Policy Issues Concerning the Reform of the Credit Rating Agencies

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Summary

This brief focuses on the role of the credit ratings agencies (CRAs) in the securitization process and the options for reform. Despite the recent financial crisis, most regulators appear intent on continuing to rely on CRA ratings for overseeing the institutions they supervise. Further, legislation in the US and the EU appears to be moving in uncoordinated directions, threatening the integration of world credit markets. Yet, the problems underlying the failures of the CRAs, and their consequences for financial efficiency and stability, are so complex and dynamic that policymakers should be very cautious about excessively prescriptive legislation because of the very real prospect of unintended consequences. A more subtle approach is needed.

The proposal here is to establish a private Board with a public mandate to set standards and to encourage their adoption. This Securitization Transaction Approval Review (STAR) Board of leading participants in securitization markets would have the mandate to improve the transparency of these markets and to realign the incentives of each agent, including the CRAs, with those of final investors.

Introduction

In the 2008 crisis, ratings of structured products proved to be more volatile and inaccurate than anyone expected, and this volatility had disastrous effects. Inflated ratings supported reckless investment and then, when reality forced a reappraisal, downgrades reduced portfolio values and forced asset sales that in turn further depressed asset values -- a downward spiral that was sufficiently prevalent and synchronous to contribute significantly to the depth of the overall crisis.

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To reduce the chances of such mishaps in the future, it makes sense to think about improving CRA rating accuracy, and also changing the institutional framework – including the structural features of the securitization process – to diminish the prospect of systemic spillovers from the securitization market.

Accuracy

Starting with rating agency accuracy, the agencies need good methods as well as the incentives to use them effectively. Today's methodologies are almost certainly deficient and improving them will be difficult: improvements in accuracy will be difficult to develop, measure, deliver, and verify. Aligning the interests of the CRAs to those of the final investor will be difficult because the CRA business model is fraught with potential difficulties: conflicts of interest, information asymmetries, free-rider problems, concentration of buyers and sellers, barriers to entry, and many specific reasons why buyers' and sellers' interests diverge from those of the ultimate investors. Nevertheless, right now, there is a general alignment of interest between the many actors in securitization. They share a desire to rebuild market trust in the securitization process – a necessary first step to reviving an efficient market for securitized debt. Thus, there is an opportunity to create a private sector Board with a public mandate that would be responsible for conducting a Securitization Transaction Approval Review (STAR). This Board should have broad membership heavily weighted to final investors to develop and promote best practices for the securitization process. That would emphasize requirements for CRAs to:

1. Make public all the data that the sponsor of the securitization has provided to the CRA. This would enable other independent experts, using different methodologies, to evaluate the credit risk of a securitization.
2. Provide some indication of the correlation of underlying assets and the range of ratings that may result under a range of stress scenarios, and refresh this data as the pool of assets matures.

The Board should establish standards for the alignment of the financial interests of the CRAs (and other participants in the securitization process) with those of final investors.

In order to counteract the trend toward balkanization of capital markets that may result from the approach to regulation the EU has taken, it may be useful to include important foreign-based investors on the Board to establish standards of transparency that could be applied in all countries. In any event,

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since these markets are truly international in scope, it is appropriate to include major European and Asian investors in this market. (More that 60 % of the subprime-related debt was placed with European institutions.)

The work of the Board should be audited annually by the Government Accountability Office (GAO), and its foreign counterparts, to ensure that it fulfills the mandates established by the Secretary of the Treasury (or the Financial Services Oversight Council of the Administration's June 2009 legislative proposal).

Systemic Issues

When it comes to the effects of CRA ratings changes on the financial system as a whole, it is more difficult to know what the strategy should be. The development of a coherent and comprehensive approach should be high on the list of priorities of the systemic risk regulator. In the meantime, there are some obvious steps to be taken to increase transparency and remove perverse effects of regulation:

1. Ratings agencies should publish the information and assumptions they use to calculate their ratings.
2. The use of ratings in regulatory standards for banks and fund portfolio regulation should end.
3. To encourage competition, the Nationally Recognized Statistical Ratings Organization (NRSRO) designation should be abolished.

The rest of this paper is divided into two parts. The first part provides an analysis of ratings agencies and their history, and looks at questions about their usefulness, how they developed their reputations for accuracy, the evolution of their business model, and how they came to lose their reputations with regard to the rating of securitizations. The second part discusses recommendations for reform put forward by the SEC, the EU and the Obama Administration. Against this background the recommendations for strengthening securitization ratings, as well as strengthening the securitization process, are put forward at the end of the paper.

