The Daily Dish

Credit Ratings (Again)

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Eakinomics: Credit Ratings (Again)

As Eakinomics noted recently, the business model of the Credit Ratings Agencies (CRAs) has – seemingly out of nowhere – come under scrutiny by regulators. Now *Financial Times* columnist Patrick Jenkins has weighed in with an opinion worthy of 2007 ("Credit ratings, like dodgy boilers, can still blow up the house").

Jenkins makes essentially two claims: (a) that regulators did little to change CRAs, and (b) that business model will hurt society because it is backward-looking and doomed by conflicts of interest.

The first is clearly not right. I am on record that the Dodd-Frank Act was far from perfect, but it did subject CRAs (along with the banks) to aggressive regulatory oversight. The resulting Securities and Exchange Commission (SEC) Office of Credit Ratings (OCR) conducts on-site examinations and ongoing monitoring to ensure CRAs manage conflicts of interest (check out the website of any CRA and you will find elaborate internal controls on conflicts) and whether their policies, procedures and methodologies are followed. The SEC publicly discloses these exam results in an annual report submitted to Congress.

Regarding the second, Jenkins rests his case on the models being based on data from the past. But that's the wrong focus. Instead, I would suggest that CRAs are desperately protective of their reputation for independence, with agencies looking at potential future risks closely. Additionally, potential conflicts of interest exist in nearly every industry and business model. How they are managed, and the processes and procedures put in place to mitigate their impact, are key to ensuring sound rating outcomes and investor confidence. The SEC has looked at the business-model topic ad nauseam, including in a 2013 study with the independent Government Accountability Office. Its conclusions are important: Through this model, ratings and methodologies are made available to everyone, for free, and are therefore subjected to everyday scrutiny from investors, academia, the media, regulators, and policymakers. This scrutiny is also a big check on any tendency to not update ratings models for new information.

Jenkins makes a great deal of information asymmetries, but they are not fixed by nature. Dodd-Frank also instituted a massive amount of disclosures to investors (Title 9) that was meant to address overreliance by investors on debt ratings; obviously there are a lot of other dimensions to that decision.

I remain confused by the sudden, misplaced interest in CRAs. They did contribute to the crisis, but structured credit based on poorly originated mortgages are the exception to the credit ratings record. Nevertheless the regulatory regime is much more rigorous, and the level of internal and external scrutiny has been raised. Jenkins' shallow alarmism is a disservice to the industry.