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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 major rating agencies—Moody's, Standard & Poor's, and Fitch—played a central role in the current financial crisis. Without these ratings, it is doubtful that subprime mortgages would have been issued in such huge amounts, since a major reason for the subprime lending boom was investor demand for high-rated bonds—much of it generated by regulations that made such bonds mandatory for large institutional investors. And it is even less likely that such bonds would have become concentrated on the balance sheets of the banks, for which they were rewarded by capital regulations that tilted toward high-rated securities. Why, then, were the agencies excessively optimistic in their ratings of subprime mortgage-backed securities? A combination of their fee structure, the complexity of the bonds that they were rating, insufficient historical data, some carelessness, and market pressures

proved to be a potent brew. This combination was enabled, however, by seven decades 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”).

5. This seems a reasonable assumption, since the bond market is, for the most part, one where financial institutions are the major buyers and sellers. It is not a market where “widows and orphans” are likely to be major participants.

How Banks Played the Leverage “Game”

Source: Financial Markets Institutions and Instruments

Restoring Financial Stability

Source: Unknown Repository

The Panic of 2007

Source: Unknown Repository

Ratings shopping and asset complexity: A theory of ratings inflation

Source: Journal of Monetary Economics

International Monetary Fund Annual Report 2008: Financial Statements

Source: Unknown Repository