The Evolution and the Usefulness of Credit Ratings

The credit rating agencies have been heavily implicated in the collapse of the securitization market and resulting credit crunch. This has caused many private groups and policymakers to call for a variety of

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reforms, including even the abolition of credit ratings. This raises two threshold questions: (1) what function have CRAs served? and (2) Do CRAs remain useful for the efficient functioning of capital markets? I explore these questions in five related sections below.

Are credit ratings necessary for the efficient functioning of capital markets?

Clearly one can have capital markets without CRAs. The world had active bond markets for at least 300 years before the introduction of the first CRA. But these capital markets, which were largely based in Europe, traded mainly sovereign debt issued in the sovereign's own currency. For this sort of capital market, CRAs would have had little to add in terms of credit risk analysis. It is not an accident that the first CRAs were established in the United States, where a robust corporate bond market first emerged. Since the mid-19th century, the US financed much of the growth of the railway industry and other infrastructure such as canals through the issuance of bonds by private corporations. The big three CRAs all have their roots in the era between 1906 and 1913, just after a number of bonds issued by private corporations had defaulted or fallen in value. (See Table 1 for a comparison of the rating scales and dates on which the big three CRAs were established.)

	Quality	Fitch Ratings	Moody's	Standard & Poor's
Started		1913, NYC	1909, NYC	1906 Standard Rating Service. Merged with Poor's to form S&P, 1941
Grades	Investment	AAA	Aaa	AAA
	Investment	AA+, AA, AA-	Aa1,Aa2, Aa3	AA+, AA, AA-
	Investment	A+, A, A-	A1,A2,A3	A+, A, A-
	Investment	BBB+,BBB,BBB-	Baa1, Baa2, Baa3	BBB+,BBB,BBB-
	Speculative	BB+,BB,BB-	Ba1, Ba2, Ba3	BB+,BB,BB-
	Speculative	CCC+,CCC,CCC-	Caa	CCC+,CCC,CCC-
	Speculative	CC	Ca	CC
	Speculative	C	C	C
	Default	D		D

Table 1. The Big Three Credit Rating Agencies

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What roles did CRAs play? They facilitated investment by non-specialist lenders, diminished asymmetry of information between borrowers and lenders, reduced overlap and duplication of effort, facilitated comparisons across securities and, thereby, broadened access to capital markets. Thus, based on historical experience, it would be possible to have capital markets without CRAs, but capital markets would likely be very different. They might consist largely of sovereign issues, which required little credit analysis, and likely would involve a much narrower range of borrowers and investors. Capital markets would be based largely on government borrowing and, inevitably, government allocation of capital. Some commentators have suggested that ratings could be easily replaced by credit spreads or credit default swaps, and while this certainly does introduce useful, forward-looking information into credit analysis, it does not solve the problem of how to evaluate the creditworthiness of illiquid securities.

How did CRAs achieve their status?

Why did investors trust the judgment of CRAs? It was largely because they achieved a reputation for independence from issuers and underwriters, and they developed a track record for accuracy. They brought considerable transparency to the market, and introduced a plausible methodology for evaluating credit risk based largely on the past performance of hundreds of similar securities, and statistics regarding the corporations that issued them. Moreover, confidence was enhanced because the principal source of revenue for CRAs was the sale of bond manuals to investors. Thus CRAs were profitable only to the extent that they added value to investors' assessment of risk. Over time, this created a natural barrier to new entrants. The main way to gain credibility was to be successful for a long period of time, which made the market for credit ratings very difficult to contest. Even before the SEC established the official category of NRSRO, the market was dominated by no more than two or three firms.

What factors drove a wedge between the interests of CRAs and final investors regarding the accuracy of ratings?

In the ensuing decades two developments tended to weaken the alignment of interests between the final investors and CRAs in the accuracy of the credit ratings. The first was an unintended consequence of the attempt by regulators to outsource much of the responsibility for evaluation of creditworthiness

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of the institutions they oversaw to the CRAs. The second event was the indirect consequence of technological change.

