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Reform in the Credit Rating Industry

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Reform In The Credit Rating Industry

by

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Abstract

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Ninety three percent of all AAA-rated subprime mortgage backed securities issued in 2006 were downgraded to junk bond status subsequent to the financial crisis. The credit rating agencies clearly failed to give the early warning signs on these and numerous financial products that went bust.

This thesis investigates the role of credit rating agencies in the functioning of financial markets and proposes policy changes to reform this industry. The sources of market failures in this industry can be traced to conflicts of interest, barriers to entry, lack of accountability, and asymmetric information. I propose three possible reforms to improve the efficiency and accuracy of financial product ratings: a government-based model, a subscription-based model, and a market-based model. I provide a comparative evaluation of each model, discuss their implementability and demonstrate how they can solve the identified market imperfections.

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Chapter 1: Introduction

The credit rating industry has been a central focus of the financial world since the 2007 financial crisis. During the 2007 financial crisis nearly $3.2 trillion[1] in loans were provided to homeowners with bad debt and undocumented income. These mortgages were then packaged up into mortgage-backed securities (MBS) and collateralized debt obligations (CDO). These two financial innovations, along with the ratings provided by the agencies, played a significant role in the 2007 financial crisis. A mortgage-backed security is a type of asset that is secured by a mortgage or collection of mortgages. These securities are also grouped in one of the top two ratings as determined by an accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution. Collateralized debt obligations are an investment-grade security backed by a pool of bonds, loans and other assets. CDOs do not specialize in one type of debt but are often non-mortgage loans or bonds.

The reason why these two innovations had such a large impact during the last recession was because they received very high ratings; mostly AAA, from credit ratings agencies and the products were not actually worthy of AAA ratings. Receiving a AAA rating means that these products are the safest type of products with the lowest probability of default. When a product receives a AAA rating, this means that there will typically be a strong demand for the product. This rating is also important because certain institutions and investors can *only* invest in products with AAA ratings, so without these ratings the demand would have been significantly less and many institutions could not

[1] See Economic Review Journal. Statistics compiled by Bloomberg.

have purchased them. These financial products were problematic because of the underlying mortgages and loans that were issued were sub-prime, which ended up defaulting when the homeowners could not make the mortgage payments. Nearly 80%[2] of all the sub-prime mortgages that were issued were adjustable rate mortgages. Initially, the homeowners could afford the monthly payments, however, when the rate of the mortgage increased, they could no longer make the monthly payments, thus defaulting (see graph below for foreclosure numbers).

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are needed to see this picture.

This meant that these two products lost significant value and at some point, nearly, became worthless. Banks and other institutions that invested in these products ended up

[2] See “Senator Dodd: Create, Sustain, Preserve, and Protect the American Dream of Home Ownership”. Dodd. 2007.

having to write off over $525 billion[3] in losses as a result of the defaults on the mortgages. There was significant moral hazard associated with the financial institutions that issued these mortgages and loans to subprime debtors, that should have never received the loans. The banks that issued these mortgages did not have to hold the mortgages because they would get packaged up and sold to investors. Some speculate that the issuers of the mortgages did not actually care if the individuals were worthy to receive these loans; they just wanted to write as many loans as they could so they could make as much money as possible. When these loans defaulted, the issuers were not holding the mortgages so they didn't have the losses that the investors had. This is just one example of how credit rating agencies and highly rated financial products can have a large impact on financial markets as well as the overall economy.

What role did credit rating agencies play in the financial crisis? The credit rating agencies were the catalyst for the 2007 financial crisis. Credit rating agencies were largely responsible for the unsustainable growth of the asset-backed debt markets[4], which eventually led to the crisis. These agencies fueled the growth for asset-backed debt markets because they were providing ratings on these financial products. As long as these products receive an "investment grade" rating, there will be substantial demand and the higher the rating of the product, the safer it is considered to be. Many of the structured finance products that were being created, such as CDOs, were extremely complex and very opaque, thus, the market depended on credit rating agencies. The high ratings lured investors in to the market and caused the market to expand significantly. The downgrades

[3] For more information on losses that result from sub prime mortgages see Onaran (2008).
[4] For more information on the 2007 financial crisis see: Reinhart, Carmen; Rogoff, Kenneth. (2007)

on financial products caused the market to collapse just as fast. The credit rating agencies created a demand for these asset-backed financial products by inaccurately rating them. The financial products, evidently, were not worthy of the ratings they received but investors, blindly, made investment decisions based off of the ratings these agencies provided.

A. Role of Credit Rating Agencies in the Financial Markets

Credit rating agencies play a critical role in the operation of financial markets. Credit rating agencies provide information and quality assessments on various financial innovations[5]. The main objective of these agencies, such as Moody's, is to determine the creditworthiness of firms and securities. In order to provide their ratings, they analyze various financial, industry, and economic information. The credit ratings agencies receive fees from the issuers that were rated. Credit rating agencies are essential in the financial markets and numerous institutions and regulators rely on their ratings. Credit rating agencies can have a dramatic impact on a firm's securities because they provide information to the buyers and sellers. Ratings can help a securities price as well as liquidity.

There are a couple problems with credit ratings agencies. First, credit ratings only contain information about cash flow risk. However, they do not include systemic risk factors. This means that the ratings do not take economic statistics and factors into consideration. An example of this is how the credit ratings agencies rated mortgage-backed securities; they did not take into consideration how a housing market collapse

[5] For more information on the role of credit rating agencies see: Coval, Joshua, Jurek, Jakub, Stafford, Erik. (2008)

would affect mortgage-backed securities and investors. A second problem with the credit rating agencies is their lack of transparency in the ratings process. Another concern is that there may be a conflict of interest between the credit rating agencies and the issuers being rated. There may be a conflict of interest because the issuers are paying the credit rating agencies for their services. Credit rating agencies play an extremely large role on financial markets because institutions, regulators, and personal investors all make investment decisions based on their ratings.

B. Credit Rating Agencies During the Financial Crisis

The three major credit rating agencies (Moody's, Standard & Poor's, and Fitch) rated numerous products incorrectly during the 2007 financial crisis. The ratings agencies were not affected by the inaccurate rating like many large institutions and investors. The credit rating agencies did not have to write off billions of dollars in loses, which is exactly what the institutions and investors had to do. However, a feedback mechanism that could have affected the credit rating could have been their share price. If there was a significant decline in the credit rating agencies' share prices than this would indicate that the market is holding them accountable. The only credit rating agency of the three major ones that is not a subsidiary is Moody's. Moody's is publicly traded and its symbol is MCO. Standard & Poor's and Fitch Ratings are both subsidiaries of larger companies, McGraw-Hill Companies and Fimalac, respectively. How was the share price of each of the companies affected by the financial crisis?

Each of these three companies had a significant drop in their share prices during and after the recession. Moody's share price had rapidly increased since 2000 reaching its all time high in October of 2007 of $73.71[6] per share. Throughout the financial crisis, Moody's share value steadily decline to a low of $16.04 per share. This is a significant loss of market capitalization and was seen with the other credit rating agencies parent companies as well. McGraw-Hill Companies (symbol MHP) reach an all time high of $71 per share in 2007 and dropped to a low of $17.64 per share during early 2009. Fimalac (symbol FIM.PA) also reached its high in 2007 at $80.12 per share and significantly decreased to $21.80 per share in 2009. These three companies follow a similar pattern, losing a considerable amount of market capitalization throughout the financial crisis.

Was the decrease in share value a result of their inaccurate ratings? It is plausible that each of these companies lost nearly 80% of their market capitalization as a result of their failure to accurately rate numerous financial products. However, during the same time period the major stock indices also lost significant value, some as high as 60% of its overall value. These three companies had larger losses in value relative to the stock indices. It is possible that the market was holding the companies accountable for their inaccurate ratings but it is difficult to determine if that was the only factor considering the overall stock market had tremendous losses as well.

