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Outcomes-Based Accountability for Credit Rating Agencies

It is now well understood that the large credit rating agencies such as Moody's and S&P were major contributors to the financial crisis of 2008. They certified tens of thousands of 'toxic' bonds based on subprime mortgages as high-quality, investment grade assets that were safe to hold for investors and banks. The failure of these 'toxic assets' to perform as promised, including the mass downgrades that resulted when their true risks were revealed, was a major trigger of the financial crisis.

The failure of the credit rating agencies to do their job of properly assessing securities risk was rooted in the conflicted incentives they face. Since they are paid by securities issuers, their incentives are to give high ratings that will help the issuers sell their product easily. Credit ratings agencies that apply particularly strict ratings standards can quickly lose business. In contrast, a later failure of rated securities to perform as advertised doesn't appear to have much impact on ratings agency profits – just a few years after the financial crisis, ratings agencies are back to making record profits.

Thus, the notion that ratings agencies must protect their reputation for quality in order to protect their business is wrong. In fact competitive pressures appear to go in the opposite direction. Extensive research – summarized in this review article by Harvard Law School professor John Coffee – demonstrates that ratings agencies abused their discretion prior to the financial crisis and ignored mounting evidence of fundamental problems in securitization markets, and responded to additional competition by lowering ratings standards, not increasing them.

The Dodd-Frank Financial Reform Act required the Securities and Exchange Commission (SEC) to implement a set of reforms of credit rating agencies in order to prevent conflicts of interest from again having a disastrous impact on rating agency performance. The agency is now preparing to finalize these rules. Unfortunately, the SEC proposal is seriously inadequate to the problem. The proposal relies essentially on ratings agency self-regulation and on disclosure of historical performance. These changes are highly unlikely to alter the fundamental incentives for ratings inflation faced by ratings agencies under the current business model.

However, there is a simple and straightforward alternative available that would alter ratings agency incentives in a decisive way. Using the statutory authority already granted to them in the Dodd-Frank Act, the SEC can hold ratings agencies accountable for the ratings agencies' own performance predictions. This could be done by imposing costly but temporary sanctions on credit ratings agencies when the performance of rated securities diverges dramatically from the the ratings agencies' own predictions.

Two steps would be required to implement this performance accountability model:

1) The SEC could require ratings agencies to associate each ratings level (e.g. AAA, AA, etc.) in each asset class with a clear quantitative prediction of the probability that the security will default or fail to make timely payments.

2) If the actual failure rate of a class of rated securities diverges significantly from the performance predicted by the ratings agency itself, the SEC could automatically suspend the ratings agency's license to rate securities in that class for a period of time. During the suspension, the ratings agency could examine and repair its ratings procedures to address the source of the accuracy problem. The inability to rate an asset class for an extended period of time would constitute a significant financial penalty on a ratings agency.

The SEC already has clear statutory authority for both steps of this procedure. The authority for the first step (associating each rating with a quantitative performance prediction) is contained in Section 938(a) of the Dodd-Frank Act. This section requires ratings agencies to establish procedures for assessing the probability that a security will default, to clearly define and disclose the meaning of any credit rating symbol, and to apply those symbols consistently. The authority to revoke or suspend the ability to issue ratings for an asset class based on the accuracy of the ratings is contained in Section 15E(d)(2) of the Securities and Exchange Act of 1934 (added by Section 932 of the Dodd-Frank Act). This subsection grants the SEC the ability to "temporarily suspend or permanently revoke the registration of a nationally recognized statistical ratings organization with respect to a particular class or subclass of securities", based on, among other factors, whether the ratings agency has produced accurate ratings for that class of securities.

If this procedure was applied in a clear, predictable, and automatic way it could significantly shift ratings agency incentives. An extended period of suspension based on inaccurate ratings predictions would constitute a serious financial penalty for a ratings agency. Looking ahead to this possible sanction would create an up-front incentive for the ratings agency to make accurate predictions. Furthermore, this type of sanction would shift competitive incentives among ratings agencies. Currently, there is little incentive for a ratings agency to diverge from other agencies in making more conservative performance predictions, as it is likely to lose business by doing so. But under this system, an agency that made more conservative predictions could avoid a future suspension of its ability to rate, and could gain market share while its less accurate competitors served a period of suspension.

A performance accountability procedure avoids government micro-management of ratings agency methodologies. It only holds ratings agencies accountable for their own predicted outcomes and leaves them free to adopt an appropriate correction when their existing methodology fails. As past failures of ratings agency performance have been unmistakable and egregious, the automatic suspension procedure could be triggered only in cases where ratings failures were large and significant.

This performance accountability procedure is conceptually straightforward and clearly within the SEC's statutory authority. But there would still be some implementation details to work out. The specific thresholds for triggering sanctions would have to be determined based on some combination of performance across ratings in an asset class. It would also be necessary to determine how to classify ratings failures short of default or failure to pay, such as the downgrading of many securities to a rating much lower than their initial rating. Working out such details is relatively simple compared to alternative methods of influencing ratings agency incentives such as fundamentally altering the rating agency business model or relying on purely administrative supervision or penalties.