Unintended Consequence

In the wake of the Great Depression, national banks, state insurance regulators, overseers of pension funds and the SEC began to rely on ratings issued by the CRAs to control the credit risk taken by the institutions under their supervision. This development subtly changed the interests of regulated investors in the accuracy of ratings, because by purchasing a security with an inflated rating they could reduce their capital requirements, or earn a higher return while still staying within the limits imposed by their supervisors. As Frank Partnoy has observed, the CRAs began selling regulatory dispensations as well as information. This pressure was intensified in the new millennium by two factors: (1) the decision by the supervisors of the government-sponsored enterprises (GSEs) that Fannie Mae and Freddie Mac could meet their promises to Congress for greater support for low-income housing through purchasing AAA-rated tranches of subprime-related securitizations. This sharply increased a not-very-discriminating demand for AAA-rated, subprime securities that was met, in turn, with an increasingly shoddy supply. (In the end, the GSEs held roughly half the AAA-rated subprime related securities.) And, more recently, (2) the introduction of the standardized version of the Basel II minimum capital standards for internationally active banks, which relies heavily on ratings issued by the CRAs. This has added to the pressure to inflate ratings so that banks could reduce capital requirements.

The insistence of various regulators that their regulatees hold mainly highly-rated assets gave an important boost to the growth of the securitization market, an innovation introduced by Fannie Mae while it was still a government-owned financial institution. The demand for highly-rated assets by regulated institutions far exceeds the supply offered by highly-rated corporations. Indeed, the number of non-financial corporations receiving the highest rating has actually fallen markedly in the past two decades, from 50 in 1980 to 2 in 2009. Securitizations helped fill this gap by synthesizing assets that the rating agencies certified as equivalent to those of highly- rated corporations.

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Ratings issued by the CRAs also became increasingly important in private contracts, as a downward change in ratings could trigger calls to accelerate repayment of debt in loan agreements, increase collateral requirements in credit default swaps, force liquidation of collateral, and accelerate payment under guaranteed insurance contracts (GICs). In periods of financial fragility, a downgrade could lead to a downward spiral for the corporation in question, possibly ending in bankruptcy.

Cartoon 1. The shift in revenue models raised questions about conflicts of interest

Indirect Consequence

The second event which tended to undermine confidence in the CRAs was the indirect consequence of technological change. Widespread use of copying machines, faxes, and, later, emails made it increasingly difficult for CRAs to generate sufficient revenue by selling bond rating manuals to investors to cover the costs of the infrastructure required to produce ratings. During the early 1970s the revenue model of the CRAs shifted from one in which the investor pays, to one in which the issuer pays. This was seen by many as an obvious and potentially worrisome conflict of interest (see cartoon 1[2]), but the CRAs generally were able to convince investors and their regulators that their interest in maintaining their own reputations for accuracy far outweighed the temptation to favor issuers relative to the interests of final investors. This may well have been true until the rise of subprime securitizations. But at the height of subprime issuance, a mere handful of underwriters could bring billions in revenues to cooperative CRAs over time. (This is quite different from the case in which a single corporation makes sporadic issues that are a fraction of the flow of revenues. Moody's, the only free-standing corporation of the big three CRAs, made nearly half its revenues from subprime securitizations in 2006.)

[2] Taken from Stu's Views, www.stus.com, used with permission.

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By the time of the financial crisis, CRAs had amassed extremely broad powers over the financial system and the economy. For example, they currently help determine capital requirements for insurance companies and commercial and investment banks, and whether securities are eligible for investment by public pension funds, mutual funds, and money market mutual funds. Ratings also determine whether some financial institutions can do business at all. For example, life insurers rated below the "A" category can scarcely write new business, and bond insurers need to be sufficiently highly-rated for their insured borrowers to achieve an improvement in borrowing terms large enough to justify the payment of a premium.

How CRAs became NRSROs

Oddly, despite the fact that the ratings of CRAs had been used for regulatory purposes since the 1930s, the SEC did not get around to specifying which CRAs could issue ratings that could be used for regulatory purposes until it devised the designation of Nationally Recognized Statistical Rating Organization (NRSRO) in 1975. This was done in a very opaque manner through the issuance of "no action" letters. As a result very few NRSROs were authorized. Indeed, the main way of becoming "nationally recognized" was to already be an NRSRO. This system was reformed in 2006 with the Credit Agency Reform Act of 2006, which attempted to make the criteria more transparent and ease the barriers to entry. As of 2008 there were 10 NRSROs, but the big three still dominated the field, and Moody's and Standard & Poor's remained the largest by far. This left CRAs in the very peculiar position of claiming to be mere publishers of opinions, but opinions that have serious regulatory consequences. So far they have largely escaped legal liability for their ratings under the protection of the First Amendment.