The contribution of this paper is to analyze the credit rating agency, identify possible imperfections, and propose reforms that could address these issues. Section 2 discusses the history of the credit rating industry, the identified market imperfections, and how the product rating market has addressed some of the same problems that are prominently observed in the credit rating industry. Section 3 presents policy

[6] All share prices were obtained from Yahoo Finance.

recommendations and alternatives to the current system as well as recent legislations that have attempted to hold credit rating agencies more accountable. The last section summarizes my findings and discusses the shortcomings of the paper.

Chapter 2: Analysis of Credit Rating Agencies

As a result of the financial crisis of 2007, there has been a significant amount of focus on the credit rating industry and some of its potential market failures. The three main rating agencies are Moody's, Standard & Poor's, and Fitch. The credit rating market can be best described as an oligopoly. Moody's and Standard & Poor's each control 40% of the market, Fitch has a market share of 14%, and seven other companies control the remaining 6%[7]. Each of these three companies is a Nationally Recognized Statistical Rating Organization, appointed by the Securities and Exchange Commission. The recent recession has brought credit rating agencies to the forefront and suggests that there might be some imperfections in the credit rating market. There could be potential imperfections in the credit rating industry because of the lack of competition, conflicts of interest, quality of ratings, and lack of accountability. Credit rating agencies have been a focal point because of the ratings they provided to some of the financial products, which in hindsight, were clearly not deserving of those ratings. One specific example is when the big three credit rating agencies failed to downgrade Enron's investment ratings prior to the company's bankruptcy. As a result, individual investors held civil suits against most of the major credit rating agencies. The ratings that the three main agencies provide to financial products are listed below:

[7] See White (2001) for more information.

Table 1: Types of Ratings

	Rating Agency	
Rating Group	Moody's	S&P, Fitch
Investment Grade	AAA	AAA
	AA	AA
	A	A
	Baa	BBB
Speculative Grade	Ba	BB
	B	B
	Caa	CCC
	Ca	CC
	C	C
Default	D	D

The Table 1 above illustrates how the credit rating agencies determine the credit worthiness of financial product. The highest rating with the least amount of risk is a AAA rating, while the lowest rating with the highest amount of risk is a C rating. Investment grade products are rated BBB or Baa and above. Ratings are essential in the credit rating industry because they could drive demand to a specific product or cause a dramatic sell off, if downgraded.

A. Industrial Background

John Moody was the first one publishing bond ratings. Moody's firm first started publishing bond ratings in 1909[8]. This financial innovation sparked other companies to enter the market. Poor's Publishing Company entered in 1916, Standard Statistics

[8] See "The Credit Rating Industry: An Industrial Organization Analysis" by White (2001) for more information.

Company in 1922, and Fitch Publishing Company in 1924. Initially these rating companies sold their ratings to investors and investors paid for their product.

During the 1920s and 1930s thousands of banks failed as a result of the Great Depression. Throughout the decade of the 1920's an average of 70 banks failed nationally each year[9]. The number of bank failures significantly increased in the 1930s. In the year of 1933, it is estimated that over 4,000 banks defaulted and around 9,000 banks defaulted for the entire decade of the 1930s. As a result of these bank failures, a few key changes that took place. The first change is the creation of the Securities and Exchange Commission in 1934. The SEC prompted legislative changes, which incorporated credit ratings, making these agencies even more important. The SEC and new legislation encouraged banks to hold safe bonds in their portfolios to reduce risk. In 1936, federal regulations prohibited banks from investing in any product that was "speculative." This meant that they could only hold financial products that were "investment grade", meaning that they were BBB or better. These guidelines still apply to banks today. This financial regulation made credit rating agencies key players in the financial markets and, also, provided them with a significant amount of power. Banks could no longer make their own judgments about the risk of a certain financial products, they were required to go on the ratings of the main credit rating agencies. Insurance companies also started to use credit ratings when state regulators wanted the companies to have adequate capital to support the riskiness of the bonds they held. The state imposed capital requirements as a result and credit rating agencies were once again called upon. In 1941, Standard and Poor's merged to form the big three credit rating agencies that are present today. During

[9] See Ganzel (2003)

the 1970s, federal regulators required pension funds, state and federal, to get their ratings from these agencies. In 1975, the SEC created **the Nationally Recognized Statistical Rating Organization** (NRSRO) to ensure that there weren't illegitimate firms creating AAA ratings. The SEC "grandfathered" the big three firms in; Moody's, Standard & Poor's, and Fitch. The SEC and federal regulators adopted the NRSROs as a source of ratings that their financial institutions must heed in their choices in financial products.

By the end of 2000, there were only three NRSROs. The SEC was the regulator that limited entry into the market. Some believe, the SEC was not transparent in its selections for NRSROs either. Up until 2000 or so, they never had defined criteria and never explained its decisions when rejecting applications. In 2003, the SEC was feeling pressure to expand the number of NRSROs so it admitted Dominion Bond Rating Services. In 2005, the SEC admitted A.M. Best into the NRSRO. In 2006, Congress passed the Credit Rating Agency Reform Act, which instructed the SEC to allow other agencies to enter the market and also made them develop a strict set of guidelines. In 2007, there were three new agencies admitted; Japan Credit Rating Agency, Rating and Information, Inc., and Egan-Jones. In 2008, two more were admitted; Lace Financial and Realpoint. Although more agencies have entered the credit rating market, they have not been competing with the big three and imperfections in the market still exist. These companies have not been directly competing with the big three because some of the companies rate different products, like insurance, and because of the reputation of the main three agencies.

B. Imperfections in the Credit Rating Industry

i. Lack of Competition

What are the underlying imperfections in the credit rating market? The first major flaw with the credit rating market is the lack of competition. Competition encourages firms to be more accurate with their ratings or else institutions and investors will no longer consider utilizing those ratings. Competition drives often leads to low quality companies exiting the market. There are two main reasons why there is a lack of competition in the credit rating industry, regulation and reputation. In 1975[10], the SEC designated bond-rating agencies as "nationally recognized statistical rating organizations" (NRSROs). The SEC automatically designated the current big three agencies (Moody's, Standard & Poor's, and Fitch) as NRSROs. This automatic designation "grandfathered" them into their current positions and the oligopoly market. This designation meant that companies had to go through these agencies in order to have their products rated, so the SEC effectively established an oligopoly market for credit rating agencies. The structure of this market has remained the same for the past 30 years until recent regulations. Current regulations also slightly limit who enters the market, the ultimate decision is left up to the SEC. The second reason that there is a lack of competition is because of reputational capital[11]. Reputational capital plays a significant role because investors and institutions rely on established agencies with a reputation of accurate ratings. Moody's CEO, Raymond McDaniel, once said " we are in a business where reputational capital is

[10] For further information see "Testimony: The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets" by Christopher Cox (Chairman of the SEC) http://www.sec.gov/news/testimony/2007/ts092607cc.htm
[11] Partnoy (1999) discusses reputational capital and how important it is to credit rating agencies.

more important." Reputational capital makes entry into the market difficult because institutions will continue to use an agency with a track record as opposed to a brand new agency with no reputation.

