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Credit Rating Agencies and the Global Financial Crisis

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Introduction

The often vitriolic public debate about the role of the credit rating agencies in the generation of the subprime crisis has revolved around an idea which now seems deeply entrenched in popular, financial market and academic understandings of the agencies and their incentives. The core element of this thinking is that how the agencies are remunerated generates a significant problem for the quality of the ratings they produce. The issue identified is a conflict of interest between the central purpose of ratings and the remuneration model that funds the ratings of the major, global agencies.

I argue that the concern with conflicts of interest in rating agencies is largely mistaken. Conflicts of interest permeate social and economic life in capitalism. How institutions acknowledge and respond to conflicts of interest is important, but the existence of conflicts of interest in itself was not the major cause of the subprime crisis. I will argue that rating agency involvement in the crisis is not a result of breaking implicit regulative rules about conflict of interest, but is attributable to fundamental dilemmas about the role of rating agencies (and similar gatekeepers) in a market system. Although criticism of conflicts of interest may serve a useful political purpose, too much attention to issues at this level will produce complacency about the inherent volatility of global finance, setting the world up for a repeat of the global financial crisis once the appetite for risk returns (Vestergaard 2009: 9).

I begin this article with a short review of the agencies' history and how they function. The article then considers the claims about conflicts of interest which have dominated the debates about the agencies since the beginnings of the crisis in the summer of 2007. I then develop an argument about the role of the agencies in making structured finance possible. It is this role that is key to understanding the global financial crisis not as a result of rule

transgression, but as a crisis at the level of the social relationships which make global finance possible. This is why the crisis is so deep and why it has been so hard to develop a response by policy-makers and market actors. The nature of this crisis transcended the very definition of crisis as understood by these actors.

Origins and Purpose

Henry Paulson, U.S. Treasury Secretary at the end of President George W. Bush's administration, made it clear when presenting the policy statement of the President's Working Group on Financial markets in March 2008 that in the midst of market turbulence, officials, politicians and their advisers believe credit rating agencies "play a major role in financial markets," and that the work of the agencies must be 'improved' in terms of the specific challenges faced in rating complex financial instruments like structured securities, and by avoiding the reality or appearance of conflicts of interest (Paulson 2008).

These comments, and the energetic reaction of European financial regulators to the perceived culpability of the agencies in the generation of the subprime crisis, point to the increasingly important job done by wholesale credit rating agencies in global markets. In fact, it was not too many years ago that rating agencies were little known outside the United States. Until the mid-1990s most European and Asian companies relied on their market reputations alone to secure financing. But this changed when the pressure of globalization led to the desire to tap the deep American financial markets and to a greater appetite for higher returns and thus risk. In these circumstances, the informality of traditional old boys' networks is no longer defensible to shareholders or relevant to pension funds half way around the world. The result is that an essentially American approach to market organization and judgment has become the global norm in the developed world, and increasingly, in emerging markets as well.

Ratings are increasingly central to the regulatory system of modern capitalism and therefore to governments everywhere. Getting credit ratings 'right' therefore seems vitally

important to many observers. But in pursuing improvement in the rating system we need to appreciate the challenges and limits to rating. I argue, after due attention to the origins and work of the agencies, that our expectations of the agencies are founded on a limited rationalist or machine-like understanding of the workings of capital markets. A more appropriately social (and dynamic) view of markets makes the challenge of effective rating even more daunting. The increasingly volatile nature of markets has created a crisis in relations between the agencies and governments, which increasingly seek to monitor their performance and stimulate reform in their procedures, just as they do in other institutions.

Rating agencies emerged after the Civil War in the United States. From this time until the First World War, American financial markets experienced an explosion of information provision. The transition between issuing compendiums of information and actually making judgments about the creditworthiness of debtors occurred after the 1907 financial crisis. By the mid-1920s, nearly 100 percent of the US bond market was rated by Moody's.

Two major American agencies dominate the market in ratings. Both Moody's and S&P are headquartered in the lower Manhattan financial district of New York City. Moody's was sold in 1998 as a separate corporation by Dun and Bradstreet, the information concern, which had owned Moody's since 1962, while S&P remains a subsidiary of McGraw-Hill, which bought S&P in 1966. Both agencies have numerous branches in the US, in other developed countries, and in several emerging markets. S&P is famous for the S&P 500, the benchmark US stock index listing around \$1 trillion in assets.