The long period in which the CRAs operated before official intervention indicates that there is probably a strong element of natural monopoly in the ratings business, but more active use of anti-trust policy might have encouraged greater innovation in the industry. A prime example is the acquisition of KMV by Moody's in 2002. KMV had derived forward-looking credit ratings from a radically different approach, relying on inferences of credit quality from stock prices. The big three still rely predominantly on historical outcomes. Although KMV decided not to undertake the costs of becoming an NRSRO, it was acquired by Moody's and ceased to be a force of innovation.

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It is not clear how the introduction of greater competition might affect the quality of ratings under circumstances in which the underlying data are not readily available to experts of all kinds. While it is possible that more competition could increase innovation, lower costs and improve the accuracy of credit ratings, it is also possible that it could result in a race to the bottom as some CRAs compete for market share by offering inflated ratings to issuers who wish to borrow more cheaply, and to regulated institutions wishing to improve their returns without increasing their capital requirements.

What ultimately undermined confidence in CRAs?

What ultimately undermined confidence in the CRAs was their obvious failure to accurately rate subprime-related securities, CDOs and other complex securitizations. Table 2 compares the worst year for multi-notch corporate downgrades – 2001, which saw the collapse of Enron, WorldCom and the largest sovereign default in history, Argentina – with the 2007-2008 downgrades associated with subprime residential mortgage-backed securities from 2007 to 2008.[3]

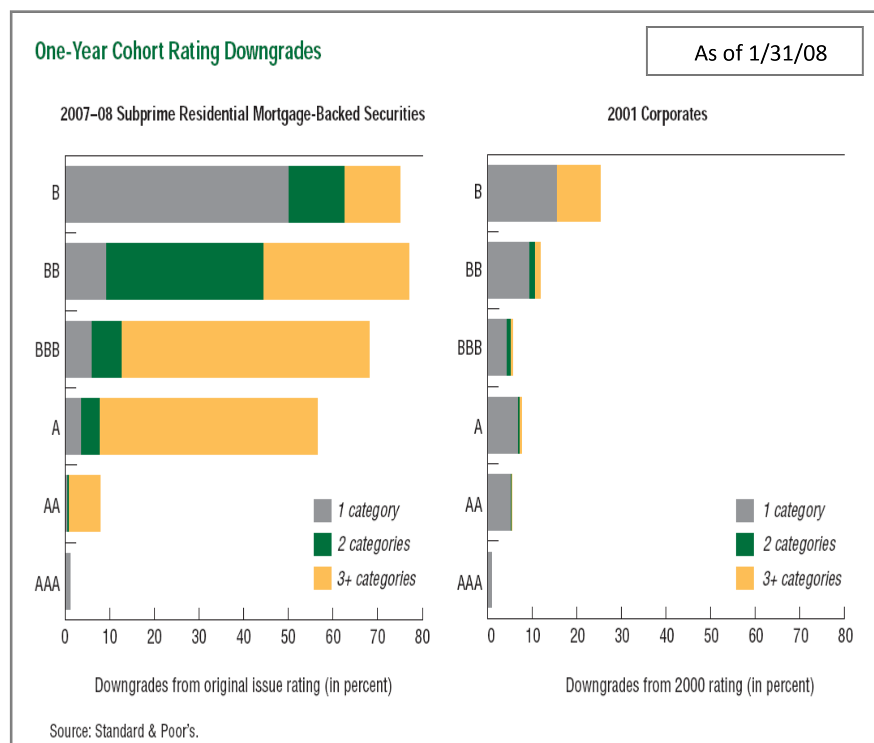

Table 2. Multi-Notch Downgrades Undermined Confidence in Ratings

[3] IMF Global Financial Stability Report, April 2008, Chapter 2, Structured Finance: Issues of Valuation and Disclosure, pg 61. http://www.imf.org/External/Pubs/FT/GFSR/2008/01/pdf/chap2.pdf

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Note that triple-notch downgrades of corporate debt are extremely rare, even in the worst year ever for corporate defaults. Moreover, most of these downgrades were concentrated in the speculative class, which is defined to be highly volatile. In contrast, triple-notch downgrades included nearly 68% of the investment grade (BBB-rated) subprime securitizations, which is often the minimum threshold of quality for securities that regulated institutions are permitted to hold. A casual inspection of the table may lead to the inference the CRAs had done a much better job of rating AAA tranches, but in fact that is only an artifact of when the measurement was made. Because most subprime securitizations are tranched, it is necessary to rerate the lowest-rated tranches before higher rated securities can be analyzed. As can be seen in Table 3, six months later more than half the AAA-rated securities were

