What Role Did Credit Rating Agencies Play in the Credit Crisis?

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This section addresses the role that credit rating agencies (CRAs) played in the credit crisis. Part A addresses the basics of the CRAs, providing a general overview of the history, policies, influence, and regulation of CRAs. For those already familiar with CRAs, Part B details their specific role in the financial crisis. Part C then outlines the major criticisms of the CRAs.

A. Credit Rating Agencies Rate Instruments and Entities to Provide Predictability to Investors

Credit rating agencies are private companies that evaluate large debtors and the financial instruments those debtors issue. Two U.S. firms dominate the CRA market: Standard and Poor’s (S&P) and Moody’s Corp. Fitch Ratings, a British Firm, is the third-most prominent. Together, these three firms hold 95 percent of the ratings market. In addition to the three big firms, approximately 100 other CRAs specialize in rating various instruments, industries or national markets.

The CRAs rate creditworthiness, which is a measure of the ability and willingness of a debtor to pay a debt. A credit rating is not a measure of the value or profitability of a financial instrument or of the debtor; it is not the same as a buy, sell, or hold recommendation from an investment analyst. Credit ratings are useful because they serve as a widely accepted, standardized scale of creditworthiness across industries, financial instruments, countries, and even time. CRAs are considered gatekeepers, because they issue ratings that help determine whether a company is worth lending to, and at what cost.

Each CRA has its own rating scale. Moody’s and S&P use the two principal scales. Moody’s highest rating is AAA, and anything between AAA and Baa3 is “investment grade.”
S&P and Fitch share a scale, with AAA being the highest rating. Ratings between AAA and BBB are “investment grade.” Ratings below these levels are considered “speculative,” a label that denotes a risky investment. The less risk a CRA perceives in an entity or the issuing debtor, the higher the rating. Therefore, when comparing financial instruments promising the same yields, investors are more willing to invest in the higher-rated instrument. Certain institutional investors, such as pension funds, are only permitted by law to invest in “investment grade” instruments. A low-rated entity must provide investors with additional incentives, such as higher interest rates, to convince them to invest. In this way, ratings directly affect the cost of raising capital. For example, in 2004, S&P data showed that if an entity advanced from a category BBB to a category BB, its borrowing costs were reduced by almost 50 percent.

While each CRA has its own unique rating procedures, the general process is similar across most CRAs. A credit rating is based on both quantitative and qualitative values. Quantitative data may include (1) data from the issuer about its financial position, especially data on cash flow relative to debt obligations, (2) data the agency gathers on the industry, competitors, and the overall economy, and (3) legal advice relating to an issuance. Qualitative data may include (1) data from the issuer about management, policy, business outlook, and accounting practices, and (2) data gathered by the agency relating to competitive position, quality of management, long-term industry prospects, and economic environment. A rating is typically reached by a team of raters under the direction of a lead analyst. A debtor or financial instrument to be rated is assigned to the analyst team that specializes in that debtor or instrument’s industry. Analysts begin by collecting information on the entity they are rating. This usually involves meeting with the debtor’s management at the debtor’s place of business. Once both quantitative and qualitative data is collected, the analysts evaluate the data and decide how
much weight to give to each factor in the analysis. The analysts present their weighting proposals to the overall rating committee, which then decides what rating the debtor or the financial instrument will receive. Before publishing the rating, the CRA informs the debtor of the rating and the reasons behind the rating. If the debtor disagrees with the proposed rating, it may attempt to provide further information to adjust the rating; however, such adjustments are rarely made. The vast majority of ratings are made available to the public free of charge on the CRAs’ homepages. However, some ratings are only published if the debtor consents.

If a rating is a “point in time rating,” the CRA’s involvement in the rated entity terminates once it publishes the rating. For most ratings, however, the CRA continues to monitor the issuer and/or its securities on an ongoing, less intensive level and continues to periodically meet with the issuer’s senior management. If the rating is subject to monitoring after it is published, a rating surveillance team reviews and revises the rating if and when it is necessary. Rating reviews occur at least once a year.

