Problematic Practices Of Credit Rating Agencies: The Neglected Risks Of Mortgage-Backed Securities

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“The credit rating agencies occupy a special place in our financial markets. Millions of investors rely on them for independent, objective assessments. The rating agencies broke this bond of trust and federal regulators ignored the warnings signs and did nothing to protect the public.”

I. Introduction

The adverse effects of the financial crisis began in 2007 with the fallout of the U.S. housing market. Effects of decreasing home prices spilled over to the broader economy because large financial institutions were heavily invested in credit instruments called mortgage-backed securities. These complex investments proved riskier and less profitable than investors initially thought and their decline in value caused has caused financial institutions to write-down trillions of dollars in assets, incur massive amounts of losses, and halt lending to other banks and businesses.

Mortgage-backed securities are created through a process called securitization. The process of securitizing mortgages is complex and involves many players within the financial markets. The financial system currently counts on these players to independently assess the risks of the mortgages that back each security sold. However, instead of conducting their own due diligence, market participants overly relied on credit rating agencies (CRA). This proved problematic because CRAs used outdated models that failed to account for changing conditions in the U.S. housing market.

This paper provides a general background of the evolution and importance of CRAs in the financial industry, and argues that a lack of regulatory sanctions, along with the absence of incentives for accuracy helped create the problem. This paper then argues that the imposition of a handicapping system similar to those used to handicap professional sports would provide a solution.

II. Credit Rating Agencies as Gatekeepers

CRAs play an important role in U.S. financial market. They serve as important gatekeepers that investors and regulators rely on to provide objective, timely and accurate financial information. CRAs are among a number of different professions that act as gatekeepers in the financial markets. The most common gatekeeper professions include auditors, CRAs, securities analysts, and attorneys.

Generally, market participants use gatekeepers in two primary capacities. First, market participants use gatekeepers in a reputational capacity. A reputational gatekeeper is a professional (individual or company) who is well known among market participants for providing neutral and accurate assessments of financial information. This status allows a reputational gatekeeper to lend its credibility to information that is communicated by a company to other markets participants. With the reputational gatekeeper’s seal of approval, market participants are more willing to rely on that information in making investment or business decisions.
decisions.
Second, market participants use gatekeepers in a regulatory capacity because the government requires their consent, approval, or certification in certain transactions. For example, securities regulations require that CRAs rate debt securities being issued in the financial markets. The government requires this because ratings theoretically provide an objective assessment of the risks inherent in the securities being offered. Unlike an issuer who has a financial incentive to exaggerate the profitability of securities being sold, CRAs are neutral because they have no financial ties to a security’s profitability. Thus, the government uses CRAs to guard against inaccurate information from misleading decisions by market participants.

Currently, CRAs act in both a reputational and gatekeeper role. However, in the late nineteenth century, CRAs initially began as pure reputational gatekeepers in selling business publications to investors. These publications contained assessments of commercial paper and other financial instruments.

Nonetheless, following the stock market crash of 1929, CRAs rapidly transitioned into a more regulatory capacity. This transition began in 1931 when the Comptroller of the Currency required banks to hold extra capital for bonds rated non-investment grade. Because the Comptroller defined the term “non-investment grade” as a security rated BBB and lower, credit ratings became essential to investors in the bond market.

Since that initial regulation, CRAs’ regulatory influence has spread while their reputation for accuracy has decreased. Currently, CRAs have been incorporated into hundreds of regulations, some of which directly concern the buying and selling of mortgage-backed securities.

III. Credit Ratings in Mortgage Securitization

Mortgage-backed securities are comprised of thousands of individual home loans, pooled into one security, and sold in shares to investors. They are created in a process called securitization.

Securitization starts when an originator (i.e., a lender) agrees to loan money to homebuyers in return for principle and interest payments. The originator then sells its rights to these payments to an arranger, typically a major bank. After purchasing thousands of loans from different originators, the arranger divides the loans into individual loan pools.

After consolidating the loans into pools, the arranger sells each pool to a special purpose vehicle (SPV), which is a separate legal entity that cuts off the arranger’s vulnerability to losses incurred from the loan pool. Ultimately, the SPV sells shares of the loan pool to investors. However, before it sells any shares, the SPV structures the loan pool into a series of tranches.

Tranches are pieces of the loan pool that the SPV separates according to risk. Tranches with the least amount of risk are referred to as senior tranches. Tranches with more risk are called junior tranches. Senior tranches are less risky than junior tranches because SPVs structure the security so that junior tranches incur losses before senior tranches. In this, SPVs allocate senior tranches with different forms of “credit enhancement.”