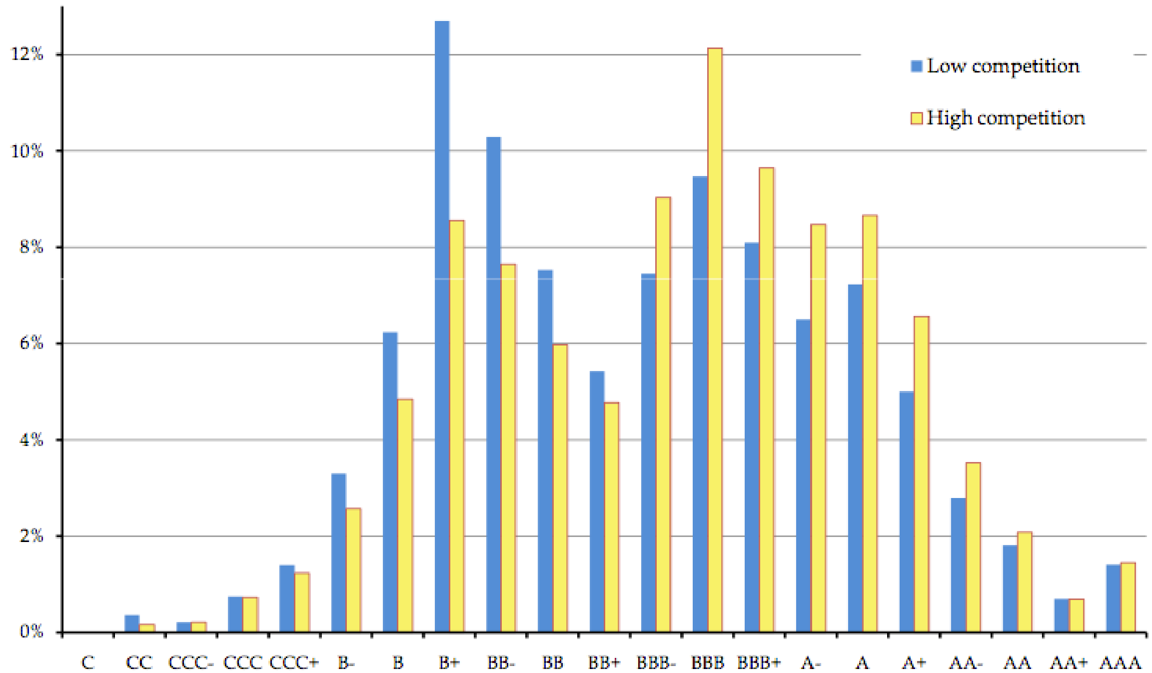
Institutions and investors also prefer a few agencies rather than a larger number of agencies. The reason for this is because that when reading the ratings on certain financial products they prefer not to have numerous different ratings by different companies. Investors prefer a select group of ratings because it keeps transaction costs low. A large number of credit rating agencies, essentially, requires the investor to do more research to determine the actual rating of the financial product as oppose to a select group of agencies doing it for them.

Although lack of competition is extremely important, there is a direct correlation with the amount of competition in the credit rating market and quality of ratings determined by the agencies. The way Becker and Milbourn (2009) determined the level of competition was by Fitch's market share. Meaning, when Fitch's market share increased there was more competition in the credit rating industry. The ratings were gathered from all agencies, not just Fitch. The graph below clearly demonstrates that competition promotes higher rates, and an overall lower quality of rating[12]. The blue bars signify low competition in the credit rating market, meaning that Fitch had a relatively small market share. The yellow bars signify periods, which Fitch had a larger market share and competition was greater in the credit rating market. The graph below covers all bond ratings from investment grade to speculative bonds. Starting with BBB- bonds and

[12] See Becker and Milbourn (2009). Becker and Milbourn believe that even if there is more competition in the credit rating industry, that it would not make a difference because of the reputations of the existing firms in the market. The increased competition will only strengthen the importance of reputation.

moving right, it is evident that during periods of higher competition, bonds receive higher ratings than in periods of low competition. Looking to the left of BBB- bonds another trend emerges, during periods of low competition more financial products are rated lower than in periods of high competition. The distribution of the ratings shifts to the right, meaning higher rated products, during periods of high competition. This graph suggests that competition has an impact on the ratings that the agencies provide. A lack of competition in the market produces, overall, lower ratings, which mean that the ratings are more accurate. The reason why competition is correlated to higher ratings is because the agencies are competing for business; therefore they will issue higher ratings to be more attractive to the companies that want to have their financial products rated. There is a tradeoff between competition and the quality of ratings. Issuers of these financial products benefit when there is more competition in the market. The argument is that more firms in the market will provide better quality ratings but this is the exact opposite because more firms are competing for business and thus inflate their ratings to attract companies. However, this problem could be alleviated if the credit rating agencies were held accountable for their ratings. Credit rating agencies might be held accountable if regulation held them liable for the ratings they provided, meaning institutions and investors could sue them. Another way in which credit rating agencies could be held accountable is by facing fines and large penalties for inaccurate ratings. These are a few examples of what could be done.

Firm credit ratings distribution: high and low competition in the credit rating industry



Source: Becker and Milbourn (2009)

ii. Conflicts of Interest

The second significant flaw with credit rating agencies is that there are severe conflicts of interest. There are two main models that the agencies use; the issuer-pay model and the subscription model. There are conflicts of interest associated with each model. The **issuer-pay model** is how credit rating agencies generate the majority of their revenue. This is when the institutions pay the agencies in order to have their financial products rated. A conflict of interest arises from this because the agencies could provide inflated credit ratings in order to attract customers and increase their revenue. Inflated credit ratings are concerning because investment decisions are made based on credit ratings, an inflated credit rating could draw more investors to a low quality financial product. A conflict of interest also arises from the subscription model; this is the model that product-rating agencies use. **The subscription model**[13] is when institutions and investors pay the agencies a fee in order to receive their ratings. There are conflicts of interest with this model because large subscribers are typically institutions and hedge funds. These subscribers typically have long and short positions on various rated products. A long positions means that they anticipate the price of the product they own to increase. A short position is when the investors anticipate that the value of a product is going to decrease, a short position essentially bets against a product. If the credit rating agencies were to downgrade a product that the institutions have a long position in, then it could lead to potential losses. Therefore, the rating agencies are incentivized to provide ratings that benefit their clients or else they might lose their subscribers. Both models that credit rating agencies use have inherent conflicts of interest, making it difficult for the agencies to provide objective ratings.

iii. Credit Rating Agencies Have Become Market Creators

With their ratings, credit rating agencies can channel demand to certain products. They have the ability to influence investors to purchase certain products depending on the rating it receives. It also works in the opposite direction; credit rating agencies could downgrade a product, leading to a significant sell off. The market acts directly upon the credit ratings of financial products. The three main agencies all explain in their business models that their ratings are opinions of the creditworthiness of the issuers. For example Standard & Poor's clearly states, "Credit ratings are opinions about credit risk published by a rating agency. They express opinions about the ability and willingness of an issuer,

[13] The subscription-based model eventually became obsolete in the credit rating industry because of evolving technology and the free-rider problem. See "The Credit Rating Industry: An Industrial Organization Analysis" by White (2001).

such as a corporation, state or city government, to meet its financial obligations in accordance with the terms of those obligations. Credit ratings are also opinions about the credit quality of an issue, such as a bond or other debt obligation, and the relative likelihood that it may default. Ratings should not be viewed as assurances of credit quality or exact measures of the likelihood of default. Rather, ratings denote a relative level of credit risk that reflects a rating agency's carefully considered and analytically informed opinion as to the creditworthiness of an issuer or the credit quality of a particular debt issue."