1. "Ratings Crises" Have Challenged the Influence of CRAs

CRA expertise in creditworthiness has become more valuable as the financial market has grown in complexity with new actors and new instruments. Years ago, financing was done mostly through commercial banks. For example, a customer would go to a bank to obtain a home loan, and a banker would sit down with the customer to determine his or her creditworthiness. If a bank decided that the customer was creditworthy, the bank would issue the mortgage. This is no longer the case. Today, most mortgages do not stay with the bank, but are sold to an issuer and pooled with other debt obligations in complex financial instruments to be sold to investors. The ultimate holders of the mortgage never have the chance to meet the debtor to determine his or her creditworthiness. Furthermore, these instruments are generally very complex and contain
bits and pieces of many loans. Most individual investors have neither the time nor the ability to investigate the creditworthiness of the loans in these instruments.

Such complex conditions create uncertainty, and uncertainty is risky. Investors tend to be adverse to risk and expect to be compensated, usually in the form of higher returns on their investment, for taking on perceived risk. This is where CRAs offer their services. The CRAs evaluate the creditworthiness of the financial instruments and issue a credit rating that is published for public use. In this way, credit ratings improve market efficiency. Instead of thousands of investors performing repetitive analysis on the same instruments, the CRAs perform the job once and provide information to the investors for no charge. It is no surprise, then, that investors rely heavily on the services of CRAs, which makes CRAs a central, imbedded feature of the financial markets.

The demand for, and therefore influence of, CRAs has traditionally been very strong in the United States, where CRAs first emerged to inform East Coast investors of opportunities in the “Wild West.” Since that time, CRA influence over investors in the United States has only grown. Investors and officials in other countries have been slower to accept CRA practices stemming from the United States. European countries, for example, have traditionally emphasized bank-oriented financing, which reduced the need for intermediaries like CRAs. Real demand for CRA services did not surface in Europe until the late 1980s. Yet CRA influence has been growing in Europe and the rest of the world since that time, especially with the increased internationalization of finance. Credit ratings standardize data from borrowers around the world to allow investors to compare the risk of investments in different countries on the same rating scale.
CRAs have gained further influence over the financial markets through governmental regulations that mandate the use of ratings and through private contract rating requirements. Governmental regulations increase reliance on ratings by, among other things, setting a permissible minimum rating for certain investments. In the United States, as of September 2008, at least forty-four regulations of the Securities and Exchange Commission (SEC) incorporate the use of ratings. For example, the SEC limits money market funds to investments in the top two ratings categories. Other countries, including Canada, Belgium, and Poland, require certain investors to obtain prior approval before purchasing certain low-rated instruments, and ban other investors from investing in low-rated investments at all. In Italy, securities must be rated before they can be offered to non-commercial investors.

The New Basel Capital Accord, or Basel II, which was introduced in 2004, further solidifies the role of CRAs in the financial markets. The Basel II framework has been or will likely be adopted by a majority of the world’s countries. The first of the three Basel II pillars is the most relevant to CRAs as it sets minimum capital requirements for credit, market, and operational risks. To calculate these risks, Basel II allows two approaches: the “standardized approach” and the “internal ratings based approach” (IRB). The standardized approach uses external ratings from “external credit assessment institutions,” which include CRAs. The IRB uses banks’ own internal ratings. If a financial institution elects to use the standardized approach, Basel II allows the institution to rely on CRA ratings instead of assessing risks itself. Some large banks will elect the IRB option, but the vast majority of small- and medium-sized financial institutions are expected to adopt the simpler standardized approach, especially in less-developed countries.
Private contracts also often involve credit rating clauses for a variety of purposes. The most common use of “ratings triggers” is to accelerate repayment of an outstanding loan or require the debtor to post additional collateral if its credit rating falls below a certain level. Debtors subject to “ratings triggers” are careful to meet CRA expectations regarding capital ratios, financial performance, etc. to avoid potentially disastrous downgrades.

