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"Regulate the Regulator"
Credit Rating Agencies and Lessons from the 2008 Financial Crisis

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Abstract

As the 2008 Financial Crisis caused global markets to contract, and people across the United States and the world suffered the costs, there has been a growing and significant body of literature investigating the relative culpability of different financial actors and institutions in perpetrating the 2008 crisis. "Regulate the Regulator" highlights the culpability of credit rating agencies (CRA) for the reason that their industry acted as a de-facto financial regulator in themselves, wielding a unique amount and type of power as the "gatekeepers" or "security guards" of capital markets. This article explores the role of CRAs in precipitating the events of the 2008 crisis by examining factors like inherent conflicts of interest, an opaque rating process that lacked substantive oversight, and the enforcement of a profit-oriented workplace culture. Taking the analysis, a step further, "Regulate the Regulator" then contextualizes the behaviour of CRAs within the post-1980s American financialization movement.

Introduction

Beginning in 2007, fractures in the United States' subprime mortgage market would spread to other financial markets and then the global economy in what would be the "most destructive economic event" since the Great Depression (Davies 2011, 1). As global markets contracted and people across the United States and the world suffered the costs, there has been a growing and significant body of literature investigating the relative culpability of different financial actors and institutions in perpetrating the 2008 crisis. In particular, the inner workings of credit rating agencies (CRAs) were notably opaque, and scholars have attempted to demystify these so-called "gatekeepers" of the financial system (Marciniak 2015, 102).

In my analysis, I will explore how CRAs inflated credit ratings, which contributed to the onset of the 2008 financial crisis, and more importantly, why they did so by contextualizing their behaviour within the post-1980 financialization of the American economy. For my research, I will be limiting the scope to the American national context. However, I do this while acknowledging that CRAs have also been criticized for their role in downgrading foreign indebted countries which exacerbated the crisis (Davies 2011, 126). I argue that credit rating agencies played a significant role in precipitating the events of the 2008 crisis due to a business-scheme rooted in conflicts of interest, an opaque rating process that lacked substantive oversight, and the enforcement of a profit-oriented corporate culture. Further, CRAs should be viewed through the lens of the financialization movement of 1980's which both laid the foundation for and encouraged their behaviour.

Throughout my research, I will be focusing on the key players in the CRA business leading up to the 2008 crisis, and while there were, and are, several more specialized agencies, the U.S. credit rating sector is highly concentrated. Standard & Poors, Moody's, and Fitch are considered the "Big Three" CRAs and are the only nationally recognized securities rating organizations (NRSROs) (Davies 2011, 123; Mennillo and Sinclair 2019, 267). The NRSROs use statistical models to pass judgement on "specific fixed-income securities, including complex financial instruments issued in structured finance, as well as on issuers such as corporations, municipalities, and governments" (Rousseau 2012, 2). These judgements are translated into a "universal letter code" which varies from "the best (AAA or "triple-A") to the worst (D, for default)" and this rating affects the interest rate or cost of borrowing (Marciniak 2015, 101; Sinclair 2005, 4). A high-quality credit rating denotes a firm's capacity to repay its debt or the risk associated with investing in a certain financial instrument (Cash 2018, 34).

This system was particularly relevant leading up to the 2008 crisis, as the securitization of mortgages into mortgage-backed securities, which fed the housing-bubble that burst during the crisis, required standardization to mediate the "information asymmetry" that made these structured financial instruments more inaccessible. CRAs help mitigate this asymmetry for investors by providing a simplified rating of complex financial information which theoretically allows them to "invest with greater confidence in the levels of risk they are undertaking," while simultaneously allowing "issuers access to investors" and the potential to "drive their interest payments down depending" on the quality of rating (Cash 2018, 34). While CRAs do not claim to recommend investments, as an investor's "willingness to take risks varies," they were nonetheless regarded as an "authoritative source of judgement," which provided them with a substantial amount of control over "access to capital markets" (Sinclair 2005, 2, 7).

Following the 2008 financial crisis, the "Big Three" CRAs were accused of assisting Wall Street in packaging loans into securities for sale to investors and stacking its compliance department with people who "awarded the highest ratings to pools of mortgages" that were soon "downgraded to junk" (Hall 2019, 3). In July of 2008, the Securities and Exchange Commission (SEC) issued a report which claimed that "profit motives had undermined the integrity of ratings" issued by the NRSROs (5). In this paper, I explore what factors lead CRAs to assign these "excessively high ratings."