Fitch has a similar statement for their business model; "Fitch is in the business of publishing research and independent ratings and credit analysis of securities issued around the world. A rating is our published opinion as to the creditworthiness of a security distilled in a simple, easy to use grading system." Lastly, Moody's clearly states "credit ratings are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, selling or holding." These excerpts from the big three credit rating agencies' mission statements clearly demonstrate how they identify their ratings as a matter of opinion. Each of their business models also discusses how investment decisions should not be based on their ratings. However, we know that certain institutions, like state pension funds, require investment in the safest products. It is clear that the ratings provided by these agencies are *directly acted upon* and have an impact on the financial markets. Conflicts of interest are once again an issue because these agencies can essentially control what products investors will purchase.

iv. Asymmetric Information

The fourth imperfection, which is strongly tied to credit rating agencies being market creators, is asymmetric information. There is a significant amount of asymmetric information regarding credit rating agencies and the products they rate. The investors do not have the same information as the sellers of these products, that is why credit rating agencies get involved. However, the credit rating agencies still know more information about the creditworthiness of a product than the investors in the product. Typically, the issuers of the product know more about the creditworthiness of the product than the ratings agencies. An example of this was during the past financial crisis. The issuers of CDOs and MBS were putting together products that they knew would be highly rated but the underlying assets were not worthy of these ratings. The majority of these products defaulted or lost significant value, but the issuers of these products were unaffected because they were the ones creating them. In order to make money they need to create a demand for the products and the only way to do that is to have them highly rated. Thus, there is a significant amount of asymmetric information on the issuers' behalf. There is also asymmetric information with credit rating agencies because investors trust their opinions, when the credit rating agencies have more information than the investors. The lack of transparency and significant amount of asymmetric information are a few of issues in the credit rating market. A result of asymmetric information is adverse selection. Adverse selection is a product of asymmetric information. Adverse selection means that there are bound to be “bad” products in the market because sellers know more information about the products than the buyers. This is true in the financial markets, specifically the credit rating industry. The issuers of financial products know more about their inherent risk than any other party. Therefore, “bad” financial products will be issued and it is the credit rating agencies’ job to determine the quality of the product. If they cannot properly asses the financial product’s inherent risk, a low quality product could be issued and receive a high rating. Adverse selection tends to occur when there is asymmetric information.

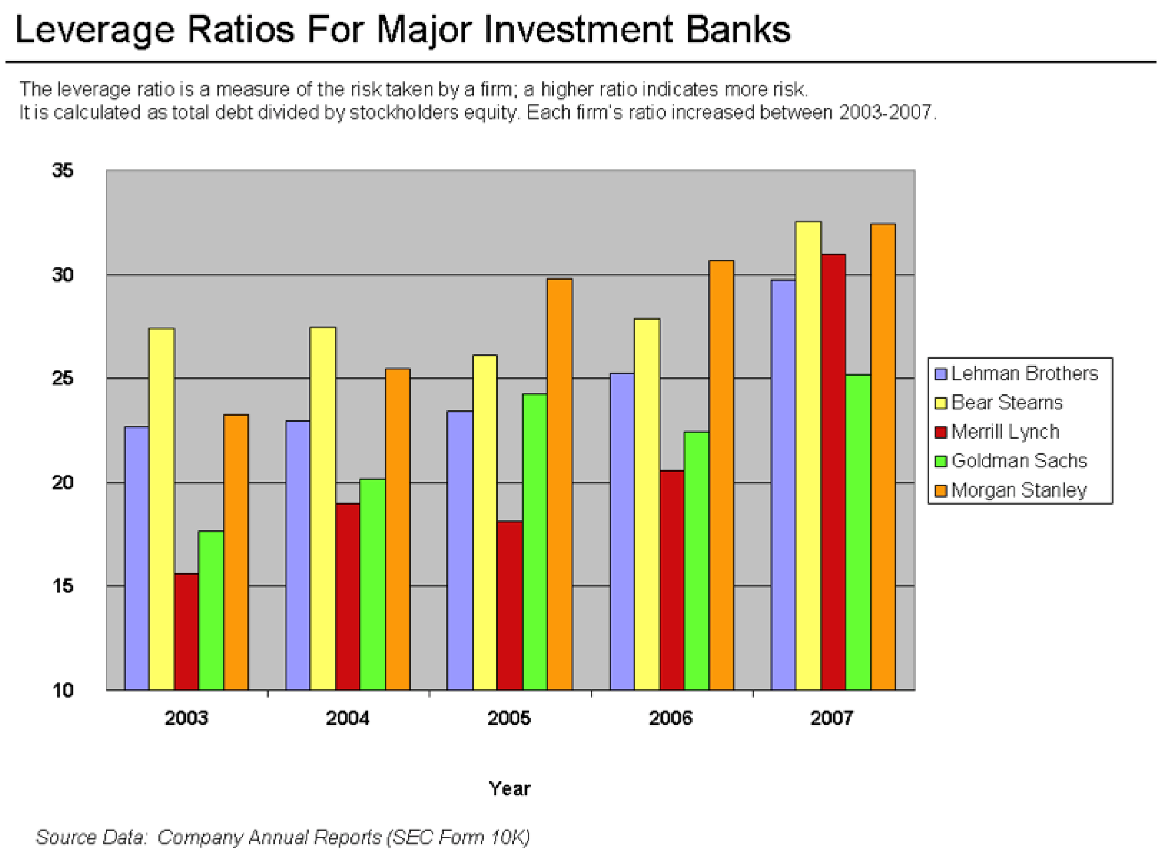
v. Accountability in the Credit Rating Industry

Why are credit rating agencies not accountable for their ratings? For the longest time credit rating the SEC protected agencies. The SEC adopted a rule that exempted all credit rating agencies from any liabilities[14]. The credit rating agencies that are exempt from any liabilities could deceive investors if they wanted and the investors can’t sue for the faulty information. This rule was passed nearly 30 years ago and stood throughout the 2007 financial crisis. These agencies have a significant effect on the financial markets and for them to be giving out any rating with any repercussions is a serious problem. An example of the effect these agencies can have is the AAA received by mortgage-backed securities. Since the agencies put AAA ratings on mortgage backed securities and similar products, investors believed they were risk-free assets and, thus, purchased them. Then, once people started to realize that the ratings might be inaccurate, the agencies downgraded the assets causing a downward spiral that lead to billions of dollars lost. While institutions and investors wrote off $525 billion in loses, the agencies were not

[14] See Nasiripour (2010)

held accountable for their ratings. This demonstrates how credit rating agencies can control investment and the sell off of financial products with their ratings and they are, clearly, not held accountable for their "opinions".

The five largest financial institutions that were involved with MBSs and CDOs were Lehman Brothers, Goldman Sachs, Bear Stearns, Morgan Stanley, and Merrill Lynch. In 2004, the SEC passed legislation that enabled these institutions to issue substantially more debt. These institutions then used the capital they received from issuing the debt to invest in MBSs and CDOs. These five institutions alone reported over $4.1 trillion in debt for the 2007 fiscal year. Not only were these institutions issuing more debt but they also were using more leverage, increasing their exposure to MBS and CDOs. The graph below demonstrates the substantial increases in leverage by these institutions from 2003 to 2007. As a result of the excessive exposure and risk these companies took to MBSs and CDOs, Lehman Brothers and Bear Stearns declared bankruptcy, Merrill Lynch was bought by Bank of America, and Goldman Sachs and Morgan Stanley each received a significant amount of capital from the Troubled Asset Relief Program (TARP). The losses of these institutions can be attributed to the financial products they were exposed to, the ratings the products received from the agencies, and the regulation that enabled excessive risk.



Although credit rating agencies are exempt from all liabilities under the Securities Act of 1933, civil suits have been filed and taken to court. Credit rating agencies have been sued in two forms; by institutions and by investors. However, neither or the groups have been successful. For example, there was a lawsuit filed against Moody's by the Jefferson County School District in 1999. In this case, the school district claimed that the poor rating provided by Moody's was materially false. The school district also claimed defamation and interference with contractual and business relations. This lawsuit was dismissed from the county court, thus Moody's was not held accountable. Another example of an institutional lawsuit is Compuware Corp. v. Moody's (2007). In this case, Compuware was suing Moody's because of alleged breach of contract, defamation, fraud, and violations of the Investment Adviser's Act for issuing a negative report on the company's financial future. This case was dismissed from court and Moody's was once again not held accountable. A third example of an institution filing a lawsuit against a credit rating agency was in 1999, County of Orange v. McGraw Hill Cos. Orange County filed a $2 billion suit against Standard & Poor's, which is a subsidiary of McGraw Hill Cos., because of alleged breach of contract and professional negligence. Both parties settled this lawsuit for $140,000, nothing close to the $2 billion in damages the county claimed. Institutions filed these three lawsuits against credit rating agencies and each lawsuit had a similar result.