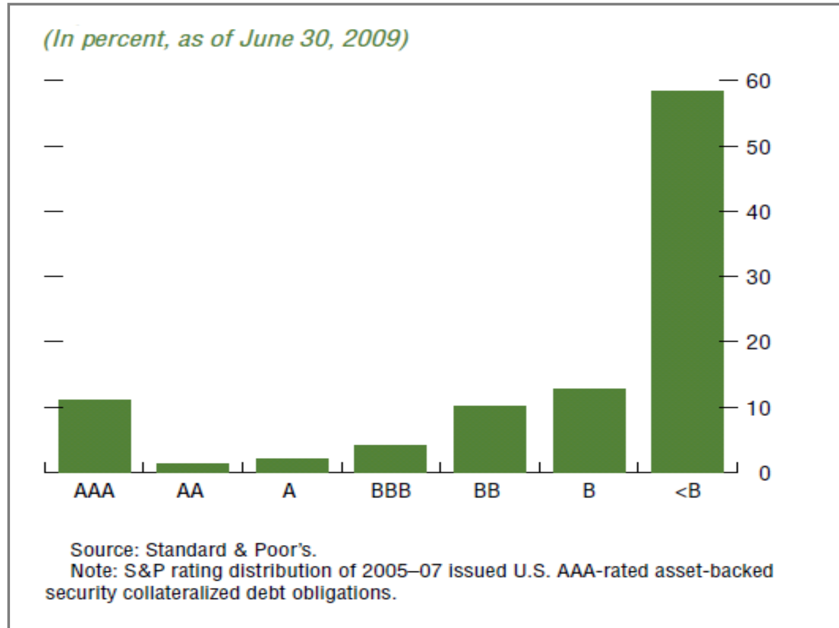

Table 3. AAA Tranches 6 Months Later

	Outstanding (in billions)
Asset-Backed Securities (ABS)	$1,100
ABS Collateralized Debt Obligations	$400
Prime Mortgage-Backed Securities	$3,800
Subprime Mortgage-Backed Securities	$780
Commercial Mortgage-Backed Securities	$940
Consumer Asset-Backed Securities	$650
High -grade corporate debt	$3,000
High -yield corporate debt	$600
Collateralized Loan Obligations	$350
Total	**$11,620**

Table 4. Approximate total of Privately-Sponsored Securitizations at the Height of the Market

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downgraded by at least three notches. [4]

The contagion from these downgrades, which were widely anticipated in credit default markets, had devastating spillover impacts on institutions and markets around the world. It led to fair value losses at institutions holding these securities. It made clear that the monoline insurers lacked reserves to back up their credit guarantees, which spilled over into the completely unrelated insured municipal market. It raised troubling questions about the competence of the models that both the ratings agencies and expert practitioners were using to forecast risk and price these securities, and the ability of regulators to supervise them. Because of uncertainty about which institutions would ultimately bear the losses, interbank markets virtually dried up, and securitized debt became almost completely illiquid. CRAs have certainly made mistakes before –the Asian financial crisis and Enron were notable examples – but this was the first instance in which they had made a mistake with regard to an entire, important category of securities amounting to nearly $12 trillion dollars.[5]

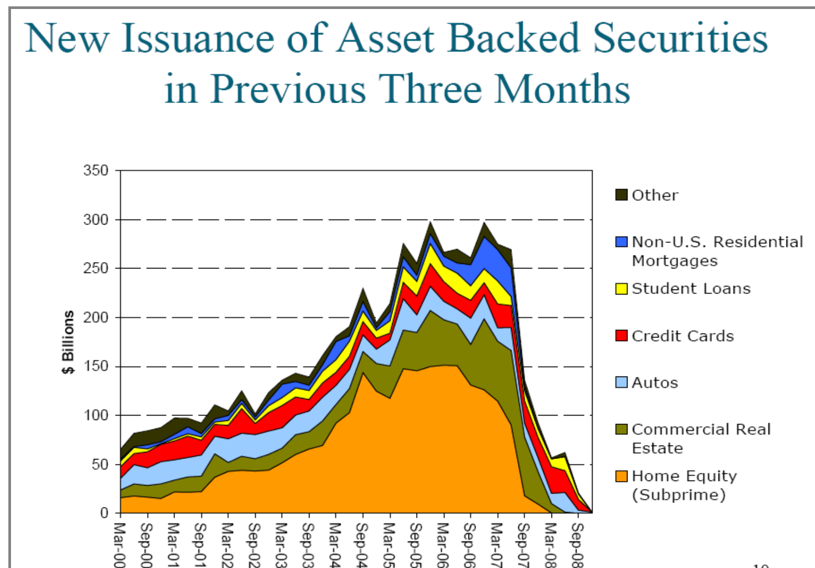

Table 5. The Collapse of the Market in Privately-Sponsored Securitizations in September 2008