Rating agency outputs comprise an important part of the infrastructure of capital markets. They are key benchmarks, which form the basis for subsequent decision-making by participants. In this sense, rating agencies are important not so much for any particular rating they produce, but for the fact that they are a part of the internal organization of the market itself. So, we find that traders may refer to a company as an 'AA company,' or some other rating category, as if this were a fact, an agreed and uncontroversial way of describing and distinguishing companies, municipalities or countries.

A rationalist way to think about what rating agencies do is to see them as serving a 'function' in the economic system. In this view, rating agencies solve a problem in markets

that develops when banks no longer sit at the centre of the borrowing process. Rating agencies serve as what Gourevitch calls "'reputational intermediaries'" like accountants, analysts, and lawyers, who are "essential to the functioning of the system," monitoring managers through a "constant flow of short-term snapshots" (Gourevitch 2002: 1 and 11). Another way to think about the function of the agencies is to suggest rating agencies establish psychological "rules of thumb" which make market decisions less costly for participants (Heisler 1994: 78).

But purely functional explanations for the existence of rating agencies are potentially deceptive. Attempts to verify (or refute) the idea that rating agencies must exist because they serve a purpose, have proven inconclusive. Rating agencies have to be considered important actors because people view them as important, and act on the basis of that understanding in markets, even if it proves impossible for analysts to actually isolate the specific benefits the agencies generate for these market actors. Investors often mimic other investors, "ignoring substantive private information" (Scharfstein and Stein 1990: 465). The fact that people may collectively view rating agencies as important – irrespective of what 'function' the agencies are thought to serve in the scholarly literature – means that markets and debt issuers have strong incentives to act as if participants in the markets take the rating agencies seriously. In other words, the significance of rating is not to be estimated like a mountain or national population, as a 'brute' fact which is true (or not) irrespective of shared beliefs about its existence, nor is the meaning of rating determined by the 'subjective' facts of individual perception (Ruggie 1998: 12-13).

What is central to the status and consequentiality of rating agencies is what people believe about them, and they act on collectively – even if those beliefs are clearly false. Indeed, the beliefs may be quite strange to the observer, but if people use them as a guide to action (or inaction) they are significant. Dismissing such collective beliefs misses the fact that actors must take account of the existence of social facts in considering their own action. Reflection about the nature and direction of social facts is characteristic of financial markets on a day-to-day basis.

Global Financial Crisis

The subprime crisis that began in the summer of 2007 may rank as one of the most traumatic global developments of the last one hundred years. It caused dismay and panic

throughout elite circles in developed countries as efforts to reignite confidence in the financial markets were frustrated again and again. Given that the subprime securities market was worth only \$0.7 trillion in mid-2007, out of total global capital markets of \$175 trillion, the impact of subprime assets is out of all proportion to their actual weight in the financial system (Bank of England 2008: 20). This suggests that an explanation for systemic crisis cannot be deduced in rationalist terms. The 'subprime crisis' is not a direct consequence of subprime mortgage delinquencies. The paralysis that came over global finance is a consequence of the intersubjective nature of markets, rather than the logical result of relatively minor problems with lending to the working poor. But this analysis of the subprime crisis is difficult to incorporate in a rationalist view of markets, in which events have logical causes. In a rationalist world, panics, crises and collapses have to be explained as a result of specific failures. It is necessary, in these circumstances, to find those institutions that did not do their jobs properly and make sure they do in future. This assumes, of course, that a proper job can be done and the problem solved.

It comes as no surprise then that the rating agencies have been subject to unprecedented criticism and investigation in the midst of the subprime meltdown. Congressional committees, the Securities and Exchange Commission, the European Parliament and Commission, and the Committee of European Securities Regulators have conducted investigations, amongst others. A very senior rating official has indicated that the crisis over subprime ratings is the most threatening yet experienced by the agencies in their century of activity. This is a curious development, given that the rating agency business is now open to greater competition since NRSRO designation became subject to the Credit Rating Agency Reform Act of 2006. It suggests that the image of a movement from regulation to self-regulation, or from police patrol to fire alarm has not created a world of autonomous non-state authorities. What we see instead is a serious disciplining of the agencies by states, intent on improving their performance (Moran 2003: 1-11). Or perhaps the identification of the agencies as scapegoats in the context of elite and public dismay over the effects of globalized markets, as US investment banks were in the 1930s (Galbraith 1954). An outcome of this crisis is likely to be a limited reconstruction of the agencies along more 'accountable' lines.

