The Credit Rating Industry: An Industrial Organization Analysis

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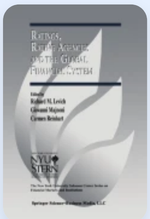

Ratings, Rating Agencies and the Global Financial System

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Abstract

The June 1999 and January 2001 proposals by the Bank for International Settlements (BIS) Basel Committee on Banking Supervision to include borrowers' credit ratings in assessments of the adequacy of banks' capital have heightened general interest in the credit rating industry: Who the industry's firms are; what they do; how they do it; and what the consequences of their actions are. This paper uses the structure-behavior-performance paradigm of "industrial organization" to shed light on the credit rating industry and to provide a

framework for arranging initial observations and developing questions for further analysis.

A striking fact about the structure of the industry in the United States is its persistent fewness of incumbents. There have never been more than five general-purpose bond rating firms; currently there are only three. Network effects—users' desires for consistency of rating categories across issuers—are surely part of the explanation. But, for the past 26 years, regulatory restrictions (by the Securities and Exchange Commission) on who can be a "nationally recognized statistical rating Organization" (NRSRO) have surely also played a role.

A curious part of the behavior of the rating firms is their coverage and their pricing. Hypotheses to explain this behavior are explored.

Although only limited information on profitability is available, it appears that bond rating is quite profitable. A growing regulatory demand for ratings (for safety-and-soundness regulation by bank regulators, insurance regulators, pension fund regulators, and securities regulators) and a regulatory limitation on supply surely are contributory factors. The BIS proposals, if adopted, will accentuate these trends for the United States and other industrial countries.

There is an alternative to these growing regulatory pressures. It would involve the safety-and-soundness regulators' becoming more directly involved in regulatory judgments, rather than abdicating these judgments to private sector bond rating firms. The SEC, and its counterparts abroad, could then vacate their roles as the certifier of credit rating firms.

These suggestions do not mean that credit rating firms should be prevented from playing a continuing role in helping issuers and investors pierce the fog of asymmetric information in financial markets. But that role should be determined by the market participants themselves, not by additional regulation that artificially increases demand and restricts supply. The latter is a recipe for shortages, rents, distortions, and stifled innovation. This is not a welcome prospect.

Preview

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