Economic Studies at BROOKINGS

Credit Ratings Agencies Woefully Overdue for Structural Change, New Brookings Paper Asserts

A single, public structured finance credit scale should become part of the U.S. regulatory toolkit for maintaining orderly debt capital markets

Credit agencies need a single, numerical, public structured credit scale to serve as a yardstick of structured credit quality in the U.S. debt capital markets, not the current ordinal scale, according to a new paper by Brookings Senior Fellow Robert Litan and ratings agency expert Ann Rutledge released today.

In spite of the fact that credit ratings agencies were widely believed to be a major cause of the recent financial crisis for their failure to warn investors of the risks entailed by the subprime mortgage securities they rated, little has been done by regulators to date to reform them, the authors write in "A Real Fix for Credit Ratings." Although Dodd-Frank instructed regulators to implement various reforms for various parts of the financial system, the credit ratings agencies continue to use the same ratings process for structured securities as before the crisis. Although various ideas to fix the system have been put forward, such as randomizing the choice of ratings agency, or replacing private ratings with those of a public agency, such as the Securities and Exchange Commission, none has yet been adopted.

"Although the SEC has required the agencies to disclose more of their methodology, the ratings process is still less than transparent," Litan and Rutledge write. Though they criticize the issuer-pay rating agency business model, they note it has been in use for more than 40 years and thus could not alone explain the "sudden explosion and subsequent collapse of the securitization market" during the financial crisis. Instead, they argue that "Transparent, numerical benchmarks of credit risk relating to structured credits should not only fix structured finance going forward, [it will] ideally help resuscitate the market but in a more sensible fashion."

They argue that the best way to fix the system is to change the way structured securities (those backed by other assets, such as mortgages and other types of loans) are rated by doing away with the century-old alphanumeric ratings of corporate bonds (AAA, AA, A, BBB, etc.) and instead to use numbers, or a cardinal rather than an ordinal (lettered) scale. "Securities that are rated only in an ordinal fashion – that is, ranked in order of likelihood of default – can be misleading, allowing sophisticated parties in the know to take advantage of naïve investors. Ordinal rankings can also lead to a sense of false comfort for investors and policy makers, which contributed to the global Financial Crisis." Litan and Rutledge also note that no two credit rating agencies use the same benchmarks, which, in structured finance in particular, is equivalent to saying no two credit rating agencies count cash the same way – which "not only violates the 'law of one price,' but the confusion for investors creates an opportunity for rating agencies to tamper with their own input scales undetected, advantaging preferred clients with cheaper funding and competing invisibly for market share."

"Given the market's propensity to exploit information asymmetries, it is not surprising that a public benchmark scale has not yet materialized spontaneously to heal the broken market. Nor is it likely to. Rating agencies for their part are no more likely now than before to volunteer to work together voluntarily to accommodate greater public scrutiny or diminish their own power," they write.

The authors outline several specific elements of true reform, the most important being a switch to a cardinal rather than ordinal ranking. The also explore which regulatory agency should spearhead credit agency reform: the SEC, either on its own or by suggestion from the Financial Stability Oversight Council (FSOC), or by the Federal Reserve. They note that the choice of regulatory sponsor depends upon the preferred regulatory model. "Regardless of which agency or agencies end up with the job, the important thing is that job itself has to be done if credibility to structured finance and to the ratings agencies and their ratings is to be restored," they conclude.

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