

Ratings Agencies, Regulation, and the Crisis

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Where did the Crisis come from?



- Macro economic imbalances that saw China exporting capital to the United States
- A failure to appreciate, both within banks and amongst regulators, the consequences of a total drying up of liquidity in the wholesale credit markets
- The market for securitized debt



- A portfolio of assets, often loans, is shifted to a SPV and used to collateralize one or more bond issues
 - ▶ Bonds are usually tranching
- Volumes have exploded in the last decade
 - ▶ Between 1996 and 2007, total volume of securitizations in the US increased from less than \$500 mn to about \$2.5 trn
 - ▶ Some banks, for example Northern Rock, came to rely upon securitizations to finance their lending

Why securitize?



- The first mortgage-backed securitization was brought to market in 1977 by BofA and was underwritten by Salomon Bros
 - ▶ It was a response to funding problems: thrifts could not raise interest rates in line with the market
 - ▶ Actually, therefore, it was really a response to regulatory restrictions
- Why securitize now?
 - ▶ Risk-sharing, commitment value, ...
 - ▶ ... And reduce regulatory capital requirements
- The motivation for securitization is often regulatory arbitrage

Why buy securitizations?



- Search for yield, which appeared to be provided by securitizations
- Risk hard to assess: securitizations opaque, often by design
- ... So high degree of reliance upon ratings agencies. And ratings appear increasingly to have been rather optimistic
 - ▶ Ratings cuts appear to have been a contributing factor to government intervention in AIG
- Should we regulate opinion production by the agencies?

Why believe ratings?



- Paid for by issuers
- So regulator reputation is of immense importance
- Did agencies stop worrying about their reputations? Why was this rational?

What are ratings for?



1. Risk assessment
 2. Gatekeeping
- ... The second role imposed by regulators: ratings used in bank capital assessments, and in determining investment universes
 - ▶ How is a BBB rating generated?
 - The motivation for securitization purchase is often regulatory arbitrage
 - We need to be very careful when designing a new regulatory framework that we do not simply exacerbate existing problems
 - On the other hand, institutions will always work to move outside the ambit of the regulator. This cannot be helped

What to do?



- Closer regulation of ratings agencies
 - ▶ Might ameliorate the worst incentive problems
 - ▶ But it might reduce the relevance of reputation even further
 - ▶ And it may even *increase* financial fragility
- Remove ratings from formal regulation
- Disclosure requirements
- Netting agreements where possible