Investors have filed civil suits against credit rating agencies as well. In 2005, Enron investors filed a lawsuit against various credit rating agencies. The investors claimed negligent misrepresentation and unfair trade practices in the U.S. Distrcit Court for the Southern District of Texas for failing to downgrade Enron's investment ratings before it declared bankruptcy. This civil suit was dismissed from court and the court found that the First Amendment protected the credit ratings agencies. Another example of an investor suing a credit rating agency is Quinn v. McGraw Hill Cos. Quinn was a majority shareholder of several Illinois banks who sued Standard & Poor's as a result of Standard & Poor's rating on collateralized mortgage obligations (CMOs). The banks that Quinn was a majority shareholder in, invested in CMOs after the banks were assured that Standard & Poor's would give the bonds an "A" rating. The CMOs were initially given an "A" rating but were later downgraded to "CCC", which is no longer investment grade. As a result of the downgrade the banks and Quinn lost significant amounts of money. The courts dismissed the case on the basis that Standard & Poor's disclaimer says that S&P's

ratings are not a recommendation to buy, sell, or hold financial products. The lawsuits filed by the investors have also ended in similarly to the ones filed by institutions.

The civil suits filed by both institutions and investors demonstrate how credit rating agencies are not held accountable for their ratings. Each of the lawsuits filed resulted in dismissal from court, with the exception of one that was settle for a small fraction of the alleged damages. A lack of accountability is evident in the credit rating industry. The companies produce ratings, which are acted upon by institutions and investors, and when the ratings are incorrect, the First Amendment protects the agencies ensuring that the civil suit will most likely be dismissed.

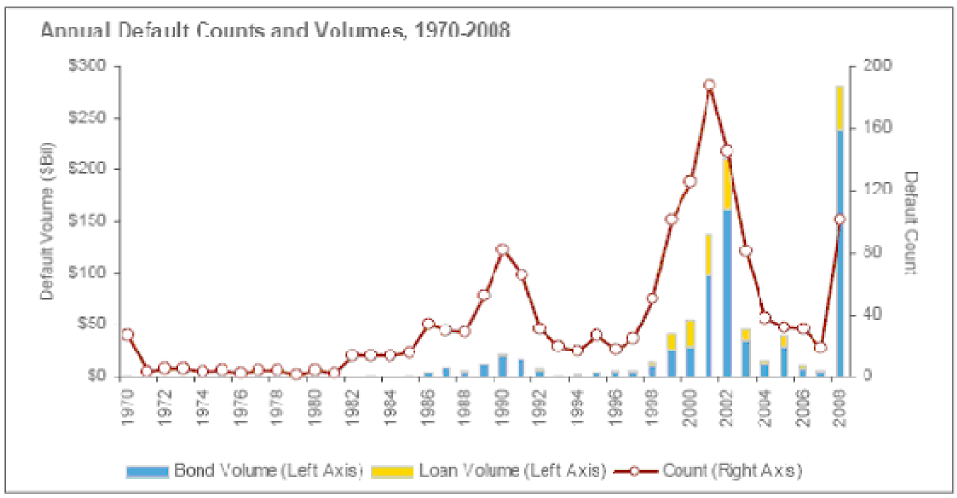
Recently, legislation was passed to hold credit rating agencies more accountable for the information they provide. This piece of legislation was the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010). This act was intended to hold NRSROs more accountable for their ratings. It holds the rating agencies accountable by letting investors take action, by the means of a lawsuit, against them if they inaccurately rate products. Although this is a step in the right direction there will need to be more accountability in order to produce the most accurate ratings.

vi. Inaccurate Credit Ratings

The final failure in the credit rating market is the inflation of credit ratings. Credit rating agencies have, some suspect knowingly, overrated financial products for various reasons. This can have a dramatic impact on the financial markets and the investments of institutions. The graph below demonstrates the amount of corporate default from 1920-2008. The amount of corporate default in 2008 is a sign of a major problem. Around $275 billion[15] in corporate bonds defaulted during 2008, many of which were not junk bonds and had low probabilities of default, according to the credit rating agencies. These losses were extremely significant and the inflated ratings were most likely contributed by a conflict of interests as oppose to accidentally mis-rating the products. The nominal value of corporate default was the highest it has ever been.

Corporate Default and Recovery Rates, 1920-2008

Exhibit 1



Source Moody's 2002 Data reflects corporate default and recovery rates through 2008.

2009 Corporate default and recovery rates may be substantially higher.

There are a few significant imperfections in the credit rating market that need to be addressed. Recent legislation has taken a step toward holding rating agencies more accountable, however much more needs to be done in order to ensure top quality, objective ratings. Credit rating agencies have such a significant impact on the financial markets, thus the reason why some policy changes might be needed. A market that has been successful in producing accurate and nonbiased ratings is the product rating market. The credit rating market might be able to incorporate some aspects of the product rating market to ensure they produce the best credit ratings.

[15] Fidelity Personal Investing-Credit Default Risk

The credit rating industry and the product rating market have many similarities. Both industries are tasked with providing accurate ratings on various products in an unbiased manor. Companies in the product rating industry have addressed some of the credit rating market imperfections. The credit rating industry might be able to incorporate some of the policies that the product rating market has in place.

C. Lessons from the Product Rating Market

The product rating market has been a relatively efficient rating market. There are many aspects of the product rating market that make their ratings some of the most reliable. One company with a great reputation is Consumer Reports. Consumer reports rates a wide variety of products ranging from cars to televisions. They have taken many steps to ensure that their ratings are unbiased and as accurate as possible. Consumer Reports publishes its reviews and comparisons of consumer products and services based on its own in-house testing. Consumer Reports allocates around $21 million per year for its testing process. Their in-house testing is important because there is no other party influencing the outcomes of their tests. Consumer Reports attempts to maintain objective and provide a unbiased rating because they purchase all their products at full retail price. This also eliminates conflicts of interest because they are paying what the consumer would pay and are not receiving any free products. Consumer Reports uses the subscription model to generate its revenue and currently has around 7.3 million subscribers. The subscription model eliminates any conflicts of interest because companies are not paying Consumer Reports to have their products rated, the way it works in the credit rating industry, therefore Consumer Reports does not have any interest in inflating certain products ratings for certain companies to generate business. Consumer Reports, also, does not print outside advertising and it doesn't allow the commercial use of its reports for selling products. This product rating company is strictly focused on providing unbiased results to the consumers. They have taken substantial measures to ensure that there are no conflicts of interest.

A significant benefit of the Consumer Reports subscription model is that it provides feedback mechanisms. A feedback mechanism is a way the market reacts to the ratings Consumer Reports provides. For example, if Consumer Reports frequently inflates product rating and gives low quality products high ratings then consumers will most likely stop subscribing for Consumer Reports services. Consumer Reports will then lose revenue as a result of their poor ratings. A feedback mechanism should be the same for the credit rating industry as well. However, two of the big three credit rating agencies are not publicly traded because they are subsidiaries of other, larger companies, eliminating the share price feedback mechanism. The only company, which is not a subsidiary, which is publicly traded is Moody's. A feedback mechanism might be investors selling Moody's shares as a result of poor ratings on financial products, but there is no evidence that this occurs. Feedback mechanisms are crucial in the financial markets and are lacking in the credit rating industry.

The main drawback from a subscription-based system, like Consumer Reports, is that they do not rate all products in the market. This implies that there might be a bias because the product rating companies might rate the popular products and overlook a quality product that has not been discovered by the market yet. A product rating company cannot rate every product in the market, making this a significant drawback.