At times throughout history, the leading CRAs have "experienced great difficulties" and even came "close to extinction" in the late 1960s. This context is integral to understanding the behaviour of CRAs. The build-up to the crisis is described by Cash as a "clear demonstration" of CRAs "operating upon the understanding that survival has to be the first and only consideration". While all firms operate by this mantra in theory, particularly in the case of Moody's and Standards & Poors, this notion was "fundamentally ingrained within their psyche, which shaped the decision-making and behaviour of CRAs to be characterized unilaterally by their desire for "profit-maximization" (Cash 2018, 46).

Conflicts of Interest

This mission to maximize profit was facilitated, in part, by the business model of CRAs that "is subject to fundamental conflicts of interest" (Davies 2011, 124). Prior to the early 1970s, CRAs depended on investors to pay for ratings, however, following the high-profile bankruptcy of the Penn Central Railroad in 1970, the business model changed to an “issuer pays” system in an attempt by firms to “assure bond investors” that their bonds were low risk (124-125). An "issuer pays" system means that the firm issuing the bonds pays the rating agency to evaluate their bonds. However, inherent to this system is a conflict of interest as rating agencies “may be tempted to downplay the credit risk of issues” and “inflate their ratings” to retain business (Rousseau 2012, 7). Further, this “renders CRAs more vulnerable to pressure by large issuers” as firms may engage in “ratings shopping” to demand credit enhancement or seek out the CRA who will provide the highest available rating (Rousseau 2012, 7; Davies 2011, 125).

In a testimony by Richard Michalek, a former vice president senior credit officer of structured derivative products at Moody’s, to the Senate Permanent Subcommittee on Investigations, Michalek outlined the typical process of assigning a rating to a client's structured obligation at Moody’s. He described that the incentives offered by “fee-based” structuring investment banks were clear: “get the deal closed and if there’s a problem later on… I’ll be gone, and you’ll be gone.” Additionally, the processes of confirming the requested rating and pricing the transaction between the CRA and issuer occurred simultaneously before a “rating committee,” in a suspiciously quid-pro-quo fashion. This description paints a sobering image of the credit rating process leading up to 2008 at the prominent CRA, Moody’s, in which “closing the deal” was prioritized over “detailed review” (U.S. Government Publishing Office 2010). The financial incentive to please issuers went hand-in-hand with the profit-maximizing mantra of CRAs, and these conflicts of interest played a significant role in the rating inflation of billions of dollars of toxic assets.

Since the 2008 crisis, CRAs have come forth to defend their “issuer-pays” system on the basis that “potential conflicts exist regardless of who pays,” as investors also have a vested interest in the rating of a bond (Davies 2011). They have further argued that the distinction between investor and issuer is not always so clear cut. CRAs claim that the key is, rather, how well the rating agencies manage potential conflicts, pointing to mitigation strategies such as “making decisions by committees, rather than individual analysts,” and “prohibiting analysts from holding fee discussions with issuers” (Davies 2011, 127). However, it is clear from Michalek’s testimony that these proposed strategies either did not adequately mitigate conflicts or were not enforced effectively, as pricing and rating were still often discussed at the same time. While CRAs may have instituted half-hearted internal efforts to curtail the shortcomings of their “issuer-pays” system, they ultimately lacked external oversight, and therefore substantive accountability.

Lack of Oversight

A business model rooted in an inherent conflict of interest was further compounded by a severe lack of regulatory oversight in the credit rating industry prior to the 2008 crisis. CRAs were not extensively or directly regulated until 2006. They were subject to the regulations and legal considerations of different areas of the economy to allow their “self-regulation and transparency” (Marciniak 2015, 100). This occurred while CRAs were growing in influence, as their ratings were incorporated by regulators into the regulation of other financial markets, “embedding them into important financial sectors” while remaining “free from direct regulation themselves” (Cash 2018, 21). Following the 2008 crisis, this raised a serious discussion on the ethics of CRAs, as the "size of their profits" and significant role in the "development of the global economic situation" implied the need for careful analysis of their governance and transparency in regards to the grading system (Marciniak 2015, 100).