See Table 4 for a breakdown of an estimate of the stock of outstanding privately sponsored securitizations worldwide and Table 5[6] for the impact on new issuance of asset-backed securities in September 2008.

[4] See IMF Global Financial Stability Report, October 2009, Chapter 2, p. 17.

[5] The fact that the total of all privately-sponsored securitizations – an order of magnitude near $12 trillion – must be estimated with considerable difficultly is an indication of how far the regulators have fallen behind actual market practice. From Richard Herring and Edward Kane, "Financial Economists Roundtable Statement on Reforming the Role of the Rating "Agencies" in the Securitization Process," *Journal of Applied Corporate Finance*, volume 21, number 1, Winter 2009, p. 2.

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As recently as 2007 in the United States, flows of credit intermediated through securitizations substantially exceeded those intermediated on the books of depository institutions (See Table 6[7]).

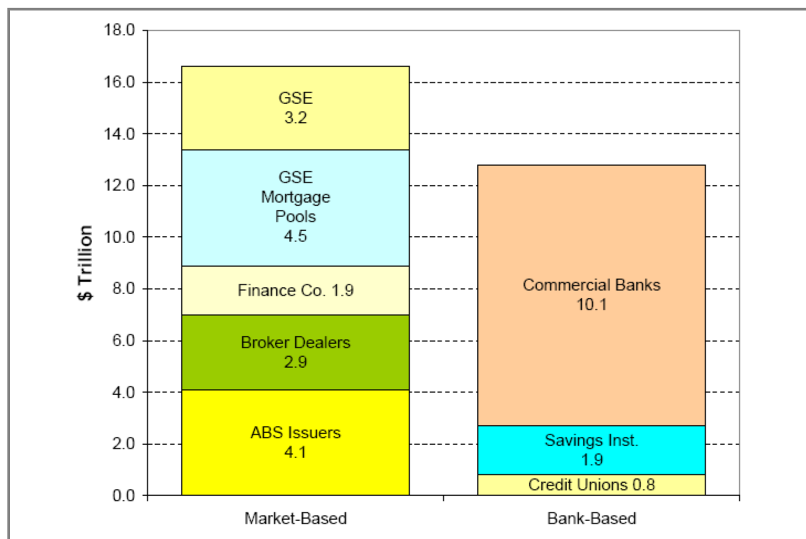

Table 6. Securitizations versus credit flows intermediated by depository institutions 2007Q2.

Reform Proposals

This section reviews four reform proposals - the SEC proposals from the summer of 2008, the EU plan, the Obama plan, and self regulation – before proposing another way forward that focuses on the establishment of a best practices standard.

The SEC proposals from the summer of 2008

The SEC made three bold proposals to restore confidence in the CRAs. The first set of proposals was to mitigate conflicts of interest. The SEC proposed that the CRAs publish all ratings and subsequent re-ratings to facilitate comparisons of performance across CRAs in a timely manner. They also proposed that CRAs disclose all information used to determine ratings for structured products, including reliance on the due diligence of others, so that independent analysts could verify ratings. In addition, the SEC proposed that the CRAs explain how frequently ratings are reviewed and whether different models are used for review than for the initial issuance of a rating. Finally, they proposed to prohibit an agency from acting as both rater and paid adviser for a tranched securitization.

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[6] Federal Reserve Bank of New York Staff Report No. 382, “The Shadow Banking System: Implications for Financial Regulation”, by Tobias Adrian and Hyun Song Shin, July 2009, pg. 5.
http://www.newyorkfed.org/research/staff_reports/sr382.pdf

[7] Federal Reserve Bank of New York Staff Report No. 382, “The Shadow Banking System: Implications for Financial Regulation”, by Tobias Adrian and Hyun Song Shin, July 2009, pg. 1.
http://www.newyorkfed.org/research/staff_reports/sr382.pdf

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The second group of proposals was intended to differentiate ratings on securitizations from those on ordinary corporate bonds. As the triple-notch downgrades have made clear, the leverage embedded in many structured products gives such instruments a much deeper downside than ordinary bonds with the same rating. The use of the same rating scale for each kind of product renders many of the traditional regulatory strategies obsolete and inevitably confuses all but the most sophisticated investors. In the event of the crisis, it appears to have confused even some of the most sophisticated investors as well.

