



# Why U.S. Financial Markets Need a Public Credit Rating Agency

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**T**he major private credit rating agencies—Moody’s, Standard & Poors, and Fitch—were significant contributors in creating the housing bubble and subsequent financial crash of 2007–08. The rating agencies are supposed to be in the business of providing financial markets with objective and accurate appraisals as to the risks associated with purchasing any given financial instrument. Instead, they consistently delivered overly optimistic assessments

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of assets that either carried high, or at the very least, highly uncertain risks.

Moreover, the reason these agencies consistently understated risks was not simply that they were relying on economic theories that underplay the role of systemic risk in guiding their appraisals, though this was an important factor. The more significant influences were market incentives themselves, which pushed the agencies toward providing overly favorable appraisals. Giving favorable risk appraisals was good for the rating agencies’ own bottom line, and the rating agencies responded in the expected way to these available opportunities. The most effective solution would be to create a public credit rating agency that operates free of the same

perverse incentive system that distorts the work of private agencies.

## PERVERSE INCENTIVES FOR PRIVATE AGENCIES

**W**ith the benefit of hindsight, the misjudgments of the agencies are now widely recognized. The economics journalist Roger Lowenstein offered this appraisal in the *The New York Times*:

Over the last decade, Moody’s and its two principal competitors, Standard & Poor’s and Fitch, ... [put] what amounted to gold seals on mortgage securities that investors swept up with increasing élan. For the rating agencies, this business was extremely lucrative. Their profits

surged ... But who was evaluating these securities? Who was passing judgment on the quality of the mortgages, on the equity behind them and on myriad other investment considerations? Certainly not the investors. They relied on a credit rating (4/27/08).

Of course, the reason investors “relied on a credit rating” is that they assumed the rating agencies were committed to providing objective and accurate risk appraisals. Indeed, the evaluations provided by the agencies are the basis for how investors price assets, which in turn has a major impact on how investment projects get financed, or even whether or not they get off the ground. For example, on average between 1950–2007, a bond that was rated as AAA by Moody’s paid out an interest rate that was almost one percentage point below a BAA rated bond. If, for example, a \$10 million bond has a maturity of 10 years, this interest rate differential amounts to a \$1 million difference in debt servicing. In the midst of the 2008 financial crisis, the spread between AAA and BAA bonds rose to almost three percentage points, thus increasing the debt servicing

spread for the same \$10 million bond to \$3 million.

In principle, the incentives in the marketplace are supposed to operate to push the agencies toward providing objective and accurate appraisals since, in principle, the only valuable product the agencies are offering in the marketplace is their credibility. As such, if an agency is failing to provide the market with credible information, one would expect they would be punished in the market—market competition should drive out the incompetent firms and reward those that are indeed providing credible information.

In fact, however, a large gap exists between this ideal set of incentives that should guide the activities of credit rating agencies and the actual incentives they face. In practice, the reason the rating agencies operate with a strong bias to provide favorable ratings on financial instruments is simple: the agencies are hired by the companies that they are evaluating. Companies therefore choose to hire agencies that they think are more likely to provide favorable ratings, which in turn enhances the companies’ ability to sell their financial instruments. The agencies, in turn, recognize this bias in

how companies will select a rating agency. The agencies therefore lean as much as possible toward providing favorable ratings.

#### **PUBLIC CREDIT AGENCY AS CORRECTIVE**

**T**he fundamental contribution of a public credit rating agency would be to offer a counterforce to the perverse incentive system facing private agencies. It is true that providing accurate risk appraisals has become increasingly challenging as securitized markets have deepened. There may well be situations in which the staff of the public agency concludes that an instrument is too complex to provide an accurate risk appraisal. In such situations, it would be the obligation of the public agency to be open with such an assessment—that is, to assess an instrument as “not ratable.” Financial market participants could then decide the degree to which they might wish to take a gamble with such an instrument.

The public credit rating agency operating in this way would dramatically change the incentives for the private rating agencies as well as the broader array of financial market participants. It would weaken the biases in favor of greater risk and complexity, and move the

financial system to operate with a higher level of transparency. The private agencies would be free to continue operating as they wish. But when their appraisals differ significantly from those provided by the public agency, the private agencies would be forced to explain the basis for their divergent assessments.

Market participants would thus be free to evaluate the full range of information and assessments available to them, from the public agency, the private agencies, and elsewhere. It is useful to recall that in the 1980s, Michael Milken of the now defunct firm Drexel Burnham Lambert created the “junk bond” market precisely by insisting that the traditional rating agencies were overly cautious in their appraisals of corporate bonds. Market participants could make comparable assessments on their own with respect to the appraisals of the public rating agencies.

#### HOW THE AGENCY COULD OPERATE

**W**e propose that all private businesses issuing securities that are to be traded publicly in U.S. financial markets would be required to obtain a rating by the public agency before any trading could be conducted legally.

The new agency could be organized to operate through procedures that borrow from existing regulatory agencies, including the Food and Drug Administration and the Securities and Exchange Commission. Just as the FDA assesses health risks associated with new pharmaceuticals before the drugs can be marketed, the public ratings agency would assess the riskiness of financial assets before the securities could be publicly traded. Unlike the FDA, the public rating agency would not have the authority to prevent securities from being marketed, but only to offer their independent risk assessment.

Like the SEC, the agency would perform most effectively operating as much as possible at arm’s length from political influences. To create a relatively autonomous operating space for the agency, we propose that one third of the agency’s Governors—of perhaps 12 Governors in total—would be nominated, respectively, by the House Financial Services Committee, the Senate Finance Committee, and the President. Nominees would then be subject to Congressional approval, following standard procedures such as those already in place for SEC or Federal Reserve governors. The Governors would

direct the day-to-day activities of the ratings agency. They would remain accountable to Congress, including through providing annual public reports on their operations.

Similar to the SEC, which is financed largely through a low-level securities transactions tax and registration fees, the public ratings agency could be financed by cost-recovery fees. Any surplus generated would be taxed at an effective rate of 100 percent and transferred to the Treasury. This would remove any incentives to manipulate ratings so as to increase revenues above cost but would also create a sustainable pool of finance to cover the costs of generating reliable public financial information.

The staff of the public agency would be compensated as high-level civil servants. They would receive no benefits as such from providing either favorable or unfavorable ratings. Indeed, a compensation system could be established whereby the professional staff is evaluated on the basis how well their risk assessments of given assets end up comporting with the market performance of these assets over time. Safeguards would be put in place to dismiss any professional staff members

who have conflicts of interest that could compromise the integrity of their ratings.

Amid the most severe economic downturn since the 1930s Depression, we face a massive long-term project of rebuilding a financial system that is capable of supporting a stable and equitable growth path for the U.S. economy. Creating a public credit rating agency can serve as one crucial tool in facing the challenges ahead.

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