
The (Continuing) Problems with Credit Rating Agencies

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As I have maintained in the press since February, the key problem facing markets today is information. Structured finance products are inherently complex and difficult to value. Hence, the marketplace is inherently opaque. Without adequate information, investors will not invest in either primary or secondary markets. In primary markets, that reluctance results in decreased lending. In secondary markets, that reluctance results in a steep lemons discount, arising because investors *do not know* the value of assets but are otherwise *able* to transact (which is not the same as a liquidity crunch, where investors *know* the value of investments but are nonetheless *unable* to transact).

Information problems (and concomitant steep lemons discounts) are the root of most every financial crisis known to history. The simple dynamics are that investors know there has been a shock to underlying asset values, but do not know the incidence of that shock (investors do not know who is exposed to the shock). Since investors do not know the incidence of the shock, they cannot accurately target their divestment and therefore rationally decrease their exposure to the sector, as a whole. In the face of information problems, typical economic stimuli, i.e., the Fed funds rate, will have little effect. Hence, while the effect will not generally cause a recession, investors who doubt the credibility of asset values will be reluctant to contribute capital toward restoring economic growth, making any recession that *does* occur both longer and deeper than would otherwise be the case.

Resolving financial crises therefore requires some certification of asset values and/or their holdings. Consider the case of the Great Depression. Bank depositors did not respond to continued assistance programs nor assurances of bank solvency until the Federal government closed the entire banking sector and required banks to be certified by examiners before being allowed to reopen. Only then did depositors regain sufficient confidence to redeposit funds in the banking sector. Still, however, banks remained reluctant to lend through the rest of the decade, making a steep recession into a Great Depression.

Information problems have increased considerably since February. With the failures of New Century and other subprime mortgage lenders, residential mortgage-backed security (RMBS) investors began to learn that a mortgage was not just a mortgage any more. Mortgages differed considerably according to the amount of documentation, loan-to-value ratio, and size in addition to FICO score.

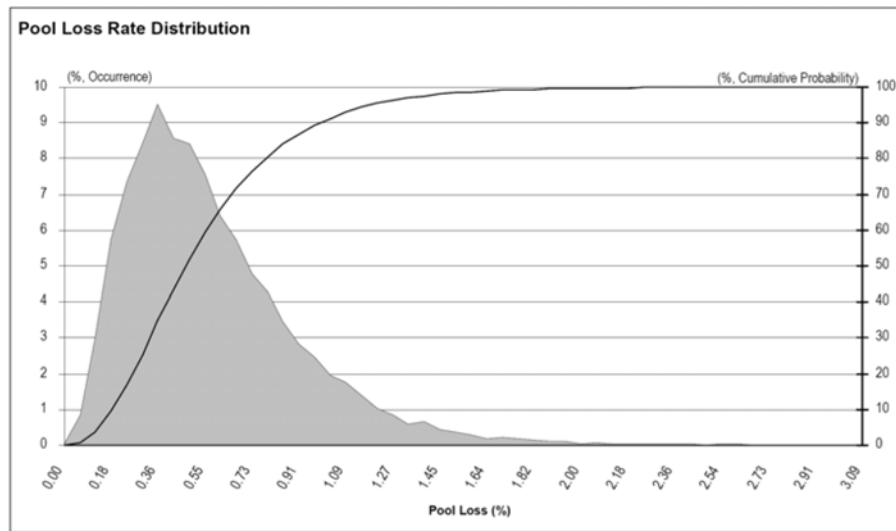
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Then investors learned about CDOs, the vehicles that resecuritized mortgage-backed security mezzanine and equity tranches. As with mortgages, CDOs differed significantly in their construction, containing as many as 80% and as little as 0% subprime mortgage mezzanine and equity exposures, sometimes within the same CDO over time (and, in the case of synthetic CDOs, sometimes the *same* replicated exposures). Investors then learned about asset-backed commercial paper and structured investment vehicles, the money market counterparts of RMBS. Along the way, the veracity of bond ratings has been called into question. Now investors are learning about how conflicts of interest among the ratings agencies and the bond insurers work to the detriment of municipal bond issuers (and local taxpayers) and to the advantage of bond insurers and CDOs (more on that below).

Yet regulators have done little to address the fundamental information problems that perpetuate the crisis. The Fed has done little over the summer beyond merely cut the Fed funds rate. The SEC remains reluctant to expand NRSRO membership or monitor ratings agencies. FASB remains on the sidelines, so far untouched by a crisis arising from the fictions of FAS140 and mark-to-model fallacies that are further encouraged by FAS156. Congress remains out of reach, as yet even considering revisions to RESPA and the mortgage interest tax deduction that started the subprime lending mess.

As a result, the problems remain as before, albeit of increased importance as we approach the first anniversary of the crisis with, as yet, no end in sight and no promise of meaningful reform.