The third and most radical group of proposals would have removed ratings from virtually all SEC regulations. This would have curtailed the trend to outsource regulation of credit quality to private parties. It is likely that it would have broadened competition as directors of investment companies began to rely on other kinds of analysts for advice, and it would have posed a useful challenge to other regulators who are relying increasingly on ratings by the CRAs – not least, the Basel Committee.

In December 2008, however, the SEC adopted only the conflict of interest proposals and deferred consideration of the other two proposals indefinitely. (It is doubtful that the most important of the conflict of interest proposals can be effectively enforced. While it would seem desirable to prohibit a CRA from performing the dual roles of consulting on, and rating, a securitization, it is not obvious how this can be distinguished from the normal industry practice of the issuer showing several different hypothetical structures to the CRA until the issuer can achieve the mix of ratings they prefer for a particular pool of securities.)

The SEC decided not to differentiate ratings for securitizations from ratings for corporate securities because it seemed unhelpful when the securitizations were virtually moribund and officials were struggling to rid institutions of “legacy assets”. But the proposal was really quite timid and could be more justly criticized for avoiding the central problem. Risk cannot be summarized in a single letter or number. Risk indicators need to display a range of probable outcomes, and ratings of structured debt need to pay much greater attention to potential correlations within the underlying pool of assets.

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The SEC decided not to remove most references to ratings from the SEC's own regulations because it seemed inappropriate when other regulatory agencies were placing greater reliance on ratings. This seems much more like enabling behavior than regulatory leadership, and surely needs to be revisited.

The new Chairman of the SEC, Mary Schapiro, has recently proposed new rules to strengthen oversight of CRAs and to curb shopping for ratings by issuers of securities. She has also promised to expand the number of, and improve the training of, supervisors for the CRAs. In view of the track record of bank examiners supervising these same securities in the portfolios of banks, it is difficult to be optimistic that placing greater emphasis on supervision will improve the quality of ratings.

The EU Plan

By an impressive margin of 569 to 47, the European Parliament voted on May 6, 2009 that from 2010, all CRAs operating in the EU will have to register and be supervised in the EU. EU institutions will only be permitted to trade securities which are rated by CRAs registered and supervised in the EU. CRAs must apply to the Board of European Securities Regulators in France for registration, and will be overseen day-to-day by colleges of national securities regulators. The regulators will be required to impose strict rules ranging from disclosure of models and methodologies to corporate governance standards, such as the presence of at least two directors whose remuneration is not tied to the CRA's financial performance. Underwriters of securitized assets will be required to retain at least five percent of the issue. Questions remain regarding the consistency of application of rules across the nations that comprise the European Union, and if the rules evolve differently not just within Europe, but between Europe and the United States, there is a serious threat to integration of international debt markets.

The Obama Plan

Under the proposed legislation submitted by the US Treasury in June, 2009, credit rating agencies would be barred from selling consulting services to companies they also rate, and would be required to disclose any conflicts of interest. They would also be required to disclose fees paid by the issuer along with each rating report. In addition, they would be subject to "look-back" requirements to address conflicts of interest that might occur when an employee of a CRA shifts employment to a firm that he or

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she had been involved in rating. The CRA would be required to reexamine the ratings assigned to that firm.

To improve transparency and disclosure CRAs would be required to employ different symbols to distinguish the risks of structured products. In addition, they would be required to disclose additional quantitative and qualitative information along with the rating. Perhaps most importantly, each CRA would be required to make available to other analysts all information received from the sponsor of an issue of structured securities. Moreover, to discourage ratings shopping, an issuer would be required to disclose all the preliminary ratings it has received from different CRAs. The SEC would be given increased authority to supervise the CRAs. In addition, the SEC would be encouraged to reduce reliance on ratings "wherever possible," a much more timid step than the original SEC proposal.

Self-Regulation

In an important sense, this approach has already been tried. Under the auspices of the International Organization of Securities Commissions (IOSCO), the CRAs adopted a voluntary code of conduct in 2004. It was entirely ineffective in preventing the problems that caused the crisis because the principles were quite broad, did not include a means of implementation, and failed to address the underlying lack of transparency and conflicted incentives.

