# Reclaim power from the ratings agencies

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Published: August 24 2007 03:00 | Last updated: August 24 2007 03:00

Recent downgrades on residential mortgage-backed securities and collateralised debt obligations, and subsequent hedge fund failures and market turmoil, have led many to blame ratings agencies for the mortgage mess. Both the European Commission and Barney Frank, chairman of the House financial services committee in the US, promise hearings into the culpability of ratings agencies.

The agencies reply that accurately accounting for risk is not their job and that they are protected by the right of free speech. They point to disclaimers in their ratings that make it clear that they are paid by the companies they rate and that ratings are statements of opinion, not recommendations.

Savvy investors should know better than to invest only on the basis of a rating, but such admonitions ring hollow. Ratings agencies do more than opine; they play an active role in structuring RMBS and CDOs. They also serve as important sources of information about securitisation performance and often enumerate measures that issuers must take to maintain ratings in troubled securitisations.

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. That fact reflects the unique power that the government has conferred on ratings agencies to act as regulators. Portfolio regulations for banks, insurance companies and pension funds set minimum ratings on debts these intermediaries are permitted to purchase. Thus, government has transferred substantial regulatory power to ratings agencies, since they now effectively decide which securities are safe enough for regulated intermediaries to hold.

Giving ratings agencies more power actually reduces the value of their ratings by creating a strong incentive for grade inflation and making the meaning of ratings harder to discern. Regulated investors encourage ratings agencies to understate risk so that the menu of high-yielding securities available to them is larger. The regulatory use of ratings thus has changed the constituency demanding a rating from free-market investors interested in a conservative opinion to regulated investors looking for an inflated one.

Although there is evidence that Moody's and Standard & Poor's remain relatively conservative when rating structured products, it is clear that even Moody's has allowed its ratings scale for securitised 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.

Given the 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 multi-layered structured finance deals, it is not surprising that investors underestimated risks so badly leading up to the recent crisis.

It is no use blaming the ratings agencies, which are simply responding to the incentives inherent in the regulatory use of ratings. The solution is for regulators to reclaim the power that has been transferred to ratings agencies to award ratings and determine the meanings attached to them.

How can regulatory power be reclaimed? Regulating the methods by which ratings agencies set standards is one possibility, although this would come at a huge cost, namely the ability of ratings agencies to use independent discretionary judgment. A better solution is to reform existing regulations to avoid the use of letter grades in setting standards for permissible investments by regulated institutions. In the absence of letter grades, banks and their regulators would look at the underlying risks of investments, not ratings. Ratings agencies sell tools to investors that permit exactly this sort of analysis. Full disclosure by regulated institutions of these new measures of portfolio risks and a greater reliance on market discipline to discourage excessive risk-taking would further improve the regulatory process.

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