The Credit Rating Agency Reform Act was enacted in 2006 to improve the quality of ratings "for the protection of investors and in the public interest by fostering accountability, transparency, and competition" (Cash 2018, 22). Yet, following this piece of legislation, the SEC's ability to interfere in the workings of CRAs continued to be limited and there was no mention of mortgage-backed securities apart from clauses prohibiting CRAs from explicitly threatening issuers with a downgrade or to withdraw if they do not "rate the entire pool of assets" (23). This example paints a picture of the regulatory mechanisms, or the severe lack thereof, in place leading up to the 2008 crisis, which failed to hold them accountable and allowed their irresponsible behaviour to persist.

CRAs further engaged in an ancillary business that contributed to a large portion of their revenues in the structured finance segment, and which further undermined the integrity of the rating process. Issuers could "work with CRAs on the composition of structured products" to "maximize the obtained rating," for a fee (Darbellay 2013, 123). Structured finance "deals with financial lending instruments that work to mitigate serious risks related to complex assets," like the securitization of mortgages (Corporate Finance Institute, n.d.). This was possible because "the rating process was a fixed target," so issuers could hire CRAs to advise them during the process of engineering complex financial products to ultimately receive a certain rating (Darbellay 2013,124). This raised "doubts about the objectivity of the final rating," pointing to the greater issue: the credit rating process was deeply mystified (Davies 2011, 125).

Given that the utility of CRAs ties in large part to their ability to resolve various information asymmetries between structured financial products and investors, "it is crucial that their ratings and processes be transparent" (Rousseau 2012). Encouraged by the lack of regulatory oversight, there was dually an inadequate level of disclosure by CRAs regarding their methodologies, particularly concerning key assumptions and rating criteria. When "complex legal structures" and important information remains opaque, "investors are unable to make independent assessments of credit risk because they lack access to fundamental data on the underlying assets" (Rousseau 2012, 5). CRAs were also "not sufficiently forthcoming" with "the limitations of their ratings" (7). Therefore, it is clear that trusting CRAs to voluntarily disclose crucial information was not an adequate solution for protecting investors leading up to the 2008 crisis, as CRAs chose to irresponsibly abuse the information asymmetries which characterized their business.

"Bad CRA Culture"

Another integral piece of the puzzle involved the workplace culture of the NRSROs, which was fostered by the same mantra of profit-maximization. According to Macartney (2019), following the 2008 crisis, the "culture of banking" became "a priority of the agenda of regulatory agencies worldwide." The culture of banking has been defined as the norms, beliefs, ideas, and behaviours within banks, which "exists in the hearts, minds, and actions of every banker" it employs. It is bank culture that "guides behaviour in the absence of regulations… and sometimes despite explicit restraints" (2). To draw on this idea of "bank culture," I want to look at the culture of CRAs as a factor that compelled analysts to provide excessively high ratings leading up to the 2008 crisis.

Mark Froeba, a former senior vice president in Moody's structured finance group, spoke about a "systematic and aggressive strategy" to replace Moody's "conservative" and "accuracy-and-quality oriented" culture with a "business-friendly" culture that made Moody's "less likely to assign a rating that was tougher" than their competitors (Hall 2019, 8-9). Froeba and nine other outspoken critics of Moody's new methodology, which they believed "allowed the firm's profit interests to trump honest ratings," were "downsized" in December 2007 (9). Several former Moody's executives have also stated that these changes made them fear they would be fired if they did not "issue ratings that matched competitors" to help "preserve Moody's market share" (26). Therefore, the enforcement of a "business-friendly" work culture pressured employees to comply with the "manipulation of the rating process to the detriment of investors" or risk losing their jobs (29). Coupled with lax regulations and the tempting financial incentives I outlined previously, this workplace environment was conducive for reinforcing and perpetuating the irresponsible behaviour that led to the exaggerated credit ratings leading up to the 2008 crisis. However, to understand the roots of this "business-friendly" CRA culture, we must look at the greater socio-economic context of the United States at the time.

The American Financialization Movement

Since 1980, economic activity in the United States has shifted "from manufacturing and service production to financially oriented investment," in a shift known as financialization (Tomaskovic-Devey and Lin 2011). Financialization refers to the "interdependent processes" of financial services firms increasing in importance in "economic, social, and political terms" and the increasing involvement of nonfinancial firms in financial activity (Tomaskovic-Devey and Lin 2011, 539). Tomaskovic-Devey and Lin (2011) trace the roots of American financialization to the 1970s Capitalist Crisis, in which a simultaneous series of destabilizing events resulted in low growth and high inflation, undermining "the legitimacy of Keynesian economic solutions." The crisis led to the mobilization of the large-firm corporate sector which sought to "reinvent the system" by pushing for "economic deregulations, lower taxes, and a smaller state." There is scholarly consensus that this movement resulted in the "installation of the neoliberal policy model" in the U.S., in a rejection of Keynesian values that held the state responsible for the wellbeing of the public, and "in favour of fostering a pro-business climate" (542). The post-1980 "neoliberal policy consensus" made regulation of new financial instruments and innovations unlikely in an act to "protect financial institutions at all costs" (543).

