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Essays

THE CREDIT-RATING AGENCIES AND THE SUBPRIME DEBACLE

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ABSTRACT

By means of the high ratings that they awarded to subprime mortgage backed bonds, the three central rating agencies... played a major role in the subprime mortgage crisis... bonds—become... by... the... ed... s that they... ssures... proved to be a potent brew. This combination was enabled, however, by seven decades

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of financial regulation that, beginning in the 1930s, had conferred the force of law upon these agencies' judgments about the creditworthiness of bonds and that, since 1975, had protected the three agencies from competition.

Notes

1. This rule did not apply to savings institutions until 1989. Its application to them in that year forced them to sell substantial holdings of “junk bonds” (i.e., below investment grade), causing the crash of the junk-bond market.
2. In the early 1990s, the S.E.C. again made use of the NRSROs' ratings when it established safety requirements for the short-term bonds (e.g., commercial paper) that are held by money-market mutual funds.
3. The S.E.C. bestowed the NRSRO designation on Duff & Phelps in 1982, on McCarthy, Crisanti & Maffei in 1983, on IBCA in 1991, and on Thomson BankWatch in 1992.
4. Other examples of “two-sided” information markets include newspapers and magazines, where business models range from subscription revenues only (e.g., Consumer Reports) to a mix of subscription revenues and advertising revenues (most newspapers and magazines) to advertising revenues only (e.g., The Village Voice, some metropolitan “giveaway” newspapers, and some suburban weekly “shoppers”).
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