

In Chapter 7, we learned that rating agencies assess the probability of default on bonds and issue ratings of the sort listed in Table 7.2. The first such ratings began in the United States roughly 100 years ago. Since 1975, U.S. regulators have designated a small group of agencies as “nationally recognized statistical rating organizations” (NRSRO). Until 2003, only three agencies enjoyed NRSRO status. Today, that number has reached ten, but the largest three – Moody’s, Standard & Poor’s and Fitch – still lead the field.

The NRSRO label provides a rating agency with official recognition that vastly increases the importance of its assessments. Various government regulators – both inside and outside the United States – evaluate the riskiness of the assets held by financial institutions by using NRSRO ratings. They require regulated institutions to bear an extra cost for holding riskier assets measured by NRSRO ratings.

By allowing rating agencies to determine the riskiness of many of the assets financial institutions hold, governments effectively transferred a critical regulatory function to NRSROs. Government reliance on these ratings naturally encourages private investors to rely on them, too. Consequently, if the rating agencies make mistakes – say, by underestimating the probability of default of a particular type of bond – financial institutions and regulators also are likely to follow suit and make errors as well.

Rating agencies have a history of underestimating the default probability of bonds during economic expansions. As a result, ratings downgrades typically increase in recessions, while upgrades are more common in expansions. Over the past decade, there also were notable instances when investors came to expect the default of large, well-known businesses – such as Enron or MCI WorldCom – that still enjoyed investment-grade ratings.

Rating mistakes contributed significantly to the financial crisis of 2007-09. Investors and regulators around the world relied on the high ratings that agencies had awarded to a large group of mortgage-backed securities (MBS). When U.S. housing prices began to fall and prices on the MBS started to decline, rating agencies began a series of sharp downgrades, sometimes lowering ratings by four notches or more from the highest level (AAA) directly to noninvestment grade (below Baa). Such downgrades reinforced the plunge in MBS prices. Losses on the highly-rated assets commonly held by banks diminished resources in the financial system, weakening it enough to help trigger (and later to intensify) the crisis.

What caused the rating errors? Agencies evaluating mortgage debt typically estimate default risks using mathematical models that rely on information about the borrowers, the houses they purchase and historical patterns of default. However, the data used did not include a period in which U.S. housing prices fell *nationwide*, because such a thing had not happened since the Great Depression of the 1930s. As

a result, the models severely under-predicted the likelihood of default on individual mortgages originated during the housing bubble. Many borrowers with limited ability to pay who had obtained loans under easy lending standards (even without documentation on income and wealth) were compelled to default (see Chapter 7 module: Subprime Mortgages). When defaults began to surge beyond what their models anticipated, the rating agencies were compelled to reassess.

Other factors also may have contributed to rating errors. For example, in developing the most complex MBS, issuers typically consulted rating agencies to determine which bond structure would lead to the highest rating (and, presumably, the highest price). Payments for such consultation have the potential to create a conflict of interest when agencies are later called on to give the issue a rating in an objective, independent fashion. Some smaller agencies did not consult, and already governments have moved to prevent such potential conflicts from arising again in the future.

Conflicts also can arise from the way rating agencies are compensated. Since the 1970s, the largest U.S. rating agencies have obtained their compensation from issuers (the *issuer pays* model). Some observers argue that such compensation produces an incentive for a favorable rating (*ratings inflation*).

As a result, proposals have occasionally surfaced that ratings users, rather than bond issuers, should pay. However, users have an incentive to let someone else pay. As we will see in Chapter 11, such *free riding* on the part of users is a problem for stock analysis, just as it is for bond ratings. Some government officials have proposed a small tax on bond buyers or on institutional investors to make a *users pay* system feasible.

Yet, it is not clear that a *users pay* system would reduce the push toward granting high ratings. Financial institutions that buy the assets also may seek higher-than-warranted ratings, because they can then take greater risk than governments wish. While the incentives are different, this problem has some similarity with grade inflation in education: teachers want their students to seem above average, because their school will benefit if its students get into better universities or find better jobs.

In any case, as governments contemplate financial system reform, the role of rating agencies will be an important topic. Officials are likely to insist that financial institutions bear increased responsibility for proving that the assets they hold have tolerable risks. Some officials also may call upon ratings agencies to use different rating scales for assets with differing liquidity, transparency and degree of standardization. When rating agencies use the same scale, as they currently do, to measure default probabilities, they may inadvertently conceal an asset's other risks.