In the past, “ratings crises” have challenged the influence of CRAs. A ratings crisis stems from a general lack of confidence in the CRAs and their ratings. The Enron collapse in 2001 shook investor and regulator confidence in CRAs. The CRAs failed to downgrade Enron from investment grade through the latter half of 2001, even though Enron’s credit and ability to pay its debts drastically deteriorated during that time. When the CRAs finally downgraded Enron, the firm was already in dire straits. The downgrade destroyed what remained of Enron’s stock, and Enron filed for bankruptcy only four days later. Similarly, when Parmalat Group collapsed, many criticized the CRAs for failing to revoke the Group’s investment-grade status until it was far too late. Also, many blamed the CRAs for overlooking red flags before the Mexican peso crisis in the mid-1990s and the Asian financial crisis in the late 1990s. After each of these crises, confidence in CRA ratings was shaken and calls for CRA reform and increased regulation were common. However, as investors calmed, the influence of the CRAs returned, and little changed in the way of legislation and regulation.

2. The Oversight System Limits the Number of CRAs and Allows for Self-Regulation

The CRAs are not affiliated with any government and are subject to very little regulatory oversight by government agencies. In most countries, including the United States, the minimal CRA legislation that exists is designed to foster CRA competition and transparency. The theory behind this type of legislation is that the market will function best if investors are informed and able to choose between CRAs. One example of legislation designed to foster CRA competition is
the U.S. Credit Rating Agency Reform Act of 2006, which empowered the SEC to oversee CRA practices. Despite SEC oversight, the CRAs are still exempted from most SEC disclosure rules, are not required to disclose confidential information that issuers provide the CRAs during the ratings process, and are exempt from most provisions of the Securities Act, which prohibits fraud in connection with the issuance of securities.

The most common form of CRA regulation involves registration of existing CRAs. In the United States, the SEC recognizes CRAs through its “nationally recognized statistical rating organization” (NRSRO) designation. As CRA ratings have grown more influential outside the United States, other countries have adopted CRA designations. However, a designation is very different from a license to operate. A CRA may operate without NRSRO or any other formal recognition status. Currently no country requires formal governmental recognition for a CRA to produce credit ratings.

The United States is typical in its designation practices. Since 1975, the SEC’s NRSRO designation of a CRA has allowed U.S. banks to rely on that CRA’s ratings for purposes of compliance with certain banking rules. These regulations have led to some problems, including possible overreliance by investors on the NRSROs. As SEC chairman Christopher Cox explained, the agency's reference to ratings in its rules “may be contributing to an uncritical reliance on credit ratings as a substitute for independent evaluation.”

Until the passage of the Credit Rating Agency Reform Act of 2006 ("the 2006 Act"), the NRSRO requirements were “vague” and “arbitrary.” There was no formal application process for NRSRO status and the process was criticized as anticompetitive: prior to the 2006 Act, only five CRAs had qualified for NRSRO status. The NRSRO designation served as a major barrier to new CRAs. The 2006 Act made it easier for competing agencies to gain NRSRO status, but the
Act did not change the underlying CRA model. Those supporting the 2006 Act believed that a greater number of CRAs might improve accountability, affordability, innovation and the overall quality of ratings.

The 2006 Act requires a CRA that registers as an NRSRO to disclose important information such as ratings performance, conflicts of interest, and the procedures used in determining ratings. The 2006 Act mandates that the SEC grant NRSRO registration to any CRA that applies and has been in the rating business at least three consecutive years before submitting its NRSRO application, unless the SEC finds that “the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the [SEC prescribed] procedures and methodologies.” Currently, nine CRAs carry the NRSRO status.