Credit enhancements can be internal contractual rights with respect to other tranches in the loan pool, or external arrangements with third parties that protect investors against financial losses. The most common forms of internal credit enhancements are (1) subordination – where junior tranches incur losses before the senior tranches, (2) over-collateralization – where the SPV creates an equity tranche that absorbs losses before the investor tranches, and (3) excess spread – where the SPV creates loss reserves or pays off delinquent payments with interest payments that exceed the payments owed to investors.
The most common form of external credit enhancement is the credit default swap. Effectively, a credit default swap is an insurance policy formed through an agreement between the SPV and a third party. Under this agreement, the SPV pays the third party to cover potential losses to investors of a particular tranche. Coverage under the credit default swap agreement is usually triggered by specified credit events. These events are usually defined as a percentage of homeowners defaulting on their mortgage payments owed to that tranche.

In 2008, credit default swaps became increasingly controversial. Because of bankruptcies or large financial losses in the financial sector, companies heavily involved in selling credit default swaps like Lehman Brothers – one of the ten largest sellers of credit default swaps – were unable to fulfill their contractual obligations to investors. Consequently, investors covered by swaps sold by those companies were exposed to unexpected financial risks.

After structuring the loan pool into tranches, the SPV hires CRAs to assign each tranche a credit rating. Mortgage-backed securities generate revenue from the principle and interest payments made by homeowners on the underlying mortgages. The CRAs’ purpose in rating these securities is to consider whether the security as a whole will meet payment and performance obligations—i.e., whether the homeowners will collectively make good on their payments.

The ratings process can be divided into four steps. First, the SPV sends information of the issuer’s background and the loan pool to a CRA analyst. Second, the CRA analyst uses that information to forecast the performance of the loan pool. In forecasting the security’s performance, the analyst inputs the information into a mathematical formula that replicates the loan pool’s revenue stream during a series of economic scenarios.

Third, the analyst evaluates the qualitative, quantitative, servicing, and legal aspects of the security. This includes information concerning security’s capital structure, its revenue stream, the loan pool’s underwriting criteria, the quality of the servicer, and the loan pool’s legal risks (e.g., the effects of bankruptcy, regulatory issues concerning the issuer/industry, the legal structure of the sale, the requirements necessary for a perfection of security interests, and taxes).

Fourth, the analyst recommends a rating for each tranche and presents it to a rating committee. The committee votes on the merits of each rating and notifies the issuer of its decision. After the initial rating is issued and the securities are sold, CRAs monitor each security and general market conditions. If the CRA discovers that new information could have a “material impact on a security’s creditworthiness,” it reconvenes the rating committee and reconsiders the rating.

Through this process CRAs have become essential parties in managing risks of mortgage-backed securities. However, a recent SEC investigation has shown that CRAs have ineffectively performed in that role.

IV. Problems in the Credit Rating Industry

In 2007, after a sudden increase in foreclosures, the SEC decided to investigate the rating practices of the three largest CRAs – Moody’s, S&P, and Fitch. From its investigation, the SEC concluded that CRAs issued inaccurate ratings because they used antiquated formulas that did not account for evolving market conditions. The SEC also concluded that CRAs knew their formulas’ were inaccurate and continued to issue ratings despite the fact that market participants relied on them.

Among the evidence supporting the SEC’s conclusions were internal emails that were
discovered during the investigation. One email summed up the problems with CRAs in a nutshell. In that email, a CRA analyst stated to a colleague that her agency’s model did not “capture half of [the deal’s] risk,” but that “it could be structured by cows and we would rate it.”

So why did CRAs fail in assessing the risks of mortgage-backed securities? As an initial, commentators suggested that the current fee structure, in which the issuer pays for the rating, creates a conflict of interest between the CRAs’ desire to obtain issuer business and the CRAs’ ability to render objective ratings. This idea is supported by other internal documents uncovered by the SEC. In an email entitled “Competition with Moody’s,” two S&P officers expressed their frustration in losing a deal to Moody’s. To prevent any future problems, these S&P discussed the possibility of diluting S&P’s rating requirements.

Commentators also suggest that security information and CRA rating methodologies are too opaque. In fact, even the raters have trouble gaining access to the necessary loan data to calculate a rating. For example, in another email, an S&P analyst requests loan documentation to review risks of a security being rated. A senior manager abruptly replied to his request by stating that, “Any request for loan level tapes is TOTALLY UNREASONABLE!!! Most investors don’t have it and can’t provide it. Nevertheless we MUST produce a credit estimate.”