Another company in the product rating market is J.D. Power and Associates. J.D. Power and Associates rates a wide variety of products including automobiles, boats, electronics and insurance. They conduct their market research through consumer surveys, which is completely funded by the company and sample sizes can range from a few hundred to over 100,000. Although they fund their own surveys, they choose whether their samples are randomly selected or consumer targeted. J.D. Power conducts its own vehicle testing in addition to the consumer surveys. The majority of the company’s revenue comes from other companies that utilize the market data that J.D. Power provides. A small portion of their revenue comes from companies that purchase licenses to use and quote J.D. Power and Associates results. There are potential conflicts of interest because of the way they generate revenue. Companies that are purchasing J.D. Power’s market data might influence J.D. Power to provide better ratings if J.D. Power rates the company’s products. It is clear that J.D. Power has not taken the same steps as Consumer Reports to address certain conflicts of interest. J.D. Power and Associates is similar to credit rating agencies in certain aspects because the way they generate their revenue, through an issuer-pay type of model, and the inherent conflicts of interest. Although there might be some conflicts of interests, their ratings are highly regarded and reliable.

How do the mission statements of product rating companies compare to credit rating agencies? There are both similarities and differences between the two industries. Consumer Reports’ mission statement says “Consumers Union (CU) is an expert, independent, nonprofit organization whose mission is to work for a fair, just, and safe marketplace for all consumers and to empower consumers to protect themselves. The organization was founded in 1936 when advertising first flooded the mass media. Consumers lacked a reliable source of information they could depend on to help them distinguish hype from fact and good products from bad ones. Since then CU has filled that vacuum with a broad range of consumer information. To maintain its independence and impartiality, CU accepts no outside advertising and no free samples and employs several hundred mystery shoppers and technical experts to buy and test the products it evaluates[16]." Consumer Reports' mission statement does not mention anything about opinions or whether or not their ratings should be acted upon. The main objective of their mission statement is to emphasize that they have taken steps to address conflicts of interest. J.D. Power and Associates' mission statement says "J.D. Power and Associates is a global marketing information services company operating in key business sectors across a variety of industries, including market research, automotive forecasting, performance improvement, Web intelligence, and customer satisfaction. Established in 1968, the company has been listening to consumers and business customers; analyzing their opinions and perceptions; and refining research techniques and study methodologies to offer some of the most advanced product quality, customer satisfaction, and tracking research available today. The company's quality and satisfaction measurements are based on responses from millions of consumers annually." Their mission statement does not mention that their ratings are opinions nor does it mention that their ratings should not be acted upon. While most credit rating agencies mention that their ratings are published opinions and should not be acted on, the product rating market does not take these measures.

[16] For more information on Consumer Reports see consumerreports.org.

It is evident that the product rating market has managed to get the rating process right. There are many aspects of the product rating market that the credit rating industry could incorporate to produce the best quality ratings possible.

D. Summary

The credit rating industry is very important and has a significant impact on the financial system. They have such a large impact because they are market makers. Since this industry has so much power in the financial markets, it's essential that their ratings are as accurate as possible. The flaws in the credit rating industry have been exposed with the most recent financial crisis. The credit rating industry could potentially learn from the product rating market. Companies, like Consumer Reports, have managed to produce nonbiased ratings by taking extensive measures to address conflicts of interest, and the same could be done in the credit rating market.

Chapter 3: A New Framework for the Industry

What type of reform would potentially increase the reliability of credit rating agencies? It is evident from the previous section that there are some significant imperfections in the credit rating market. A large numbers of credit ratings did not accurately reflect the ex-post risks embedded and the 2007 financial crisis highlighted this. The ratings on various financial products could have been affected by conflicts of interest and lack of accountability. There are three types of reform that might provide better results than the current ratings system. The credit rating market could be market-based, subscription based, or government based. There are benefits and drawbacks from each option however, they might be more effective at providing the most accurate credit ratings.

A. Market-Based System

One possible solution that would reform the credit rating industry would be to move credit rating agencies to a market-based system, meaning that there are no ratings because the market determines the creditworthiness of the product and this is reflected in the price of the product. A market-based system would be based on credit default swap rates. A credit default swap is a contract in which the buyer of the credit default swap makes a series of payments to the seller and receives payoff, in exchange, if the credit instrument experiences a credit event, such as default. Credit default swaps are used to hedge risk and are a form of reverse trading. For example a product with a low probability of defaulting would be traded at lower levels than products with higher probabilities of defaulting. The market would, essentially, determine if the specific products are investment grade or speculative based on the prices of the credit default swaps.

There are many benefits to a market-based system. The first benefit would be the elimination of conflicts of interest. Currently, there is a tremendous amount of conflict of interest in the credit rating industry and a market-based system would take a significant step to ensure that no firms are influencing the ratings of specific financial products. A second benefit of moving to a system based on credit default swaps is that investment decisions would no longer be based on “upgrades” or “downgrades” put out by credit rating agencies. Institutions would be forced to conduct their own research on the financial products they are investing in and they are held accountable for the outcomes of their investment decisions. A third important benefit is that credit rating agencies would no longer be in federal regulations. This means that there will not be an artificial demand for certain products just because they are required by regulation.

It should be noted that a market-based system has some drawbacks. The first drawback from a market-based system is that certain financial products will not be “rated”. In a market-based system there are not credit default swaps on every product, therefore certain products will be omitted from the system, similar to the product rating market. In the issuer-pay model, like the current credit rating system, any product can receive a rating as long as the issuer pays one of the credit rating agencies. This means that specific products are not omitted from the system. A second drawback from a market-based system is that specific credit default swaps might not be very liquid. This would mean that there is low volume, which would significantly affect the spread (the difference between the bid and the ask) of the products being traded. A credit default swap that isn't very liquid would not reflect the true creditworthiness of the underlying financial product. Each system has its advantages and disadvantages, thus making it challenging to determine which is the most efficient.

Although the market-based system has its drawbacks, it is likely to provide an unbiased evaluation of financial products. It will otherwise be difficult to get an unbiased evaluation if credit rating agencies are involved. This is just one plausible option that would address some of the identified imperfections in the credit rating industry.

B. Subscription-Based System

Another possible solution to reform the credit rating industry would be for the agencies to move away from the issuer-pay model to the subscription-based model in order to generate revenue. The subscription-based model is when investors or institutions pay the credit rating agencies in order to get their ratings on specific financial products. This is how Consumer Reports operates and how the credit rating agencies operated over 40 years ago.

The subscription model in the credit rating industry has its benefits. One of the biggest advantages of this model is that the majority of the existing conflicts of interest will be eliminated. Conflicts of interest would be eliminated because companies would no longer be paying the agencies to rate their products. The subscription model would remove the issuers of the financial products entirely, whereas they currently deal directly with the credit rating agencies. A second indirect benefit of this model is that it will promote accountability because the subscribers will no longer purchase the credit rating agencies' products if their ratings are constantly inaccurate or inflated. The current issuer-pay model does not hold credit rating agencies accountable for their ratings because there is no way for the companies to lose revenue. The current system encourages companies to inflate ratings in order to gain issuers. If the agencies provide inaccurate ratings there is no way for the investors to hold them accountable, however if there was a subscription based model investors could. The subscription model had proven to be effective in the product rating market and it could do the same in the credit rating industry.

