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The Ratings Racket

How politicians enforce the credit oligopoly.

How badly do the major credit-rating firms have to perform before investors stop using their services? That's a trick question, because investors aren't allowed to stop using them. State and federal regulations that lock in the rating oligopoly remain untouched by recent "reforms."

The major credit-rating agencies—Standard and Poor's, Moody's and Fitch—assess the likelihood of default on corporate bonds and other debt instruments. Their famous failures in rating mortgage-backed securities have led to several recent efforts at reform. New York Attorney General Andrew Cuomo struck a settlement with the big three requiring them to charge for preliminary research, not merely for a final rating. The hope is that they will not feel pressured simply to sell good grades to the issuers of the securities they rate.

At the federal level, since the enactment of a 2006 law to encourage more competition, the SEC has anointed seven other firms as "Nationally Recognized Statistical Rating Organizations" (NRSROs), the same favored status enjoyed by the big three. Two weeks ago, the SEC proposed more disclosure of the firms' track record and more investor-friendly descriptions of rated securities. If the SEC now follows through at a meeting today on its plans to eliminate regulations requiring the use of NRSRO-rated securities, investors will be freer to discover the best methods for judging credit risk.

Private debt buyers are also showing more discernment, at least for now. Barclays CFO Chris Lucas recently predicted that investors will place "less reliance on third parties such as rating agencies in making investment decisions... Instead, investors will make their own informed view of what they're investing in, with more fundamental credit analysis."

The biggest remaining problem is that other state and federal regulations still lock out competitors. The Federal Reserve, Wall Street's new lender-of-first-resort, will only accept investment-grade securities as collateral under its various lending facilities. This makes sense to protect taxpayers, but what doesn't make sense is that the Fed will not accept ratings by anyone not named S&P, Moody's or Fitch. Even companies designated NRSROs by the SEC are not acceptable.

The Fed defines investment-grade securities as those "rated BBB- or higher by at least one of the three principal credit rating agencies and no lower than that by the others." The irony here is that the Fed, which felt compelled to clean up the subprime mess caused in part by faulty ratings from the big three, is now perpetuating the same oligopoly that helped create the mess.

At the state level, various rules favor the big three. For derivatives held by the Wisconsin state investment fund, swap and forward counterparties must be rated by Fitch, S&P or Moody's. Vermont's state retirement system explicitly demands securities rated by the big three, but for certain types of issues the fund allows securities "rated by Moody's or an equivalent rating agency." While one could interpret this phrase as allowing more firms to compete, the state has obviously put a very heavy thumb on the scale in favor of just one company. You have to admire the Vermont lobbyist with the Moody's account, but is this any way to encourage the firm to perform at its highest level?

Next door to Vermont, the New Hampshire Public Deposit Investment Pool demands commercial paper rated by the big three. The Pennsylvania Municipal Retirement Board also requires ratings from the big three for various securities. The State of New York Deferred Compensation Board is even more selective, mandating the use of issues rated by just the big two. Its Stable Income Fund can hold money market funds rated only by S&P and Moody's.

The big three say they welcome competition, and no wonder. They know the politicians have handed them a rigged game. Government reformers seeking to avoid a repeat of the credit-ratings meltdown should start with the most obvious solution: Stop enforcing this oligopoly.

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FINANCIAL NEWS

Rating agencies have 'milked' regulatory relationship

Duncan Kerr
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The deeply embedded nature of the credit ratings system in financial market regulation is a fundamental problem that needs to be addressed as rating agencies have exploited this regulatory dependence over many years, according to an academic and commentator.

Frank Partnoy, a law professor at the University of San Diego and author of “Infectious Greed,” a book that chronicles the rise in the use of derivatives in the financial markets, told conference delegates the agencies have been “milking” this regulatory dependence, Reuters reports.

He said the credit ratings serve as a kind of regulatory license, not just information or opinion, and that “this regulatory dependence on ratings is a cow that the ratings agencies have been milking for many years, and the cow has gotten fatter and fatter and fatter.”

Partnoy, who was speaking at a conference in London yesterday, added: “If there were some way that we could get rid of it, we could move to the next stage and not have all this dysfunctionality where people have to have a rating for capital reasons.”

The US Securities and Exchange Commission said yesterday that it may propose eliminating the requirement that money market funds hold only securities with high credit ratings, among other measures to reduce reliance on the ratings produced by the agencies.

At the conference, senior executives of the three major rating agencies Standard & Poor's, Moody's Investors Service and Fitch Ratings said that they did not want the ratings they afford securities to play a regulatory role, and ratings should be considered mere opinions.

Ian Bell, S&P's European head of structured finance ratings, said: “What we produce is an opinion... that's all it is intended to be. A number of governments, particularly the US government, have decided to take that opinion and to attach certain rights to it.”

He added: “We have vociferously said it is the wrong thing to do, but nevertheless governments have chosen to do that.”

Partnoy acknowledged that the problem with the credit rating system is deeper than regulation. "There is a follow-on behavior effect that is associated with regulation. Once people start to use a certain kind of nomenclature, they lock in.” But he also proposed an alternative system.

He said: “Regulation should depend on market prices... on credit spreads.”

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