Reconsidering Conflict of Interest

The major discrete criticism of the agencies that followed the onset of the subprime crisis is that ratings were defective and did not warn of trouble ahead because of the perverse incentives created by a conflict of interest at the heart of the business model adopted by the agencies. The idea is that because rating agencies are funded by fees paid by issuers or sellers of securities they have strong incentives to inflate ratings to please their customers. The financial and popular press alike treated the observation that rating agencies were funded by those they rate as a scandalous revelation (Wighton, 2009; Baker 2009: 100).

Originally, in the first days of Moody's Investors Service, ratings were paid for by the sale of newsletters about credit quality. But this model became less effective in the 1960s when a bull market put a premium on information. Newspapers and other news services treated ratings as news, turning ratings announcements into public goods, obviating the need for payment by investors. Free riding became a major issue. The expansion of the financial markets in the 1960s, after decades of subdued activity following the Great Depression, World War II and the founding of the Bretton Woods regime meant the agencies needed more resources to respond to the greater volume and complexity of securities than could be provided by the vulnerable subscription system. This is what drove the agencies to change their business model at the end of the 1960s.

In principle, there is indeed a conflict of interest in rating. Crockett et al. assert that "Conflicts of interest occur when a financial service provider, or an agent within such a provider, has multiple interests that create incentives to act in such a way as to misuse information" (2003: xix). The idea here is that conflicts of interest mean the market gets less information or lower quality information than otherwise. In concrete terms, the inference is that payment of fees by issuers compromises the principle-agent relationship between the agencies and investors who use ratings as part of their decision-making. The agencies are assumed in these circumstances to issue less critical ratings than they otherwise would.

The problem with this view is the assumption that an inherent conflict must equal an empirical problem. But there is no equivalence in the material world. What we actually find in rating, as in many other spheres, is a conflict of interest certainly, but no more so than exists in universities in which students pay tuition fees that support the salaries

of the professors who grade their examinations. Rating agencies, like universities, manage this dilemma, in the case of the agencies through codes of conduct, and by de-linking analysis and remuneration for analytical staff.

The management of this conflict is not just in a negative or legalistic form. The agencies have strong incentives to maintain their reputations. Prior to government utilization of ratings in prudential regulation starting in the 1930s a Moody's rating was already a market-determined necessity in order to sell municipal bonds. Rating cannot therefore be reduced to a 'regulatory license' as some scholars have suggested (Posen and Smick 2008: 8-9). There are strong business reasons for the agencies to avoid rating inflation because reputation underpins their franchise, as it does in eminent universities.

If conflicts of interest were a major material problem in the rating industry we would expect to find a series of empirical cases that could be interpreted as supporting this claim. No doubt there would have been much talk of scandal and corruption in the agencies. But this is not the case, leading other observers to suggest that the agencies do indeed manage their conflicts effectively (Smith and Walter 2002; Crockett et al. 2003; Coffee 2006; Véron 2009). The problem with rating is not a conflict of interest in the conventional sense. The problem is much deeper. I examine this in the next section.

Conflict of Role

Two impulses seem to dominate responses to major crises. The first is to search for and attach blame to those who are alleged to have brought the crisis about, the culprits. This provides material for the media and incessant chatter in blogs. This impulse gives rise to panels of bankers who are forced to apologize for their alleged errors in front of Congressional and British Parliamentary committees. I have explored the uses of moral panic elsewhere (Sinclair 2010).

If this first impulse is politically useful, embarrassing to a few and somewhat satisfying to many others, the second impulse is, in the circumstances of this crisis, more likely to damage collective welfare. The second impulse is to create – typically in haste – a framework of regulative rules that are “heavier” or “harder” or more somehow more “serious.” The impulse to regulate is derived from a failure to understand what it is the rating agencies did that was actually in error and a failure to accept the social nature of

finance and the circumstances that brought this crisis into being in the first place. It is this understanding that forms the substance of my reconsideration of conflict of interest.

The prevailing understanding behind the impulse to punish and regulate seems to be that the people involved were doing things wrong. It is as if the mechanic fixing your car has downloaded the wrong software updates to the car's computers. No tip for him then and perhaps a remedial visit to mechanics school or the sack when the next round of layoffs come along. But this mechanical analogy will not do for global finance. Finance is not, contrary to the financial economists and their Efficient Markets Hypothesis, a natural phenomenon. While financial markets may display regularities in normal times, these regularities are not law-like because diachronic change is an ever-present feature of all social mechanisms, including markets.