The establishment of best-practice standards[8]

The government could convene a Board of leading participants in securitization markets and give them a mandate to improve the transparency of these markets and to realign the incentives of each agent, including the CRAs, with those of final investors. This Securitization Transaction Approval Review (STAR) Board would be tilted toward leading institutional investors – pension funds, mutual funds, insurance companies, banks and endowments – but would also include various service providers – underwriting investment banks, originating lenders, lawyers, accountants, rating agencies and monoline insurers, all of whom share an interest in revitalizing the securitization process.

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[8] This is a highly abbreviated summary of a proposal by Richard Herring and Allen Levinson, "Restoring Confidence in Securitization – Why and How," May 2009.

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Investors would be assured that each new securitization awarded the STAR standard meets industry-wide best practices for transparency, due diligence, and communication of all relevant details to prospective and ongoing investors, and that all service providers have financial incentives that align their interests with those of the investors in the transaction. If the STAR approach successfully minimizes the risks of the securitization ***process***, market forces will lead to efficient pricing of securities based on the fundamental risks inherent in the underlying collateral and the associated tranching of the various securities, without adding the large uncertainty premium for the process itself, which now exists.

The key to the STAR evaluation is the establishment of explicit best practice hurdles for all service providers. Following is a starting point for discussion of such best practices, which the Board would, of course, refine. For example, CRAs would continue to opine on the credit quality of the securities based on their own criteria, but would be subject to three rigorous transparency requirements: (1) full disclosure of the assumptions that were used in assigning the rating; (2) full disclosure of all information received from the sponsor of the securitization; and (3) disclosure of the stress tests designed to provide insight into the likely stability of the rating in response to changes in assumptions. (CRAs would not be required to disclose the details of their models because this is proprietary information and CRAs should be given incentives to improve the accuracy of these models.)

Moreover, as rating agencies need to be heavily scrutinized concerning their assumptions about correlations in the underlying collateral, lawyers and underwriting investment bankers would be required to assume an affirmative obligation to look for and report any undisclosed correlations in the underlying collateral, or structural anomalies in the securitization that could adversely affect performance. Most importantly, to financially align incentives between service providers and investors, fees paid to regular service providers would be paid pro-rata, gradually, in line with return of principal to investors, so that service providers would be putting their fees at risk in the event of defaults in the underlying loans held as collateral, and would share in the economic risks of the transaction as partners with the investors.

This simple approach to aligning the interests of agents with those of final investors is likely to be less effective and possibly perverse with regard to CRAs. They are making probabilistic assessments of the likelihood of default on securities or tranches of securities that differ widely in quality. Their incentive

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structure should encourage them to provide the most accurate assessment of the probability when a security is issued, and to change that assessment as soon as conditions warrant. Perhaps the most effective way to achieve that goal is through heightened transparency that will permit other experts to provide alternative assessments based on their own methodologies. Over time market participants can judge which experts are pricing market outcomes most accurately, and their ratings will be worth more to issuers because they will reduce uncertainty to final investors and enable them to borrow on more favorable terms.

The government should remove ratings from all regulations to diminish this source of pressure for grade inflation, and make it possible for other kinds of experts to advise investors regarding the quality of credits when useful. To be effective this removal of ratings from the regulatory process should include state-regulated firms as well. The Government Accountability Office would be required to report annually to Congress on how effectively the Board has implemented the government's mandate to enhance transparency and better align the interests of the participants in the securitization process with those of investors.

Conclusion

In view of the widespread criticism of the performance of the CRAs before and during the credit crisis, it is surprising that we still lack consensus about how they should be reformed. Legislation in the US and the EU appears to be moving in uncoordinated directions, threatening the integration of world credit markets. Moreover, neither legislative approach deals effectively with the root problems of improving the transparency of the ratings process, and realigning the incentives of the CRAs with those of final investors. Worse still, most regulators appear to intend to continue to rely on CRA ratings for overseeing the institutions they supervise. This not only undermines incentives for independent analysis by regulators and regulated investors, but also it also leads to pressures on CRAs to inflate ratings. The quasi-official status of CRAs arguably undermines their effectiveness.

All participants in the securitization process have strong incentives to restore confidence in the process. This may be one problem that can handled by setting ground rules – improving transparency and aligning incentives of agents with final investors – and leaving the details of implementation to those

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who best understand these markets. Moreover, if the Board included foreign-based institutional investors, it might become a market-based alternative to the EU approach.

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