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RESEARCH SUMMARY

In February 2013 the federal government filed a $5 billion lawsuit against Standard & Poor's (S&P) for allegedly inflating the ratings that it assigned to mortgage-based bonds and misleading investors from 2004 to 2007. Inflated ratings by all of the major credit rating agencies (CRAs) contributed to the 2008 financial crisis and have led to expanded regulation of the CRAs and calls for even more regulation.

But a new Mercatus Center at George Mason University study argues that piling more regulation on the CRAs is unlikely to make the ratings market work better. Instead, less regulation and more competition among the providers of creditworthiness information—of which the CRAs are just one category—would improve the workings of this sector and could spark innovation with respect to methodologies, technologies, and perhaps even new business models for this sector.

KEY FINDINGS

For almost 80 years US financial regulators, first with banks and subsequently with insurance companies, pension funds, broker-dealers, and money market funds, have required their financial institutions to heed the ratings of the major CRAs (which, in addition to S&P, include Moody's and Fitch). This "regulatory reliance" has ensured an audience for the major CRAs and their ratings, thereby enhancing their position in the financial markets. Simultaneously, this regulatory reliance has made it harder for smaller providers of creditworthiness information to gain traction.

Some Important Characteristics of the Bond Markets and the CRAs

Any discussion of the CRAs should keep in mind some important characteristics of the bond markets and the CRAs.

The major players in the bond markets are banks and other financial institutions. An important implication from this is that bond "investors" are largely the bond managers for these institutions, who are—or should be expected to be—professionals who can figure out the best sources of information about bonds.

The major CRAs' business model since the late 1960s has been that the bond issuers pay for the CRAs' ratings. (The prior model was that investors paid for the ratings.)

- The "issuers pay" model has an obvious conflict of interest, which has long been known.
- Despite the obvious conflict, the CRAs' concerns about their long-run reputations as providers of reliable information prevented (and continue to prevent) the conflict from significantly distorting their ratings of the uncomplicated corporate, municipal, and sovereign bonds that have been the standard fare of the rating business.

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- However, the CRAs did assign excessively optimistic ratings for mortgage-based bonds, which contributed to the financial crisis of 2008. The conflict was more serious in this area because there were a few large issuers of these bonds, and the available information about the bonds was sparse. Another contributing factor is that the bonds were rated in the context of general optimism about housing and residential mortgages.

The Drawbacks of Regulation of the CRAs

In light of the CRAs' performance with respect to the mortgage-based bonds, the expansion of CRA regulation in 2010 (to address conflict-of-interest and transparency issues) and the urge to regulate them even more are understandable. Nevertheless, the drawbacks of CRA regulation are important.

- Such regulation, because it tends to impose large fixed costs, bears more heavily on smaller CRAs (of which there are currently seven that are regulated by the SEC) and discourages future entry by smaller potential providers of creditworthiness information. These smaller firms and new entrants are often important sources of new ideas and innovation.

- Such regulation is, at best, an indirect way of improving the accuracy of the CRAs' ratings and may actually achieve little in this regard.

RECOMMENDATIONS

Since existing regulation already enhances the position of the major CRAs, additional regulation would likely exacerbate the problem. Instead,

- the SEC should require that the issuers of mortgage-based bonds make more information about their bonds widely available to bond analysts and investors, as well as to the CRAs;

- Congress must insist that the financial regulatory agencies cease their regulatory reliance on the CRAs' ratings and employ alternative methods to ensure that their financial institutions invest in appropriate bonds that will keep those institutions in a "safe and sound" condition;

- Congress can then instruct the SEC to cease—or at least substantially cut back on—its regulation of the CRAs; and

- the market for the provision of creditworthiness services would then be open to entry, and to the new ideas and innovation that entry can bring, for the first time in almost 80 years.

To read the study in its entirety and learn more about the author, see "An Assessment of the Credit Rating Agencies: Background, Analysis, and Policy."