However, there are some drawbacks to the subscription model. Similar to the market-based system, certain products might be omitted from the rating process. A second disadvantage that could arise from the subscription-based model would be the free-rider issue. This is the initial reason why the credit rating agencies moved to the issuer-pay model. Individuals that do not subscribe to the agencies might get the information from a subscriber, causing losses in revenue for the credit rating agencies. The free-rider problem is a significant issue with this business model and a cause for concern among credit rating agencies. The third disadvantage of this business model is that there could be a potential conflict of interests. A conflict of interest could occur because of the institutions that would subscribe to receive the rating information. Large institutions and hedge funds would be the majority of subscribers and the main form of revenue. Institutions and hedge funds invest in various financial products and the ratings of these products could have a direct impact on the value of these financial products. The credit rating agencies might be incentized to provide inaccurate ratings to keep their subscribers happy. If large accounts threaten to cancel their subscription if ratings are not to their liking, the agencies could potentially have a conflict of interest. However, a conflict of interest might always exist but taking steps to address it is how the credit rating industry will be improved.

A fourth drawback of the subscription-based model is that not all of the information is accessible to the public. Individual investors would find it difficult to obtain credit rating information because the majority of small investors could not afford the subscription. However, a plausible solution to price discrimination could be a government subsidy. The government could provide an allowance to small investors that cannot afford the costly subscription. In the corporate environment the government could enable corporations to pay for their subscriptions with pre-tax dollars, which is another way of subsidizing the subscription for institutions that cannot afford it. A government subsidy would benefit all parties because all investors could obtains a subscription, the agencies are generating revenue from new subscribers, and conflicts of interest are minimized.

The subscription model would be a good alternative to the issuer-pay model. A subscription-based system would provide increased accountability while eliminating some conflicts of interest. There are drawbacks associated with the subscription-based model, like the free-rider problem and omission of certain financial products. Overall, this system is a plausible alternative to the issuer-pay model.

C. Government-Based System

Implementing a government-based or government funded credit rating agency is another possible reform that could make the credit rating industry more efficient. A government-based system would be similar to the Food and Drug Administration[17]. Funds in the federal budget would be allocated to ensure the government-based credit rating system would be able to operate effectively. The government-based system would allow every investor and institution to access its ratings on various financial products. The ratings would be public goods and the government would incur all costs. In order to have products rated, the issuers would approach the government-based credit rating agency and provide all necessary information, as they would to the current private credit rating agencies. The issuers of the debt will have to incur all costs associated with the ratings process. The government-based system would then provide ratings on the various financial products. A government-based system has been sufficient in the food and drug market, suggesting that it might be effective in the credit rating industry.

There are many benefits to a government-based credit rating agency. The first is that credit ratings will be available to everyone because it is a public good. Making credit ratings a public good would eliminate some of the disadvantages of the subscription-based system and the issuer-pay system. A second benefit is that financial products would not be omitted from the evaluation process. In a government-based system, all issuers would be able to have their products rated, something that would be difficult in a subscription-based and market-based system. A third benefit from a government-based system would be a central rating agency, as opposed to numerous agencies with different types of ratings and rating methodologies. Both institutions and issuers would benefit from a uniform way of rating products. A government-based system might encourage more accurate ratings because it would have a vested interest in the health of the U.S.

[17] For more information on the FDA see fda.gov

economy, making it less likely to inflate ratings because of the impact downgrades can have.

While there are many benefits to a credit rating system backed by the U.S. government, there are also disadvantages. If a government-based system were to rate financial products there could be a potential conflict of interest. If a government-based system were to rate U.S. debt then it might be inclined to provide a AAA rating. The government-based agency, most likely, would not downgrade U.S. debt because of the negative repercussions it would have in terms of financing and stability. This demonstrates how a conflict of interest could arise; however the government-based system would be very reliable with corporate debt and financial products. A second disadvantage of this system is that the U.S. government backs the credit ratings; therefore if financial products are misrated then the government is held accountable. This could pose a problem because if the government-based credit rating agency provides high ratings on products which later default, the government might be sued by the investors who relied on the credit ratings.

A serious problem that could be encountered by a government-based system is that citizens might not be willing to have their tax dollars go towards an institution that does not directly benefit them. If taxpayers are not willing to fund a new government agency then this would not be a possibility. A second serious problem that could arise is moral hazard. The government-rating agency could potentially rate certain bell-weather institutions generously because of the ramifications they could have on the overall financial markets, which directly affects the U.S. economy.

The government-based system could be an efficient way to produce accurate credit ratings with minimal conflicts of interest. This solution has its advantages and disadvantages but it's a strong alternative to the current credit rating system.

Each one of these systems is a plausible solution to the current imperfections in the credit rating industry (see the table below for the benefits and drawbacks for each). A single solution cannot address all the issues in the market, however it is essential to minimize the imperfections. It is evident that the credit rating industry needs to be reformed and each one of these solutions is a step in the right direction.

<table>
<tr><th colspan="3">Benefits and Drawbacks to Each Plausible Reform</th></tr>
<tr><th>Policy Recommendation</th><th>Advantages</th><th>Disadvantages</th></tr>
<tr><td rowspan="3">Market Based Model</td><td>Minimizes conflicts of interest</td><td>Some financial products will not be rated, omission of products</td></tr>
<tr><td>Investment decisions no longer based on ratings</td><td rowspan="2">Specific products might might lack liquidity, making it difficult to assess credit worthiness</td></tr>
<tr><td>Removal of credit rating agencies from federal regulation</td></tr>
<tr><td rowspan="4">Subscription Based Model</td><td>Minimizes conflicts of interest</td><td>Some financial products will not be rated, omission of products</td></tr>
<tr><td rowspan="3">Promote accountability because of feedback mechanism</td><td>Free-rider problem</td></tr>
<tr><td>Not all information is accessible to public</td></tr>
<tr><td>Potential conflicts of interests could arise</td></tr>
<tr><td rowspan="3">Government Based Model</td><td>Credit ratings are public information</td><td>Potential conflicts of interests could arise</td></tr>
<tr><td>All products could be rated, none are omitted</td><td>Government could be held accountable for inaccurate ratings</td></tr>
<tr><td>Central rating agency, set methodology for rating products</td><td>Would need tax payers' approval</td></tr>
</table>

Chapter 4: Alternative Industry Solutions

The three policy changes mentioned above are strong options to reform the credit rating industry; however, there are a couple other alternatives that could have a significant impact as well. Two additional ways that the credit industry could be reform is through a two-tier system and a rating agency established to perform evaluations of the credit rating agencies.

A. Two-Tier System

A two-tier system would have both subscription-based agencies and issuer-pay based agencies. Combining both systems would enable the consumers to reap the benefits of each system. A two-tier system would be established by having a select group of rating agencies operating on the issuer-pay model and another group operating on the subscription model. The main group would be the ratings agencies that were operating on the subscription model. This would be most effective because the issuers of debt are no longer influencing the ratings on the products being rated. All the major corporations and their financial products would be rated by the agencies under the subscription model. The second tier would be the issuer-pay agencies. This group would be paid by companies to rate their products but the products are the ones that were omitted from the first tier. This system would enable all products to be rated in a way that minimizes conflicts of interest. Both tiers of this system would have to collaborate with each other to ensure that the same products are not getting rated twice. Investors would benefit because they would still be able to get their ratings from the three main credit rating agencies with the best reputation, while still being able to find ratings on lesser know products through the second tier. The two-tier system would incorporate the benefits of each system and would, most likely, lead to more accurate ratings.

B. Rating Agency For Credit Rating Agencies

A new financial innovation that might develop as a result of the 2007 financial crisis would be a rating agency providing ratings on credit rating agencies. A rating agency of this sort is needed in the market because investors and institutions might find it difficult to determine which credit rating agency provides the highest quality ratings. This new rating company would operate under the subscription model so that there are no conflicts of interests. The company would gather information on the products each credit rating agency rates, the ratings they received, the performance of the products, and the conclusion if the products received the proper rating. The rating firm would then compile this information and provide a detailed analysis of which credit agencies were the most reliable and provided the best information. There is a significant benefit to this proposal; there would be a feedback mechanism for credit rating agencies. Credit rating agencies have lacked a significant feedback mechanism and, thus, one of the reasons why they aren't held accountable for their ratings. This new rating agency would be a feedback mechanism because if the credit rating agencies didn't provide accurate or unbiased ratings, the rating company will determine that and investors will be made aware. Investors and Institutions would no longer rely on the credit rating agencies; hurting their reputational capital. As previously mentioned, reputational capital is essential for credit rating agencies and a way to hold them accountable would be to hurt their reputation in the market. This new rating agency would provide a means to do that and fill the need for a feedback mechanism.