In all, these issues are a result of the government’s inadequate oversight of the credit rating industry. In this, regulators fail to deter CRA misconduct because they impose inconsequential penalties on CRAs that issue inaccurate ratings. Moreover, the current regulatory environment does not encourage the market to economically value accurate ratings over inaccurate ratings.

With respect to penalties, the SEC has demonstrated little backbone in deterring CRAs from issuing inaccurate ratings. For instance, after its 2007 investigation, the SEC failed to recommend any punitive action against the CRAs involved. Instead, the SEC only recommended remedial measures, which the CRAs agreed to before the investigation’s findings were published.

Nevertheless, even if the SEC wanted to penalize inept CRAs, it would be difficult to do so because Moody’s, S&P, and Fitch dominate the ratings business. In fact, in 2007 the so-called Big Three agencies rated 98 percent of the asset-backed securities issued in the U.S. This market dominance has stifled competitive pressures in the industry causing CRAs to become complacent in not updating and improving rating methodologies.

The dominance of the Big Three is a direct result of the Nationally Recognized Statistical Rating Organization (“NRSRO”) designation. This designation is required by the government for CRAs to be used for regulatory purposes. From the time of its creation in 1975 until 2002, the SEC only granted NRSRO status to seven CRAs. Because the Big Three subsequently acquired four of those agencies, the industry transformed into a virtual oligopoly. Since 2002, the SEC has taken steps to increase competition and reduce regulatory reliance on NRSROs. However, those actions have had little effect on the dominance of the Big Three.

In addition to insufficient penalties, current regulations fail to provide economic value in accurate ratings. On the sell-side, issuers want the best rating possible (accurate or not) because a good credit rating permits the issuer to sell its security to large institutional investors. And because issuers retain no interest in the profits or losses of that security, they are more concerned about the marketability of the security rather than the likelihood of its profitability.

On the buy-side, one would think that investors would pay more money for accurate ratings. However, in a market bubble environment like that of the housing market, investors are less adverse to risk. Accordingly, many institutional investors disregard proper due diligence and instead demand securities with the highest credit rating, regardless of its accuracy. High credit
ratings are attractive to investors because, when the bubble bursts, good credit ratings provide corporate officers with an excuse for bad investment decisions and poorly executed risk management procedures.

For their part, CRAs claim that ratings accurately capture risk over time when compared to other relevant public information. However, this argument falls short in today’s market because mortgage-backed securities are complex investment vehicles whose structure and risk many market participants do not understand. Furthermore, as discussed above, buy-side entities have little access to information about the security’s underlying assets.

V. Proposal: Handicapping The Credit Rating Agencies

Indeed, the SEC has taken steps to encourage competition in the credit rating industry by increasing the number of NRSROS and reducing reliance on those designated CRAs. However, more must be done to inject economic value into a rating accuracy. To accomplish that goal, this paper proposes to handicap CRAs by imposing a regulatory disadvantage to CRAs with less accurate rating histories.

Handicapping the CRAs could be similar to the system used by The United States Golf Association in regulating the game of golf. Generally, the purpose of a golf handicap is to level the playing field between players of different skill levels. It accomplishes this by giving less skilled golfers a numerical advantage over a competitor. This numerical advantage is determined by the difference between each golfer’s playing ability and it is deducted from the less skilled golfer’s final score at the end of the round.

For example, if Golfer A averages 75 strokes on a par 72 course, he has a handicap of 3. If Golfer B averages 80 on a par 72, he has a handicap of 8. When Golfer A plays against Golfer B, Golfer B receives a five-stroke advantage. After completing the round, both golfers add up their individual scores. Golfer B then subtracts five strokes from his score and compares that score with Golfer A’s score. The lowest score wins.

Regulators could apply a similar concept to CRAs. To calculate a CRA’s handicap, the SEC would take that CRA’s average accuracy in rating a particular type of security (e.g., asset-backed securities). Based upon the accuracy of its past ratings, and other relevant historical data, the CRA’s handicap will be the best predictor of the likelihood that the rating will be accurate. After calculating the handicap, the SEC would apply the CRA’s handicap to the ratings that it issues. Depending on the CRA’s past accuracy its handicap could lower or increase the overall rating that is used for regulatory purposes.

To illustrate, if a CRA initially rates a particular security AAA, the SEC will take the AAA rating and apply the CRA’s handicap. If the CRA has a poor track record in rating similar securities the handicap could potentially reduce the gross rating from AA to A, depending on the severity of the CRA’s past inaccurate ratings. As such, if the CRA’s track record demonstrates total unreliability, the handicap could even reduce the rating below BBB. In that case institutional investors would be barred from buying shares in that security.

