher risk, but also higher expected returns for existing shareholders.

The regulatory effects of credit ratings are not limited to banks and insurance companies. For example, money market funds are barred from investments rated lower than AAA (i.e., the highest rating category). However, interestingly enough, highly rated asset-backed securities played a central role in the money market turmoil that marked the outset of the 2007-2009 financial crisis.

Another important question is why would these firms issue inflated ratings if their reputation is at stake and their trustworthiness is at the heart of their business model? The answer lies in the incentives of these firms and in the nature of the competition across the NRSROs. Let us start with a fundamental question: Who pays for these ratings? Initially, it was investors who purchased the ratings from the rating agencies but the so-called "investor pays" model soon became unpractical for several reasons. First, investors were not willing to pay for information that was available for free to other investors. Second, buy-side investors would reward rating agencies for underestimating risk as high ratings loosen regulatory restrictions on the types of instruments they can invest in. Consequently, the "investor pays" model was replaced by the "issuer pays" model, in which issuers pay rating agencies to rate their companies and make that information available to investors. Unfortunately, this gives the issuer an incentive to choose the rating agency with the most favorable opinion of the company.

Although competition among rating agencies could alleviate this problem, the barriers to entry into this industry have also been heavily influenced by regulators. 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 EVIDENCE

Since the outbreak of the financial crisis, there has been a widespread perception that credit ratings for asset securitizations were overstated. But is there no alternative explanation for the dramatic decline in the market value of so many asset-backed securities that were rated AAA by the rating agencies? Although with the benefit of hindsight this might seem implausible, a rigorous analysis requires contemplating alternative hypotheses. For example, is it possible that the majority of market participants considered the crisis an event so unlikely that it barely affected investors' assessment of the probability of default of securitized assets? In other words, perhaps credit ratings issued before 2007 were partially correct and did recognize the risk of securitized assets, but were affected by a widespread misperception of systemic risk. An even more extreme alternative hypothesis is that credit ratings were accurate and reflected the underlying credit risk of securi-

tized assets. After all, a AAA rating means that the probability of default is very low, but not zero.

To assess the credibility of these claims, we need to know whether in the period prior to the crisis, rating agencies were systematically ignoring the risk from securitizations. This is the question that, along with my co-authors, I assess in the paper "Asset Securitization and Credit Risk," published in a recent issue of The Accounting Review. The paper finds a marked difference between the way risk was assessed by the bond market on the one hand and a major credit-rating agency, Standard & Poor's, on the other.

In its assessment of risk, the bond market took into account all asset-based securities issued by the banks in the three categories sampled by the study — those backed by residential mortgages, by consumer loans and by commercial loans. In contrast, assessments by Standard & Poor's reflected only the small portion of issued securities that the banks retained in their own accounts and did so only in the case of residential mortgages but not the other two types. But why would the market perceive as risky assets that had been sold to investors and, according to the accounting rules, were no longer part of the bank's balance sheet? The answer is that the bank still kept ties with those assets in the form of implicit guarantees and thus those assets possibly affected the bank's credit risk.

The evidence that the bond market recognized the risk of assets securitized prior to the 2007-2009 financial crisis is not consistent with the idea that credit ratings reflected a potential misperception of systemic risk that was prevalent among market participants. Rather, the lack of correlation between ratings and securitized assets implies that rating agencies ignored the risk of those assets or, if anything, only recognized the risk of the securitized assets explicitly retained by the bank.

THE SOLUTION

The solutions to the problems in the credit rating industry can be classified into two basic approaches. One view is that, because their ratings are closely tied to financial regulation, these agencies should be as closely subject to regulation as banks and insurance companies. The other view is that rating agencies deserve to have the same freedom of speech as a broker who advises investors to buy some particular stock, but let the buyer beware.

These two approaches have led to very different proposals. Recent regulatory initiatives emphasize the need for increased oversight of credit rating agencies. Most importantly, the Dodd-Frank bill in the U.S. established a new Office of Credit Rating Agencies at the SEC to strengthen regulation of credit rating agencies and new rules for internal controls, independence, transparency and penalties for poor performance. In Europe, there are proposals for mandatory registration with the European Securities and Markets Authority (ESMA) and a requirement to force corporations to rotate their rating agency.

However, there are other proposed solutions that put less emphasis on regulatory oversight. For example, some propose the establishment of centralized clearing platforms for ratings (from a sample of approved rating agencies, the centralized clearing platform chooses which agency will rate the debt for a flat fee). Others lean towards withdrawing the financial regulations that thrust the rating agencies into the center of the debt markets and tie capital and reserves requirements (if any) to market measures. Still others propose to increase competition in the rating industry by revisiting the requirements for the NRSRO status. Unfortunately, all these solutions have important trade-offs and implementation problems that need to be carefully analyzed and thus it is likely that these unresolved issues will continue to be on the table in the future.

THE LACK OF CORRELATION BETWEEN RATINGS AND SECURITIZED ASSETS IMPLIES THAT RATING AGENCIES IGNORED THE RISK OF THOSE ASSETS

MORE INFORMATION:

[1] Barth, M. E.; Ormazabal, G. & Taylor, D.J.: "Asset Securitizations and Credit Risk" *The Accounting Review*, vol. 87, No 2, March 2012, pages 423 - 448.