Figure 1: Cumulative Losses in an RMBS Pool



ResiLogic: U.S. Residential Mortgage Loss Model Technical Document

Source: FitchIBCA, ResiLogic: U.S. Residential Mortgage Loss Model Technical Document, Jan. 18, 2007 at 11.

RATINGS ACTIONS ARE STILL LATE

If investors and regulators had the benefit of transparency, there would have been no crisis. Pressures began mounting in subprime mortgages well before 2007, although ratings agencies seem to have believed that those pressures would

abate. It has been said before (although many still deny the fact), *RMBS will not post subsequent recoveries that will restore investors.*

Figure 1 shows that RMBS cumulative losses increase at a decreasing rate. That is, they increase and then level off to horizontal as mortgages in the pool default and go into foreclosure early in the loan histories and then do not default as much later on.

The important point is that since there is no turning back, RMBS must be rerated and downgraded *as early as reasonably possible*. Ratings agencies have claimed over the summer that the initial rating of a security is based on prospective behavior, while rerating is based on actual (retrospective) behavior.

The direct result of “driving using the rear-view mirror,” is that investors are still trying to catch up with losses that are already in the pools. Since RMBS performance will not recover re-rating only “after-the-fact” hurts investors and merely fuels speculation about further losses.

Going forward, however, despite all the current rerating activity there is still no clear systematic surveillance/review/rerating program or methodology provided by the industry to avoid repeating past mistakes. Investors realize that is not acceptable and therefore shun structured finance investments.

RATINGS STILL MEAN DIFFERENT THINGS FOR DIFFERENT PRODUCTS

All major NRSROs have allowed their ratings to reflect different economic magnitudes of risk for different financial products. As I wrote in my Congressional Testimony, “Although there is evidence that Moody’s and S&P remain relatively conservative when rating structured products, it is clear that even Moody’s has allowed its ratings scale for securitized products to become inflated. Bloomberg Markets reported in July that: “Corporate bonds rated Baa, the lowest Moody’s investment grade rating, had an average 2.2 per cent default rate over five-year periods from 1983 to 2005, according to Moody’s. From 1993 to 2005, CDOs with the same Baa grade suffered five-year default rates of 24 per cent, Moody’s found.” In other words, long before the current crisis, Moody’s was aware that its Baa CDO securities were 10 times as risky as its Baa corporate bonds.”

But the problem is even worse than that, because Bloomberg did not compare to the least risky alternative, just the benchmark corporate. That same global scale, indicates that municipal bonds have a five-year Baa default rate of 0.097%, or about *1/250th* that of CDOs.

Furthermore, according to Moody’s 2007 study on the differences between the ratings scales, a state general obligation bond rated A1 by Moody’s is really equivalent to a Aaa-rated investment on Moody’s “Global Scale.” Municipal bond insurance for an A1 state general obligation bond therefore merely translates the A1 municipal rating to the Aaa corporate (global) rating *without any reduction in risk*. It is no wonder, therefore, that municipalities facing decreased tax revenues in the face of the credit crunch are asking whether bond insurance is really necessary in today’s credit markets.

Given the different and shifting meanings of Baa and other ratings as measures of risk, and given the high rate of financial innovation and the lack of transparency inherent in structured finance deals, it is not surprising that investors underestimated risks so badly leading up to the recent crisis. But

without information moving forward, investors will, again, continue to shun the structured finance sector.

CONFLICTS OF INTEREST IN THE ISSUER-PAYS SYSTEM ARE STILL UNRESOLVED

At the heart of the difficulties described above (particularly with respect to wide differences in the degree of economic risk attached to various ratings) are the conflicts of interest inherent in an issuer-pays ratings industry whose products are protected as opinions under the First Amendment.

Ratings agencies claim that the issuer-pays model has been adequately insulated from inherent conflicts of interest. But more than a year after the 2006 Credit Improvement Act and roughly nine months of industry distress and numerous Congressional hearings no investor-based rating agencies (where buyers pay for ratings) have been accorded NRSRO status. The fact is, despite existing NRSRO claims to the contrary, it is *impossible* to tell whether investors will favor the investor-pays model until such agencies can compete on a level playing field with existing NRSROs.

Furthermore, notwithstanding who pays credit ratings are still considered opinions protected as free speech under the First Amendment. Those “opinions,” however, carry substantial regulatory weight, being the primary basis for fiduciary consideration under numerous statutes and regulations. Ratings agencies, therefore, have effectively sold regulatory judgments to the highest bidder.

The regulatory use of ratings has changed the constituency demanding a rating from free-market investors interested in a conservative opinion to regulated investors looking for an inflated one. Unlike typical market actors, ratings agencies are more likely to be insulated from the standard market penalty for being wrong - the loss of business. Issuers *must* have ratings, even if investors do not find them accurate. Bad ratings – and hence many of the information problems that spawned the current crisis – will therefore not go away without regulatory intervention, preferably before the crisis unnecessarily worsens further.