
FROM THE EDITORS



David Smick

Disenfranchise The Ratings Agencies

The House Oversight Committee's hearing on the role of credit ratings agencies lived up to its billing. Great examples of fraud by well-aware participants were brought into evidence by both accusatory witnesses and self-confessing emails. The ratings agencies had sold out to their investment bank clients, giving AAA ratings on securities they did not want to understand for streams of fee-based business. People who trusted the ratings agencies when buying securities were let down. Expressing outrage about the perfidy of intentional over-ratings, however, really misses the point for regulatory reform going forward.

The real issue with ratings agencies is that, even when they are uncorrupted, reliance on them is harmful to the stability of our financial system. Without regulatory encouragement of that reliance, they have no real market for their wares. Even with that regulatory enfranchisement in our markets, they serve no useful purpose except inherently to mislead investors. And that's with the best of intentions. When subjected to the slightest temptation, their incentives lead the ratings agencies to exploit both those rated by them and those who buy rated securities.

Ratings agencies claim that what they assess is default risk, pure and simple, on a comparable and comprehensible scale. Yet, just about every single part of that description is incorrect. Default risk is never pure and simple except for the most vanilla of repeatedly reproduced securities—in which case, economic fundamentals are all it takes to assess the risk, with the ratings adding no value (as a host of economic studies have demonstrated). If the securities to be rated are more complicated, less frequently replicated, and

therefore without clearly comparable securities on which to form a track record, the judgment behind the rating should be worth more. Instead, the ratings are worth less because they fail to capture the variation of the risk over time. They also fail to be comprehensible, because what is AAA for a municipal bond is different from what that means for an emerging market subordinated debt contract which is different in turn from a CDO.

Usually, when this is pointed out, the agencies will insist that is because the purchaser (or observer) is asking about more than default risk, which is unfair to the ratings. The agencies, however, are left with two unappealing alternatives if that is the case. Either default risk is actually unimportant, since ratings were wrongly high ahead of the Latin debt crisis of the early 1980s, the U.S. savings and loan crisis of the 1980s and 1990s, the Mexican crisis of 1994–95, the Asian financial crisis of 1997–98, the IT bubble of 1998–2001, or the current financial crisis, and so the ratings are useless. Or default risk interacts with changing

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economic circumstances and particularly liquidity concerns in a complex dynamic manner, rendering the simple ratings useless.

So why don't investors just ignore these useless letters? Because even those who figure this out are not allowed

to. Ratings are entrenched in large parts of our banking and broader financial system in lieu of supervisory or investor judgment, especially under the Basel II accord. Certain funds are only allowed to invest in "AAA" securities, for example, or lenders are required to charge more once a rating is downgraded.

Thus, in addition to being useless, whenever ratings are clearly behind the curve of financial developments, the catch-up downgrades become accelerators of problems. They make perhaps viable firms (or governments) suddenly pay more for credit at the same time they are under attack or suspicion. Like most inflexible things that react to market movement in discontinuous fashion at random intervals, ratings tend to increase volatility and encourage overshooting of prices. Just like nominal wage rigidities, such as multi-year labor contracts, influence exchange rate movements, credit ratings influence interest rates for the worse, and without any redeeming social benefit.

In theory, ratings allow the small or unsophisticated investor to know what she is getting into, which could promote the general welfare by clarifying what is safe and thus encouraging deeper fixed-income markets. In practice, *caveat emptor* should hold just as true for bond markets as for equity or foreign exchange trading. Buyers who think they are sufficiently aware of the attributes of a security because of a credit rating are deluding themselves, or rather are being deluded.

No one suggests that a central institution could definitively tell one the worth of a stock, especially under changing circumstances. So why should that be true for a fixed-income security? The worth, plans, and financial environment of the underlying issuer are just as difficult to assess accurately as it would be for an equity. Even without recent perhaps excessive innovations, the distinction between credit and equity securities has been eroding for some time now. Giving investors a sense of false security about bonds rather than having them do the same research—or the same delegation to indices or active managers—that they do for equities leads to bad decisions and exploitative outcomes

inherently. Better not to give such overrated assurance that is undependable. Those who suggest, moreover, that the U.S. Securities and Exchange Commission (hardly a bastion of forecasting distinction) can assume the role of the agencies, or assure their accuracy in assessing risk, also miss the point. There is no substitute for the investor herself rolling up sleeves and engaging in the difficult, gritty work of analysis.

Finally, it so happens that U.S. firms have dominated the ratings game for decades, and have acted as *de facto* gatekeepers for companies and governments wanting to come to bond markets. Like all gatekeepers through time, they have been much-hated middlemen, extracting their tolls through their location astride a passage, not through any value of service provided, and generally having an arbitrary

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nature that erodes the legitimacy of those who install them at the gates. At a time when U.S. arrogance over imposing or exporting our financial model is getting a huge backlash, it would be a win-win-win for the incoming Obama administration to disenfranchise the ratings agencies from their gatekeeper position: a win for investors and borrowers who have more efficient markets with fair buyer beware, a win for foreign governments who can claim the United States rolled back part of their financial overreach, and a win for the United States that will show itself willing to reform.

Our financial system is a highly adaptable organism forever evolving. Disenfranchise the ratings dinosaurs and the broader system will produce a myriad of small, more agile, more inventive private risk assessment investor services. For these advisory firms, accuracy of prediction would not be a secondary concern as it is for today's compromised, monopolized ratings giants; accuracy would be their only means of staying in business as they work side-by-side with fully engaged investors.

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