The CRAs advocate for greater self-regulation based on a code of ethics. They argue that self-regulation is the best way to keep CRAs unbiased and flexible in the face of changing markets. The International Organization of Securities Commissions (IOSCO) has been active in promoting CRA self-regulation. In 2004, the IOSCO Technical Committee released its Code of Conduct Fundamentals for Credit Rating Agencies, which stressed the need to improve transparency and protect against conflicts of interest. Most of the CRAs have since voluntarily adopted codes based on these IOSCO provisions. Critics of self-regulation argue that CRA self-regulation has clearly failed, given past and current financial crises. Reformers suggest that self-regulating CRAs have been lacking in quality, reliability and independence, and therefore greater governmental regulatory action is necessary. EU internal market commissioner Charlie McCreevy called the code of conduct adopted by the CRAs a “toothless wonder,” because a CRA that fails to follow the code of conduct faces no significant negative consequences. EU
Ministers suggested that CRA self-regulation through codes of conduct is no substitute for EU-wide registration and a “strengthened oversight regime” to improve disclosure, help prevent conflicts of interest, and reduce investor overreliance on ratings.

**B. CRAs Were Implicated in the Recent Credit Crisis Due to the Influence of Their Ratings of MBSs, CDOs, and Financial Institutions**

The volume of requests for rating structured finance products such as mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) increased drastically between 2004 and 2006, as did the complexity of the rated products. In hindsight, it appears that the structured finance hype caused the CRAs to lose their grip on reality. Lehman Brothers had an A rating only a month before its collapse. Worst of all, the CRAs rated thousands of derivative securities backed by subprime mortgages as AAA. Not only did the CRAs fail to react to changing market conditions in time, but they played a central role in creating those market conditions. The CRAs were criticized for worsening the credit crisis by overvaluing complex mortgage-backed instruments, by underestimating the complexity of those instruments, and by being slow to downgrade them when their creditworthiness worsened. In addition to the CRAs’ faulty understanding of the mortgage-backed instruments and their overoptimistic view of the housing market, the CRA weaknesses explained in Section III—conflicts of interest, lack of transparency, and lack of competition among rating agencies—contributed to the overvaluation of many mortgage-backed instruments prior to the credit crisis.

In a U.S. House Committee on Oversight and Government Reform investigation, committee chairman Henry Waxman said his investigators uncovered documents showing that CRA executives knew the subprime market was weak before it collapsed, yet failed to reflect this knowledge in their ratings. These documents included an email from a Moody’s employee who wrote that some MBS ratings made it appear that Moody’s was either “incompetent at credit
analysis” or that raters “sold [their] soul to the devil for revenue.” An email from an S&P employee read, “Let’s hope we are all wealthy and retired by the time this house of cards falters.” Finally, many market participants placed too much reliance on ratings and failed to perform their own due diligence to determine the strength of the new instruments. Perhaps investors would have discovered sooner the fragility of some of the overrated instruments and issuers had fewer investors blindly relied on the CRA ratings. This Part outlines the role of CRAs in securitization and how that role helped lead to the global financial crisis, how the CRAs reacted to the subsequent meltdown, and how investor overreliance on ratings furthered market failures.

1. CRAs Rated MBSs and CDOs Highly Despite Limited Information, Building Investor Confidence in the Instruments Prior to the Crisis

A central problem leading up to the global financial crisis was that CRAs rated billions of dollars of structured finance instruments too highly. Structured finance is a financing technique where financial institutions pool numerous obligations together and sell the interests in the pool to investors. The structured finance instruments at the heart of the current credit crisis are mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs). These instruments are more complex than most of the traditional bonds and securities that CRAs have been rating for more than 100 years. CRAs have been criticized for not fully understanding the risks and complexity of the MBSs and CDOs that they rated.

The CRAs had a central role in the development of these complex instruments. Lenders wanted to sell risky subprime mortgages that they had originated to remove the assets from their balance sheets and free up capital for new loans. In this way, the lenders could avoid the risk of holding the mortgage and also collect more loan fees from the new loans. This is where the MBS became useful. The MBS could turn low-rated securities, such as subprime mortgages, into
AAA-rated securities. Recall that regulations and internal criteria prevent many institutional investors, such as money market funds, from holding low-rated securities. The “magical” transformation of subprime mortgages from junk to AAA allowed these regulated investors to enter the subprime mortgage market, which was very profitable at that time.

