The (Limited) Role of Credit Ratings in the Financial Crisis

The cover story of this issue of *Region Focus* seeks to frame the policy debate about the future of the credit rating agencies. It's certainly a timely discussion. When financial institutions began to post significant losses, some observers suggested that many financial institutions had invested in new, complex securities — some of which have been downgraded to junk status today — mainly because those assets were at that time given a seal of approval by one of the "Big Three" rating agencies. Some of the reform proposals being discussed in Washington are geared toward eliminating what many argue were conflicts of interest that arose in the course of awarding those ratings.

It's important to acknowledge the concerns that many have about the agencies and how those agencies might have influenced the quality of investor information. After all, clear and reliable information is an important component of a properly functioning market. If an investor doesn't understand how a securitized asset is constructed — maybe because it is too opaque or simply too confusing to understand — market discipline may be weakened. Either a lack of transparency or a lack of comprehension by the buyer of an asset can lead to little or no check on the originators and underwriters of those securities.

Yet it may not be entirely appropriate to blame the apparent shortcomings of the securitization markets simply on the complexity of the products. If indeed that complexity raised sufficient concern among investors, it should have been reflected in the prices of those assets. And if those risk premia were not as high as we think they should have been after the fact, an undeserved credit rating may not have been the only contributing factor. It could be that investors simply had an incorrect view of the future of the economy or of particular institutions.

Nor is it appropriate to place all the blame with the credit rating agencies. Yes, an investor's false sense of security may have been reinforced by the inflated grade given to a securitized asset by the rating agencies. But intelligent institutional investors also probably had some understanding that the ratings awarded by the Big Three agencies were flawed in certain respects. That could have just as easily been factored into the price too. And indeed it was, to some extent, as structured securities routinely traded at spreads greater than similarly rated, but less complex, corporate bonds. This leads one to question the extent to which investors had a competing incentive to ignore countervailing information about the potential riskiness of the securitized assets they were buying.

One plausible reason investors bought these securities involves the incentives built into the capital requirements that financial institutions must observe. Credit ratings issued by the agencies were used to assign "risk weights" to the securities banks held. If the grade was high, banks could hold less capital as a buffer against losses. That gave banks an incentive to hold the highest-yielding (that is, riskiest) securities with any given rating — in short, potentially overrated securities.

Such a strategy might seem especially desirable to certain financial institutions if market participants believed the federal government would treat those institutions as "too big to fail" and would take action to keep them alive in the face of impending insolvency. This implicit promise to bail out institutions considered important to the stability of capital markets could have dampened market discipline no matter how good the information produced by rating agencies and others might have been.

When the government is in the business of protecting a certain class of investors and institutions against downside risk, it should be no surprise that those investors and institutions are more likely to take on risk. It should also be no surprise that information which might have spurred caution might be given less attention in such cases.

Better information — whether through a reformed rating process or through increased disclosure — could contribute to better functioning markets. But better information alone will not be sufficient to bring effective market discipline to bear on institutions that are widely viewed as too big to fail. What will be necessary is a widespread belief among investors that the government will not necessarily protect large institutions which make imprudent investments. So far, investors have little reason to believe that is the case. Indeed, quite the opposite. Establishing tighter boundaries on the financial safety net — and making those boundaries well known and credible — is a key task facing policymakers.

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