John Searle made a useful distinction relevant to this problem. He suggested it is possible to distinguish rules that “regulate antecedently or independently existing forms of behavior...” from a much more architectural form of rule (Searle 1969: 33). These other “constitutive rules do not merely regulate, they create or define new forms of behavior.” He goes on to suggest that chess and football are only possible with rules. The rules make the game. The basic point here is that the public and elite panic has focused on regulative rules and those who allegedly broke them. But this is not the problem with rating agencies or what has brought about the global financial crisis. Constitutive rules have been damaged, and this is why the crisis is so deep and so obviously challenging to the powers that be.

In the case of the rating agencies, I argue that what I would now term regulative conflicts of interest are insubstantial and no more than a useful rhetorical device to address poor forecasting. What are important and little commented upon are the constitutive conflicts. The major conflict of this order has been going on since the early 1980s and the rise of structured or asset-backed finance. Structured finance is important because it has been the major means through which financial innovation has made illiquid debts like credit card receivables, car loans and mortgages into tradeable, liquid securities. In a context of low interest rates and the hunt for yield, structured finance has grown into around 40 percent of total global debt securities of around \$30 trillion.

When people think of financial innovation they inevitably think of computers and highly-educated 'rocket scientists'

developing quantitative techniques for managing risk. But that is not the heart of this matter. Lawyers are key to this. The real essence of structured finance is the legal rights to revenues organized in the contracts and trusts which underpin the securities. This documentation can run into thousands of pages. The point is that these legal underpinnings give different rights to different tranches of a security. Some, such as the AAA tranche, have the right to be paid first. While others had to wait in line. This is how a mass of not very creditworthy subprime mortgages could produce some AAA bonds. These investors had first right to revenue and the expectation was that even if some subprime mortgage holders defaulted as expected enough would pay so that those with the highly rated securities would be paid in full. Unfortunately, when expectations are upset and people are uncertain this model does not work and securities of this type look dubious. Add recession to this picture and you can imagine a wholesale right-down of the global market in securities.

But as disastrous as this is, it is not the specific constitutive conflict of interest the rating agencies committed. That failure was to move into the markets themselves. For decades Moody's and Standard & Poor's had played the role of a judge or referee, standing back from the action and making calls as necessary. This role is what they were valued for and it is this role which allowed them to build-up reputational assets. The problem is that structured finance is only possible with the active involvement of the rating agencies. The agencies and their ratings actually make the distinct tranches of structured finance possible. Because of the complexity of the legal documentation and protection necessary for these tranches, the raters did not operate as judges. In structured finance the raters increasingly acted as consultants, helping to construct the securities themselves, indicating how they would rate them if organized in particular ways.

Conclusions

It is intriguing that despite the worst financial crisis since the 1930s and the identification of a suitable culprit in the rating agencies proposed regulation should be so insubstantial, doing so little to alter the rating system that has been in place in the US since 1909 and Europe since the late 1980s. Part of this can be put down perhaps to a lack of confidence on the part of regulators and politicians in the efficacy of traditional solutions to market failure. It may also recognise the weakness of ostensibly heavily regulated

institutions such as commercial banks and an understanding that the financial system is, despite the rating crisis, likely to continue to move in a more market and more rating-dependent direction in future. Indeed, the rating agencies have been major beneficiaries of the bailout program, reporting substantial returns despite the crisis (Ng and Rappaport 2009).

The global financial crisis is a crisis at the constitutive level. It reflects a deep loss of confidence in the basic infrastructure of the capital markets. This loss of confidence is a social rather than a technical process and tinkering with regulative rules, while tempting and politically distracting, will not address the heart of the matter. Like the Great Depression it seems likely that the damage done to the social relationships which underpin global finance, such as the reputational assets of the rating agencies and the trust financiers have in each other, may take many long years to recover. It is tempting in these circumstances to prescribe a simple fix, but institutions, contrary to some, develop over time and like communities, do not heal instantly. Encouraging institutional diversity and restraining hubris about alleged cures is our best way through. For the rating agencies, attending to the relationships and the expectations that built their reputations in the first place is their best course of action. The extent of substantial change is likely to be limited.

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