Governmental, quasi-governmental, or private entities create MBAs by purchasing mortgage loans from banks, mortgage companies, and other originators and then assembling the mortgages into pools, called “collateral pools.” Fannie Mae and Freddie Mac, which are U.S. government-sponsored entities, and banks issued most MBSs. The top bank issuers in 2007 were Countrywide, J.P. Morgan, GMAC, Lehman Bros., and Citigroup. MBS issuers incorporate the mortgages into a special-purpose vehicle (SPV), which is a corporation with no people or assets aside from the mortgages it holds. The mortgages in the SPV are combined and re-divided into several senior/junior component parts, or “tranches.” A conventional MBS uses a three-tier design with junior, mezzanine, and senior tranches. Each tranche then issues tradable, interest-bearing securities that are sold to capital market investors.

The purpose of tranching is to create at least one class of assets with a higher credit rating than the average rating of an MBS’s underlying asset pool. CRAs rate each tranche based on the creditworthiness of the loans in that tranche and the tranche’s enhancements, such as prioritization and any insurance on payments. Tranches get higher credit ratings primarily by having a higher priority: issuers guarantee “senior” tranches will be paid before “junior” or “mezzanine” tranches. Senior tranches receive high ratings while junior tranches have low credit ratings. The equity tranche, the most junior tranche, is paid last and normally constitutes around 2 percent of the MBS. The senior tranches typically make up 80 percent of the MBS and, until the housing market collapsed, normally carried AAA ratings. Low-risk investors prefer senior
tranches, the mezzanine level appeals to investors seeking a bit more return in exchange for a riskier security, and the equity tranches are intended for investors such as hedge funds looking for high returns despite the risks involved.

CRAs advised MBS issuers on how to structure and prioritize the tranches of an MBS. The goal was to help issuers squeeze the maximum profit from an MBS by maximizing the size of its highest rated tranches. The mezzanine tranches, however, presented a problem—they made up a significant portion of MBSs, but were too risky for most institutional investors. Around 2003, the CDO came to the “rescue” to solve this problem and generate still more business for the thriving CRAs.

A CDO is even farther removed than an MBS from the original mortgages it holds. Rather than buying mortgages, like MBSs do, the SPVs that issue CDOs buys MBSs. Many MBS mezzanine tranches were incorporated into CDO collateral pools along with other types of assets. Like mutual funds, CDOs buy and sell mortgage bonds throughout their existence. Therefore the collateral pool of a single CDO can constantly change. CDOs are also divided into senior, mezzanine, and junior tranches. Before the crisis struck, CRAs rated the vast majority of CDOs as AAA, despite being backed by some of the riskiest pieces of the MBSs. Again, the key was prioritizing and insuring the CDO tranches. Also, as with the MBSs, the CRAs worked closely with CDO issuers to help them obtain the highest ratings for the largest percentage of CDOs possible. CDOs are issued primarily by large banks. Top CDO issuers in 2007 were Merrill Lynch, Citibank, and UBS. The CDO market grew at an incredible pace: from $150 billion in 2000 to $1.2 trillion in 2007. CDOs got so popular that issuers even created CDOs containing tranches of other CDOs (called “CDOs-squared”) and CDOs of CDOs of CDOs (called “CDOs-cubed”)! 
Many investors did not fully understand these MBSs and CDOs, and CRAs played a central role in building investor confidence in these instruments. Because these instruments were able to incorporate subprime mortgages, which carried higher interest rates than standard mortgages, they were able to promise higher returns to investors. Never mind that a significant percentage of the mortgages would default—the mortgages were backed by houses in a market where housing values always seemed to go up, and at the time the land backing a mortgage was usually worth more than the mortgage. That is why most tranches in a typical MBS or CDO were rated AAA. These MBSs and CDOs promised higher returns than many traditional financial instruments, and many were rated as highly as the traditional instruments. Investors were hooked.

In reality, the CRAs did not look at the individual creditworthiness of the mortgagors. In the words of one veteran Moody’s analyst, credit analysts are not “loan officers,” but rather statisticians. The CRAs usually did not even have access to individual loan files. The CRAs rated the creditworthiness of these instruments by referring to statistics based on historical data showing how many people with shared characteristics, such as income and geography, typically pay their mortgages. The situation for CDOs was worse—CDOs were rated by CRAs that had no idea what MBSs or other securities the CDO pool would purchase.

