



The Daily Dish

Who Should Pay for Ratings?

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Eakinomics: Who Should Pay for Ratings?

The role of credit ratings in the financial crisis put a real [focus](#) on credit rating agencies (CRAs) – notably the “big 3” of Moody’s, S&P, and Fitch. The [report](#) of the Financial Crisis Inquiry Commission contains some unflattering language from the majority opinion: “We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction.”

My own dissenting opinion notes that: “Failures in credit rating and securitization transformed bad mortgages into toxic financial assets. Securitizers lowered the credit quality of the mortgages they securitized. Credit rating agencies erroneously rated mortgage-backed securities and their derivatives as safe investments.”

But neither party recommended, nor did Congress pursue, changing the basic structure of the credit rating activity. Issuers of securities continue to pay for the CRAs to provide ratings. So, a decade later, it is of considerable interest that in his [remarks](#) to the Investor Advisory Committee, Securities and Exchange Commission Chair Jay Clayton included:

Credit rating agencies: How much do retail investors rely on credit rating agencies and how much influence do they have in today’s marketplace? Are they appropriately disclosing, monitoring and managing their conflicts? Are investors actually harmed by the compensation models of credit rating agencies? Are there alternative payment models that would better align the interests of rating agencies with investors? This raises the question: How should one think of “investor pays” versus “issuer pays” for ratings? Here are a few quick points, limited by the space and caffeine available.

First, a subscription was the original business model for CRAs, meaning the United States has tried the investor-pays model before and switched. Upon reflection, there are some clear problems with the idea. Large investors could have a disproportionate impact on what issues got a rating. The more obscure sectors, where ratings are likely the most important, might be left by the wayside. But more important, only the subscribers get the rating information. This exclusivity gives them an information advantage and diminishes the efficiency of markets in guiding capital to its best location.

Second, the basic critique is that in the issuer-pays model, issuers can shop for good ratings. But those ratings would be available freely to everyone – no informational asymmetries – and everyone can check the track record of the CRAs. This transparency makes it hard to believe that systemic bias could survive as a basic business model.

Nothing is perfect. But at the broadest level, the *status quo* supports the greatest market efficiency and ability to attract capital to niche investments, and it still has a market-based mechanism to ensure quality and control potential conflicts of interest. There is a reason the investor-pays model disappeared and issuer-pays should not.