The prevailing view on Wall Street and amongst American economists at this time was that "financial markets are self-regulating" (Tomaskovic-Devey and Lin 2011, 543). This led to a series of deregulatory financial policies and increased levels of financial investment. Yet, the state and financial markets found it difficult to adapt to the new absence of regulation, and as a result, the financial regulatory system became increasingly fragmented. Such conditions explain the lack of substantive oversight of CRAs leading up to the 2008 crisis, as recent history lacked a sound tradition of-and frankly the capacity for- financial regulation, as the neoliberal view that firms operated efficiently and thus should be allowed to self-regulate prevailed. However short-sighted, these deregulatory measures were calculated attempts to ensure the preservation and prosperity of financial actors.

According to Tomaskovic and Lin (2011), during this time, there was also a fundamental change in "managerial behaviour," as "short-term planning to increase stock prices" became the primary focus. This was reinforced by "a misapplication of agency theory" that encouraged tethering executive compensation to stock price "rather than long-term market share, sales or production-based profit" (545). For example, Brian Clarkson was a Moody's executive promoted to CEO during the build-up to the 2008 crisis and was essential to establishing the cut-throat "business-friendly" work culture that I described in the previous section. Clarkson's compensation was "tied up in Moody's market share," despite Moody's spokesman insisting that the "compensation of Moody's analysts and senior managers" was not linked to "financial performance" (Hall 2019, 34). This resulted in "an incentive system for high risk, short-term behaviour," that simultaneously lacked responsible oversight from the firm's leadership (Tomaskovic-Devey and Lin, 2011, 546).

Some have argued following the 2008 crisis that such "business-friendly" work cultures that bred unethical behaviour and inflated credit ratings were merely indicative of misbehaviour, in that firms simply needed reminding to realign with the correct culture of the market. Once these "bad apples" realigned, we could trust markets to "function properly again" (Macartney 2019, 2-3). However, Macartney points to how it is the structure of American financial markets which "determines the culture" of banks, and the "problematic culture" of American banks exposed following the 2008 financial crisis "has far deeper roots than misconduct" (3). It is precisely the financialization movement that bred this "bad bank culture," through its distortion of the American economic structure. I would argue that this theory of "bad bank culture" applies to "bad CRA culture" as well as they operated within the same economic structures and faced widely similar experiences with deregulation and incentive-schemes.

Conclusion

From my investigation, I have found that credit rating agencies played a significant role in the precipitation of the 2008 financial crisis due to inherent conflicts of interest rooted within their business model, a mystified rating process that lacked substantive oversight, and a high-pressure "business-friendly" culture which prioritized profit over accuracy. Further, this analysis should be contextualized within the financialization of the American economy since the 1980s, which set the stage for a fragmented financial regulatory structure and encouraged the short-sighted behaviour reflected within the NRSROs. An abundance of literature has attempted to point the finger at a variety of actors to assign relative culpability, and by looking at the 2008 financial crisis "from a longer institutional perspective," we can view it as a result of a concentration of financial activity, "embedded within an increasingly retiring and obsolete regulatory structure," in which executive incentive systems were encouraged to favour "short-term financial speculation over long-term growth" (Tomaskovic-Devey and Lin 2011, 548).

I wanted to particularly highlight the culpability of CRAs for the reason that their industry acted as a de-facto regulator in themselves, wielding a unique amount and type of power as the "gatekeepers" or "security guards" of capital markets (Marciniak, 2015, 102). Therefore, while traditional financial firms like investment banks were responsible for the proliferation of mortgage-backed securities, CRAs had the opportunity to mitigate the effects through a commitment to due diligence. Instead, they chose to abuse their position for profit. Therefore, moving forward, the American government must continue to learn from the 2008 crisis and "regulate the regulator." Without such a commitment, CRAs will have no reason to hold Wall Street accountable, and it is 'Main Street' that will pay the price.

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