2. When the Housing Market Collapsed, CRAs Quickly and Drastically Downgraded MBSs and CDOs

It is clear that CRAs held an overoptimistic view of the housing market and the default rates for subprime mortgages. They failed to consider the real consequences and probability of a major housing market downturn. While one house might be able to be sold to redeem its mortgage, the market will not allow one million houses to be sold to redeem all their mortgages. As one Moody’s executive explained, “Fitch and S&P went nuts. Everything was investment
grade . . . The machine just kept going.” S&P executives later admitted that many of the assumptions underlying mortgage-related ratings from 2005 to 2007 were erroneous. Even as the subprime market began to unravel in the United States during 2007, many of the MBSs continued to receive or maintain AAA ratings. As the housing market worsened and many mortgages went into default, investors questioned the validity of the AAA ratings. In April 2007, S&P announced that it was adjusting the method of rating subprime mortgages and the instruments incorporating them. They admitted that the previous model, which was introduced in 2002, did not fit the current housing market. This confirmed investor concerns that CRAs had failed to consider the possibility of a housing market downturn and its effects on subprime mortgages.

CDOs held many more subprime mortgages than MBSs did, and when the U.S. subprime mortgage market collapsed, CDOs were hit harder than the MBSs. However, CRAs had rated MBSs and CDOs similarly up to that point, which caused investors to view MBSs with nearly as much suspicion as CDOs. This general suspicion caused investors to flee from CDOs and MBSs alike, which caused the value of both instruments to drop and worsened the credit crisis. Investors suddenly viewed all real-estate backed instruments as toxic and refused to continue purchasing those instruments. Lenders were unexpectedly stuck with billions of dollars in mortgage-related assets on their books—assets they had expected to sell. The value of these assets was deteriorating and lenders stuck with these assets found themselves with too little capital to continue lending.

As the housing market worsened and foreclosures increased during the summer and fall of 2007, the CRAs downgraded billions of dollars of MBSs and CDOs. Many formerly AAA-rated securities were downgraded five levels to a speculative grade, otherwise known as “junk.”
In the third quarter of 2007, CRAs downgraded $85 billion in mortgage securities. In the fourth quarter alone, $237 billion in MBSs were downgraded. In the first quarter of 2008, an additional $739 billion in MBSs were downgraded, and $841 billion were downgraded in the second quarter of 2008. That amounts to nearly $2 trillion in downgrades in those four quarters alone. Insurers of MBSs and CDOs found themselves with insufficient capital to meet all the claims from the failing instruments. Many MBS and CDO holders found their once valuable assets to be worthless.

The largest holders of CDOs and MBSs bore the brunt of the initial blow. As of mid-2008, foreign investors held 20 percent of the MBSs, while Fannie Mae and Freddie Mac held 16 percent, and commercial banks held 16 percent. Key CDO investors included banks, insurance companies, pension funds, and hedge funds. Downgrades caused major problems for banks holding CDOs and MBSs because their capital ratios were adversely affected. If the banks failed to improve their capital ratios, the CRAs threatened the banks themselves with rating downgrades. The collapse of the investment bank Lehman Brothers is a drastic example. Lehman Brothers was looking for a buyer in September 2008 and it had a lot at stake. Given the massive amounts of CDOs and MBSs in Lehman Brothers' portfolio, the CRAs said they would be forced to cut the bank’s ratings if it failed to find a buyer. A ratings downgrade would have made it almost impossible for Lehman Brothers to raise enough capital to stay afloat. Only days after the CRA ultimatum, Lehman Brothers filed for bankruptcy due to its inability to raise capital or find a buyer. Banks were not the only institutions affected by ratings downgrades. The liquidity crisis of AIG, a major American insurance firm, was intensified by a string of ratings downgrades in mid-September. The U.S. government stepped in to rescue the ailing firm soon afterward. One of the primary reasons AIG and other insurance companies were downgraded was due to their
holdings in derivatives that the CRAs had once rated as safe investments. The National Association of Insurance Commissioners (NAIC) criticized the CRAs for their role in downgrading insurance companies for holding investments that the same CRAs once rated as safe to own.

