THE FINANCIAL PAGE
RATINGS DOWNGRADE

When Barack Obama went to Wall Street last week to make the case for meaningful financial regulation, he took well-deserved shots at some of the villains of the financial crisis: greedy bankers, reckless investors, and captive regulators. But to that list he could have added credit-rating agencies like Standard & Poor's and Moody's. By giving dubious mortgage-backed securities top ratings, and by dramatically underestimating the risk of default and foreclosure, the agencies played a key role in inflating the housing bubble. If we're going to reform the system, fixing them should be high on the list.

Unfortunately, that's not an easy task, since over the years the government has made the agencies an increasingly important part of the financial system. Rating agencies have been around for a century, and their ratings have been used by regulators since the thirties. But in the seventies the S.E.C. dubbed the three biggest agencies—S.&P., Moody's, and Fitch—Nationally Recognized Statistical Rating Organizations, effectively making them official arbiters of financial soundness. The decision had a certain logic: it was supposed to make it easier for investors to know that the money in their pension or money-market funds was going into safe and secure investments. But the new regulations also turned the agencies from opinion-givers into indispensable gatekeepers. If you want to sell a corporate bond, or package a bunch of mortgages together into a security, you pretty much need a rating from one of the agencies. And though the agencies are private companies, their opinions can effectively have the force of law. The ratings often dictate what institutions like banks, insurance companies, and money-market funds can and can't do: money-market funds can't have more than five per cent of their assets in low-rated commercial paper, there are limits on the percentage of non-investment-grade assets that banks can own, and so on.

The conventional explanation of what's wrong with the rating agencies focusses on the fact that most of them are paid by the very people whose financial products they rate. That problem needs to be fixed, and last week the S.E.C. proposed new rules to address conflicts of interest. But there's a much bigger problem, which is that, even though nearly everyone knows that the agencies are compromised and exert too much influence, the system makes it impossible not to rely on them. In theory, of course, the mere fact that a rating agency says a particular bond is AAA (close to risk-free) doesn't mean that investors have to buy it; the agencies' opinions should be just one ingredient in any decision. In practice, the government's seal of approval, coupled with those regulatory requirements, encourages investors to put far too much weight on the ratings. According to

CHRISTOPH NIEMANN

a recent paper on the subject by the academics Darren Kisgen and Philip Strahan, that's true even when the agency doing the rating doesn't have a long track record. During the housing bubble, investors put a huge amount of money into AAA-rated mortgage-backed securities—which would have been fine had the rating agencies' judgments been sound. Needless to say, they weren't. Despite subprime borrowers' notoriously shaky finances, the agencies failed to allow for the possibility that housing prices might fall sharply.

The rating agencies' role in inflating the bubble is well known. Less obvious is their role in accelerating the crash. Agencies have typically resisted changing their ratings on a frequent basis, so changes, when they occur, tend to be belated, widespread, and big. In the space of just a few months between late 2007 and mid-2008 (after the housing bubble burst), the agencies collectively downgraded an astonishing $1.9 trillion in mortgage-backed securities: some securities that had carried a AAA rating one day were downgraded to CCC the next. Because many institutional investors are prohibited from owning too many low-rated securities, these downgrades necessarily led to forced selling, magnifying the panic, and prevented other investors from swooping in and buying the distressed debt cheaply. In effect, the current system pushes many big investors to buy high and sell low.

Rating agencies existed long before they carried a government imprimatur, and, their recent dismal performance notwithstanding, they'll exist in the future, if only because few investors have the patience to sort through all the bond offerings and structured-finance deals out there. But we need a divorce: the rating agencies shouldn't be government-sanctioned and government-protected institutions and their judgments shouldn't be part of the rules that govern how investors can act.

Given how rarely real reform happens in Washington, that may sound like a hopeless goal. But last summer the S.E.C. seriously considered enacting a series of proposals that would have gone some way toward uncoupling the rating agencies from the regulatory system. The plan fizzled, however, thanks in part to pressure from a surprising source: big investors. Oddly, the ratings system, broken as it is, remains attractive to many investors who have been burned by it. For one thing, it provides an easily comprehensible standard: without it, we'd need to come up with new ways of measuring risk. More insidiously, the ratings system provides a ready-made excuse for failure: as long as you're buying AAA-rated assets, you can say you're being responsible. After the housing crash, though, we know how illusory those AAA ratings can be. It's time for investors to face reality: working with a fake safety net is more dangerous than working without any net at all.

—*James Surowiecki*

NEWYORKER.COM
The Balance Sheet, James Surowiecki's blog.