Ultimately, this proposal will improve the credit rating industry. As an initial matter, handicapping CRAs will allow investors to easily compare the accuracy of each CRA. This will negate the blame game and increase the economic value of CRAs that accurately assess risk. Handicapping CRAs will also create regulatory penalties for CRAs that consistently issue bad ratings. Such penalties will encourage CRAs to improve both their ratings methodologies and due diligence standards. Ultimately, these penalties will offset any adverse monetary incentives presented by the issuer pays model.
V. Conclusion

In conclusion, CRAs are essential to maintaining market transparency and managing the market risk. However, CRAs have taken advantage of this influential position by using inaccurate rating methods that failed to capture foreseeable market risks. Regulations and regulators overseeing the credit rating industry allowed this to happen by failing to penalize incompetent CRAs and failing to create an environment that economically values rating accuracy. Policymakers can remedy these problems by implementing a handicapping system that integrates the accuracy of a CRA’s past ratings into the regulatory and economic value of its future ratings.

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1 This contribution is an abridged version of Problems and Reforms in Mortgage-Backed Securities, 79 MISS. L.J. (forthcoming 2010).

2 B.S., 2002, Boston University School of Management; J.D., 2009, Loyola Law School, Los Angeles. I thank my family for their support – my wife Vivian, my parents Phil and Maureen, and my sister Megan. I also thank the faculty at Loyola, especially Professors Lauren Willis and Gia Honnen-Weisdorn, for their encouragement and dedication to students.


ii Ben Bernanke, Chairman, Fed. Reserve, The Crisis and the Policy Response (Jan. 13, 2009). In a statement before the House Committee on Financial Services, Dean Baker reiterated that estimates have placed losses of the banks at more than $2 trillion. See TARP Oversight: Is TARP Working for Main Street?: Hearing Before the H. Comm. on Fin. Serv., 111th Cong. 1 (2009) (statement of Mr. Dean Baker, PhD, Co-Director, Center for Economic and Policy).

iii On February 8, 2009, Lloyd Blankfein, CEO of Goldman Sachs, wrote an article in the Financial Times where he commented on seven lessons that he learned from the current economic crisis. Specifically, he noted that “too many financial institutions and investors simply outsourced their risk management. Rather than undertake their own analysis, they relied on the rating agencies to do the essential work of risk analysis for them.” Lloyd Blankfein, Do not destroy the essential catalyst of risk, FIN. TIMES, Feb. 8, 2009, at 7.


v See Cantor & Packer, supra note iv, at 4 (discussing reliance on CRAs).


vii The term “market participant” generally refers to persons buying, selling, and marketing financial products.

viii See Coffee, supra note vi at 308.

ix Id.


xii The SEC recognizes the dangers of “publicity efforts” that will “condition the public mind or arouse public interest” in a particular security before verified information is provided to investors. See In the Matter of Carl M. Loeb, Rhoades & Co. and Dominick & Dominick, Securities Act Release No. 34-5870 (Feb. 9, 1959).

xiii See Cantor & Packer, supra note iv, at 4.

xiv Id. at 5-7.

xv Id.

xvi A 2004 survey by the Association for Financial Professionals found that only 53 percent of professionals believed that the ratings of their organization were accurate. Although this is up from 2002, when only 29 percent of professionals indicated that their ratings are accurate, the numbers have most likely declined since events after the housing market crash have revealed rating inaccuracy. See 2004 CREDIT RATING AGENCY SURVEY 6-7 (2004),
available at www.afponline.org/pub/pdf/2004_10_research_cra_report.pdf. However, with more regulations requiring their use, CRAs could afford to sacrifice their reputations in realizing increasing profits. See Partnoy, Siskel and Ebert, supra note x, at 684.

See Partnoy, Siskel and Ebert, supra note x, at 690.


See e.g., In re Worldcom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 652 (S.D.N.Y. 2003) (discussing the role of Bank of America as a lead arranger and its due diligence requirements). See also John Patrick Hunt, Credit Rating Agencies And The "Worldwide Credit Crisis": The Limits Of Reputation, The Insufficiency Of Reform, And A Proposal For Improvement, 2009 COLUM. BUS. L. REV. 109, 136 (noting the dominance of a few major banks that act as arrangers); SEC SUMMARY REPORT, supra note xii, at 6.


Id.


PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 8 (Mar. 2008) (“The subprime RMBS and the ABS CDOs were structured in tranches and a very large share of the total value of the securities issued was rated AA or AAA by the credit rating agencies.”).

SEC SUMMARY REPORT, supra note xii, at 6.


Id.

Id.

Id.