Many of the recent major downgrades on financial institutions and securities were drastic. Rather than slowly decreasing a rating as the markets changed, CRAs deeply and suddenly downgraded the ratings, which caused panic among investors. There was little or no communication from the CRAs leading up to a downgrade, which increased investor uncertainty as to which entities or investments would be downgraded next. It has been suggested that if CRAs had better monitored these investments and entities, such drastic, sudden downgrades would not have been necessary. Fewer drastic downgrades may have provided investors with more time to adjust their investment strategies and avoided the panic caused by a sudden steep downgrade.

In light of all the drastic downgrades the confidence of most market participants, both in the United States and abroad, quickly waned. Private investors and institutions holding CDOs criticized the fact that CRAs gave AAA status to many CDOs that, in hindsight, were clearly backed by risky securities. Institutions holding these instruments that CRAs had once rated as safe suddenly were punished by downgrades themselves as they found it impossible to rid themselves of the toxic assets. In general, investors argued that the AAA-rated CDOs made a “mockery” of the AAA rating, which left all investors questioning even the safest of AAA investments and caused investors to flee from anything rated less than AAA. The failure of AAA-rated instruments was a major shock given the traditional reliability of the rating: between 1970 and the current crisis, Moody’s had never downgraded an AAA-rated corporate bond to
lower than A. Suddenly, an AAA-rated instrument had become susceptible to failure. This loss of faith in ratings played a large role in freezing the financial markets.

3. Investors Relied Too Heavily on Ratings, Rather Than Performing Due Diligence

The CRAs should not be forced to shoulder all the blame for the current ratings crisis. Even though CRA ratings are not intended to be used as buy, sell, or hold recommendations, many investors use them as such. These investors failed to adequately perform their own due diligence and often did not look beyond the rating. Many investors did not even read the rating rationale and disclosure documents that the CRAs publish for each rating. Instead, they relied exclusively on the published rating and on the ongoing market excitement surrounding MBSs and CDOs.

Furthermore, many investors treated credit ratings as an absolute truth. These investors treated rating agencies as having unlimited access to corporate information in calculating the company’s credit rating, much like an auditor would. However, in rating an MBS, for example, a CRA does not see individual loan files or information identifying borrowers or specific properties. The CRA only receives a list of credit characteristics provided by the banks issuing the original mortgages or the investment bank issuing the MBS. If a CRA receives incomplete or inaccurate information about the entity it is rating, the rating will also be incomplete and inaccurate. A rating is only as accurate as the information that goes into its calculation.

C. CRAs Have Been Criticized for Conflicts of Interest, the Dominance of the Industry by U.S. Firms, and a Lack of Transparency

As explained earlier, this was not the first ratings crisis. However, it may be the broadest in scope. Since the downturn, many, including the SEC and other U.S. government agencies, have criticized CRA practices. In August 2007, the SEC conducted an intensive investigation of the practices and performance of the top three CRAs. The SEC issued its findings in July 2008.
The SEC found that there was a substantial increase in the number and in the complexity of MBS and CDO deals since 2002, and that some of the rating agencies appear to have struggled with this growth. This Part outlines the major criticisms of CRA practices, including conflicts of interest, U.S. firms’ domination of the industry, and a lack of transparency.

