Mission impossible for ratings

The US Securities and Exchange Commission is soliciting views on how to reform the credit rating process to minimise conflicts of interest and assure higher-quality ratings. But this exercise is based on an erroneous view of the possible, argues ***David Rowe***

It is widely recognised that credit rating agencies failed miserably in their mission to provide credible evaluations of the quality of highly structured residential mortgage-backed securities. Many argue this failure was a direct result of conflicts of interest inherent in the 'issuer pays' structure of the rating market.

While there is an element of truth in this view, it fails to capture the whole story. The only fully credible path the rating agencies could have taken was to refuse to wade into this swamp in the first place. Having done so, they could have retained some of the credibility they have lost by refusing to rank the tranches of these securities on the same AAA to CCC scale traditionally used for corporate bonds and other traditional debt securities. Insisting on a new and distinctive rating scale, however, might well have been equivalent to refusing the business outright. For the arrangers of such securities, use of the traditional scale was a crucial advantage, as it allowed these securities to be eligible for purchase by many conservative long-term investors with mandates defined on this basis.

Currently, the US Securities and Exchange Commission (SEC) is soliciting comments on various proposals to reform the institutional framework of credit ratings. The supervisor wants to ensure effective ratings, as if there is some objective truth that can be discovered as long as the right incentives are in place. In fact, when dealing with innovative, highly complex and historically untested structures, no such objective truth exists. The perceived credit quality of such instruments can be as diverse as views on whether a given company's shares are a buy or a sell. Imposing a one-size-fits-all rating scheme risks unrealistically homogenising market perceptions that should be highly diverse if adequate information for detailed analysis was widely available. Furthermore, it is just such homogenised perceptions that can lead to herd behaviour and major market dislocations when broadly shared expectations prove to be unfounded.

Trying to reform market structure in search of a non-existent objective measure of credit quality and associated risk amounts to a mission impossible. It is bound to bureaucratise and homogenise ratings, thereby creating an inflexible structure that is vulnerable to a systemic crisis. In fairness, the SEC is only doing what was mandated by the US Congress. Nevertheless, what should be done is to seek a framework that will make all the relevant data underlying such securities readily available in a standard format to a broad community of analysts.

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With access to the details underlying financial contracts and instruments (such as underwriting standards and statistics, pricing, terms and conditions, representations and warrants, as well as appropriate process and workflow calculations), new, complex and untested products could be analysed in a wide variety of ways. This would probably lead to an equally wide variety of opinions on their likely performance. As programmers often say, 'that's not a bug, that's a feature'. This is how markets are supposed to work. Over time, different views would prove more or less indicative of actual performance. Moreover, such heterogeneity of views is characteristic of a robust structure that tends to resist major systemic upheavals.

The question is how governments can promote such a structure. In particular, how can they ensure that detailed data will be maintained and updated as conditions change? I believe the essential lever for achieving this is a process that utilises transaction credits. At one level, these can be a form of cash discounts for greater volumes of trading. These also can be used to provide discounted access to the detailed data needed for continuous risk assessments. An exchange for trading these products that was built on the foundation of such data would be able to charge for continuing access to the essential risk assessment information. Furthermore, discounts on the data fees would be linked to trading volume. In essence, the most valuable resource such a system would create – namely, access to currently updated underlying data – would be used as an incentive to drive trading volume and market liquidity, thereby addressing the biggest hurdle to the success of any new market venue.

A more detailed outline of such a system is described in a US patent granted to Marketcore, a small intellectual property company, under the title Efficient Market for Financial Products (see *http://www.marketcore.com/patents_efficientmarket.php*). In the end, the SEC would do well to spend more time considering how to foster this type of institutional structure that encourages and rewards disclosure than in tilting at windmills in the belief that reshaping the credit rating market can produce uniquely reliable risk estimates of new, complex and historically untested financial instruments. ■