SEC SUMMARY REPORT, supra note xiii, at 7; IOSC, supra note xii, at 9; see also Claire A. Hill, Securitization: A Low-Cost Sweetener for Lemons, 74 WASH. U. L.Q. 1061, 1070-74 (1996) (discussing the CRAs’ role in securitization).

SEC SUMMARY REPORT, supra note xii, at 7; IOSC, supra note xii, at 9.

See IOSC, supra note xii, at 9 (“This analysis also includes assumptions as to how much principal would be recovered after a defaulted loan is foreclosed.”); Wong, supra note xxv, at 351.

Id.

In Professor Reiss’s article, he discusses the effect that anti-predatory lending laws in Georgia, New Jersey, and North Carolina have on the legal risks associated with mortgage-backed securities. He argues that because these states passed laws making investors liable for lending law violations, mortgages from those states were not sold on the secondary market because CRAs would not assign them a favorable rating. Id.

SEC SUMMARY REPORT, supra note xii, at 9; IOSC, supra note xii, at 7-10.

SEC SUMMARY REPORT, supra note xii, at 9; IOSC, supra note xii, at 7-10.


One of the changing conditions in the U.S. home mortgage market has been the sudden influx of subprime

xiv In hearings before the Congressional Committee on Government Oversight and Reform, Congressman Henry Waxman suggested that the CRAs focused on profits rather than actual risks of the securities they rated. In this, Congressman Waxman noted that “The total revenues for the three firms doubled from $3 billion in 2002 to over $6 billion in 2007. At Moody’s, profits quadrupled between 2000 and 2007. In fact, Moody’s had the highest profit margin of any company in the S&P 500 for five years in row.” Credit Rating Agencies and the Financial Crisis, supra note i, at 5.

xv Credit Rating Agencies and the Financial Crisis, supra note i (Instant Message Conversation between Shannon Mooney and Ralul Dilip Shah, April 5, 2007); SEC SUMMARY REPORT, supra note xix, at 12 & n.8.

xvi Id. at 23.

xvii Credit Rating Agencies and the Financial Crisis, supra note i (E-mail from Yo-Tsung Chang to Joanne Rose, et al., May 25, 2004).

xviii See Hunt, supra note xx, at 126-27 (defining transparency as “investors’ ability to understand how agencies arrive at ratings and their ability to monitor how ratings perform”).

xix Credit Rating Agencies and the Financial Crisis, supra note i (E-mail from Frank Raiter to Richard Gugliada et al., March 20, 2001).

xx SEC SUMMARY REPORT, supra note xix, at 6.

xxi In a 2008 proposal, the SEC noted that “According to their most recent Annual Certifications on Form NRSRO, S&P rates 197,700 issuers of asset-backed securities, the category that includes RMBS, Moody’s rates 110,000 such issuers, and Fitch rates 75,278 such issuers. No other registered NRSRO reports rating more than 1,000 issuers of asset-backed securities.” SEC, Proposed Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-57967, File No. S7-13-08, at 5 (June 16, 2008), available at http://www.sec.gov/rules/proposed/2008/34-57967.pdf.

xxii Recently, the Treasury Department enacted the Term Asset-Backed Securities Loan Facility, which provides government loans to investors of asset-backed securities. To be eligible to receive these loans, securities must “have a long-term credit rating in the highest investment-grade rating category (for example, AAA) from two or more major [NRSROs].” See Press Release, SEC, Talk Task Force Expanded to Address Public-Private Investment Plan (April 28, 2009), available at www.sigtarp.gov/.../TALF_Task_Force_Expanded_to_Include_PPIP.pdf; See also SEC, TALF FAQs 1, www.federalreserve.gov/newsevents/.../monetary20090303a2.pdf.

xxiii Hill, supra note xxxv, at 54.


xxvi Professor Reiss states that, “The lack of a rating from at least one of the privileged raters . . . is the financial equivalent of a death sentence for a residential mortgage-backed securities offering.” See Reiss, supra note xxxix, at 988. See also Unterman, supra note xxix, at 90-91 (discussing the role of institutional investors in buying mortgage-backed securities).

xxvii Professor Robert Shiller suggests that investor confidence is not always rationally based in a market bubble environment. Rather, he suggests that investor confidence is sometimes based on blind emotional trust that dismisses instinctive doubts about other players in the market. See Robert Shiller, Animal Spirits Depend on Trust, WALL ST. J., Jan. 27, 2009, at A15.


The handicapping concept is further explained in *Problems and Reforms in Mortgage-Backed Securities: Handicapping the Credit Rating Agencies*, 79 MISS. L.J. (forthcoming 2010).