A major criticism of the CRAs is that they face irreconcilable conflicts of interest given the close relationship many CRAs have with the banks issuing the securities that the CRAs rate. Principally, most ratings are solicited and paid for by the entity being rated: the issuer. In the early days of CRAs, issuers did not pay for the ratings. When a rating is unsolicited, it is easy to see that the CRA’s final customers are members of the public. However, when a rating is solicited, it is less clear whether the CRAs ultimately serve the investing public or the rated, paying entity. Large CRAs receive most of their revenue from fees paid by issuers, and issuer-paid ratings represent 98 percent of ratings produced. After an instrument is rated, the issuer can decide whether or not that rating will be published, or “issued,” and CRAs are only paid if the rating is in fact issued. Issuers are not afraid to engage in “ratings shopping.” For example, an investment bank that receives a better rating from one CRA than another will likely return to the higher-rating CRA the next time it issues a similar instrument. The main concern surrounds frequent issuers, whose fees make up a significant portion of CRA’s profits. A few financial institutions conduct most CDO and MBS deals. Therefore, a CRA will be tempted to provide banks with high ratings in hopes that the “client” will return with more rating business. One senior executive at Moody’s warned the Moody’s board of directors that issuers of MBSs awarded business to the CRAs that produced inflated ratings.

Additionally, CRAs have begun providing advice for a fee to companies looking to improve their ratings. This creates additional conflicts of interest. For example, if a company
follows the CRA’s advice, the CRA may be tempted to issue the company a higher rating. Such practices would make CRA advice very valuable to companies looking to improve their ratings. CRAs attempt to avoid this conflict of interest by rating in teams and by separating their rating divisions from their advising divisions. The 2007 SEC study found “serious shortcomings” regarding CRAs’ attempts to manage both these types of conflicts of interest.

An additional concern is that the U.S. firms’ dominance of the CRA market forces rated businesses and governments worldwide to conform to U.S. business ideals in order to achieve high ratings. U.S. CRAs argue that their evaluation approaches are free from influences based on the location and legal system of the rated entity. However, some governments, such as Germany and Japan, are concerned that CRAs based in the United States make high ratings contingent upon the rated entities’ willingness to incorporate U.S. ideas of best business practices. These countries have governmental regulations designed to limit the power of U.S.-based CRAs within their countries and to foster their own national CRAs.

Another concern is lack of transparency. CRAs provide information on their rating methodologies, and the press release that accompanies a rating typically lists the key assumptions upon which a rating is based. However, many specifics, such as the qualitative analysis that goes into the ratings, go largely unreported. Critics also argue that CRAs do not adequately disclose the level at which they are monitoring an existing rating, nor when, whether, and why they consider altering that rating. These critics suggest that if more information is available about the inputs, analysis, and monitoring of each rating, market participants will be able to make more informed decisions regarding the rated instrument or entity. The 2008 SEC report confirmed that the CRAs do not always disclose significant aspects of the ratings process,
and in particular that policies and procedures for rating MBSs and CDOs could be better documented.

**D. The Credit Crisis Shattered Confidence in the CRAs, Which Will Need to Prove Their Utility to Investors If They Are to Hold Continued Influence Post-Crisis**

The CRAs were overly optimistic—they failed to consider the consequences of a housing market downturn and consequently overrated of billions of dollars in MBSs and CDOs. When the market took a turn for the worse, institutions and private investors holding those highly-rated instruments found the value of their portfolios drastically reduced when the CRAs, realizing their mistake, rapidly downgraded MBSs and CDOs. Institutions holding a large amount of such instruments then faced downgrades themselves, because their portfolios were suddenly worth a fraction of their previous value. The financial markets froze when investors fled from the drastically-downgraded MBSs and CDOs and the institutions holding them.

The success and influence of a CRA depends on its reputation. A CRA’s only product is information, and therefore investors must perceive that information as timely, unbiased, and accurate. The ongoing crisis has proven that ratings can be inaccurate, untimely, and affected by CRA conflicts of interest. Many market participants no longer trust the ratings that CRAs produce, which has led to another Enron-style ratings crisis. Regulators have already begun to react to this ratings crisis by enacting reforms—for example, the SEC recently instituted new rules increasing CRA disclosure requirements, prohibiting CRAs from rating debt they helped structure and barring analysts from accepting gifts or entertainment exceeding $25 in value from issuers of the debt they rate. In 2009, the European Union enacted its own CRA legislation that provides for EU-level registration and regulation of CRAs operating in the EU. While the CRAs will likely survive the current ratings crisis intact, they may have to prove their utility again before investors will trust them as gatekeepers once more.
Sources

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