C. New Regulation in the Credit Rating Industry

After the 2007 financial crisis, some steps have been taken to make the credit rating industry more reliable. The two main bills that were past that affected credit rating agencies were the Credit Rating Agency Reform Act, as previously mentioned, and the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank legislation has attempted to protect against similar crises reoccurring in the future. Dodd-Frank has also had an impact on the credit rating industry.

The first provision from this piece of legislation was the removal of credit rating agencies references from all government regulation. This means that investors and issuers are no longer required to use any particular benchmarks of risk, such as credit ratings. This impacts the credit rating industry because credit ratings from these companies are no longer essential, making their ratings less significant in the market place. The credit rating industry strongly opposes this provision because their ratings are no longer mandatory. This rule change, once adopted, effectively frees banks from having to pay one of the designated agencies to rate their products. Credit rating agencies have done a significant amount of lobbying as a result of Dodd-Frank. The big three agencies have spent over $6 million in lobbying since this legislation was passed in 2009. This capital was to delay various provisions of the financial reform. However, credit ratings will continue to have a strong impact on the market and the credit rating industry will continue to be market makers.

Two other provisions from the Dodd-Frank legislation require the SEC to conduct a study to determine which ways the independence of NRSROs can be strengthened, as well as, a study of alternative business models for NRSROs compensation. These are steps to address conflicts of interest because their business models are the biggest concern. These three provisions are the most significant ones affecting credit rating agencies. The financial crisis of 2007 highlighted weaknesses in the credit rating industry and the government has taken steps to address these weaknesses. However, there are other policy changes that might make the industry more efficient and reliable.

D. Alternative Perspectives to Increased Regulation

While many scholars and government officials believe more regulation will be better for the credit rating industry and the financial markets, White (2010) argues the contrary. White's has a different perspective on what needs to be done in the credit rating industry. White believes that increased regulation will only raise the costs of providing ratings and, thus, would raise the barriers of entry into the market. This, White argues, will tend to discourage new ideas, new methodologies, new technology, new business models, and even discourage innovation. The increased regulation will only make the credit rating agencies more important in the financial markets, which is the opposite of what the regulation is focused on. White suggests " There is a better way. That way involves less regulation of the credit rating agencies, as well as a reformulation of the prudential regulation of financial institutions' bond portfolios. The result would be more entry and more innovation in the provision of information for the bond markets and greater efficiency in those markets." Less regulation is a strong alternative because it would encourage competition. There are many other sources about the creditworthiness of bonds and its issuers, in addition to the major credit rating agencies. White also says that the reliance on credit rating agencies has been a function "of over seven decades of prudential regulation of institutional bond portfolios, which began with banks and then spread to insurance companies, pension funds, securities firms, and money market mutual funds, whereby these institutions were required to heed the ratings of a select handful of rating firms." White makes a strong argument for deregulation because of the disadvantages that the new regulation could have.

Bonewitz (2010) also believes that there needs to be reform in the credit rating industry, but not in the form of increased regulation. Bonewitz argues that regulators need to remove the NRSRO distinction from the credit rating industry and establish a system based on market measures. Bonewitz says "NRSROs currently lack incentives to preserve their reputation for accuracy when it conflicts with selling regulatory licenses and garnering short-term profits. Replacing the NRSRO mechanism with a system that shifts ultimate responsibility from certified third parties to regulated investors, but allows such investors to largely rely on market measures of credit risk, will improve the performance of credit rating agencies, enhance the protection of investors, and encounter less credible resistance. Without further reform, inaccuracy will remain endemic to the NRSRO regime and another round of painful, dilatory downgrades should be expected with the next market downturn." This is another alternative perspective on the reform that needs to occur in credit rating industry to address the existing imperfections.

A second paper that has similar views on reform in the credit rating industry is Utzig (2010). Utzig believes that placing the NRSRO label on an agency "places CRAs in a position of unqualified authority as the central source of information about the creditworthiness of bonds and structured finance products." Utzig also examines competition in the credit rating industry and appropriate reforms to address this imperfection. Utzig argues that "the current tight oligopoly is unlikely to be broken up under the existing "issuer pays" system because neither issuers nor CRAs have an interest in more ratings. Nevertheless, switching to an "investor pays" model should not in itself be expected to produce a quick fix. Whereas in the "issuer pays" model competition can lead to inflated ratings because the company chooses who should rate them, in the "investor pays" model there is a free rider problem, and it is not clear how the free market can resolve it. This dilemma could, however, be solved by decoupling the competition problem from the ratings market. The service required is an assessment of credit quality or the risk of default. A credit rating is only one of the instruments capable of performing this task. Credit default swaps, for example, fulfill a comparable function from an alternative starting point. If the relevant market is defined in this way, financial market regulation itself will automatically have a direct role to play in enhancing competition because by using ratings to regulate banks it contributes directly to the reduction in competition." This excerpt provides a plausible alternative to the current issuer-pay and investor-pay models.

Stiglitz (2010) argues that increasing competition in the credit rating industry will not correct any existing imperfections. Stiglitz believes that increased competition would not correct the industry because conflicts of interest would still exist which is the most significant imperfection. Removing the barriers to entry is a very small reform, which would not address the underlying problems. Stiglitz argues that much larger reforms need to take place in the credit rating industry.

Chapter 5: Conclusion

The goal of this study was to determine what type of reform would best suit the credit rating industry. An analysis of the credit rating industry suggests that there are numerous imperfections, which need to be addressed. The main imperfections existing in the credit rating industry are a lack of accountability, lack of competition, conflicts of interest, and asymmetric information. Regulations, the SEC, and the financial markets/investors have not held credit rating agencies accountable for their ratings, which is evident by the lawsuit examples provided above. The lack of competition has resulted from barriers to entry established by the SEC and the conflicts of interest are a product of the issuer-pay model. Since the credit rating industry has such a large impact on the financial market, it is essential that these issues are addressed.

These imperfections suggest that there must be a reform of the way credit rating agencies generate revenue and steps must be taken to hold them accountable for their ratings. The first major reform was moving towards a market-based system. This system would completely do away with credit rating agencies, eliminating many conflicts of interest and giving the market perceptions on the creditworthiness of financial products. Another suggested reform was moving from the issuer-pay model to a subscription-based model, similar to how Consumer Reports operates. This would eliminate some significant conflicts of interest and would be beneficial to the financial industry. The third plausible change would be to have a government-based system. This also has many advantages over the current issuer-pay model. Each one of these possible reforms has advantages and disadvantages, but the main objective is to produce unbiased and accurate ratings.

The solutions that I believe would be the most effective would be the market-based solution or the subscription-based model. Conflicts of interest, in my opinion, have hindered credit rating agencies' ability to accurately rate financial products. Both the market-based and subscription-based solutions attempt to minimize conflicts of interest, which leads me to believe that they would have the best outcome. It is critical that proper actions are taken to address the many imperfections of the credit rating industry.

Regulators have taken steps to address some of the issues in the credit rating industry, however much more needs to be done. This thesis highlights some shortcomings and provides possible solutions. There are some limitations of this paper however. Future research might want to examine which AAA rated products have defaulted since they were rated by the rating agencies and why those products received those ratings. The credit rating industry is essential to the financial markets, thus the reason why reform must correct the current market imperfections.

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