

## **SECURITIZATION AND SUBPRIME CRISIS: A CRITICAL ANALYSIS OF THE ROLE OF CREDIT RATING AGENCIES**

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### **Abstract**

Rating agencies play a vital role in converting illiquid assets into marketable securities. This paper provides a critical review of credit rating agencies (CRA) role in the securitization process with a view to finding out how far the CRAs are responsible in causing the crisis. On the basis of the critical review, we posit that credit rating agencies are partially responsible (investors and regulators/policy makers are the other partners who cannot avoid responsibility) for flourishing securitization markets and subsequent subprime crisis. Conflicts of interest, lack of transparency and lax regulation encouraged rating agencies to do a poor job in rating and indulge in unethical jobs. We suggest that the rating agencies' activities need to be closely monitored and they should be made subject to tougher regulations as investors (especially small investors) often value ratings for informational content and make their investment decision based on their ratings.

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# SECURITIZATION AND SUBPRIME CRISIS: A CRITICAL ANALYSIS OF THE ROLE OF CREDIT RATING AGENCIES

## INTRODUCTION

Securitization refers to operations in which the cash flows from specific assets are isolated from the balance sheet of the originating institution and used to support marketable securities (Thompson, 1995). It is a financial instrument aimed at transforming a pool of assets into marketable securities. The marketable securities are backed by the cash flow stream related to the underlying assets (ABS) (Caselli & Gatti, 2005). The aim of Securitization is to transform illiquid assets into marketable securities. Asset Securitization transforms private debt (such as bank loans) into public debt (marketable securities)(Sinkey,2001). It is a means of risk management, which allows issuers to reallocate, commoditise and transfer different types of risks (e.g. credit risk, interest rate risk, pricing risk etc) to capital market investors in return for some fair market price. Securitization helps financial institutions to transfer risks associated with a pool of assets to the secondary market investors. It contains hidden risks that from time to time result in very substantial losses. With the most securitized loans, neither the originator, nor the guarantor, nor the investors in the securities monitor the borrowers (Sinkey, 2001). As a result, there exists greater risk of borrowers being defaulted resulting in non- payment of interest/principal to the investors. The risks that investors in securitized bonds bear depend mainly on the quality of the underlying assets, rather than the creditworthiness of the issuer or the originator (Tasca & Zambelli,2005). In essence, securitization is an alternative and diversified source of finance based on the transfer of credit risk (and possibly interest rate and currency risk) from lenders to investors (Jobst, 2008).

Although securitization could be both 'on balance sheet' and 'off-balance sheet', the term has been used more recently to refer to the 'off-balance sheet' securitisation. While banks and other financial institutions view securitization as an expedient means to escape inconsistent regulatory capital charges for credit exposures (i.e. for "optimisation of regulatory capital"), non-financial entities employ securitization primarily for the liquidity management of existing receivables (Jobst, 2006: 735-36).

Securitization got its start in the US financial system in the 1970s. At that time, the Government National Mortgage Association issued securities backed by a pool of residential mortgage loans. Starting in the 1980s, other income-producing assets began to be securitized (Jobst, 2008). During the last decade or so, it has rapidly developed in Europe especially in the UK, Italy, Germany, Australia and French.

Easing regulatory *capital requirements* (by lower bad debt provisions) in order to manage risk, reduce the size of the bank but at the same time increasing their return on capital (through repeated securitisation) are the main motivations for securitization (Jobst, 2005). ABS allows banks to transfer the funding of loans to the securities markets and provides them with off-balance sheet financing. Banks however, are required to report a part of the ABS as liabilities that they guarantee through credit enhancement provisions (Wolfe, 2000).

By securitising assets and removing them from their balance sheet, banks can use the cash proceeds for a number of reasons such as to reduce deposit levels, retire a debt, and buy back share capital (Wolfe, 2000). Twinn (1994 in Wolfe, 2000) shows that as capital requirements of bank increases, so does the absolute quantity of assets securitized. Banks willing to expand their loan provision business without increasing their capital or liabilities resort to securitization. Corporate issuers securitize to efficiently access capital markets in

lieu of intermediated debt finance at a cost of capital, which would not be possible on issuer's own credit rating more efficiently (Jobst, 2006).

The securitized lending function has three steps: originate, sell, and service. When servicing rights are sold, securitized lending can be reduced to a two-step process; originate and sell (Sinkey, 2001). By contrast the traditional approach of bank lending is balance-sheet lending, which has four functions: originating, funding, servicing, and monitoring.

Originating refers to making the loan, funding implies that the loan is held on the balance sheet, servicing means collecting the payments of interest and principal, and monitoring means to conducting periodic surveillance to ensure that the borrower has maintained the financial ability to service the loan (Kothari, 2006).

Securitization is often blamed for contributing to the global financial crisis. Ingham (2008: 149) observed, "securitization of the US subprime mortgages led to the global financial crisis during summer 2007". Securitization-disintermediation increased the magnitude of lending to subprime borrowers and in due course at high default rate (Bicksler, 2008). Financial assets worth billions of dollars were being written off by US and European banks as the securitized mortgages became illiquid. Governments across the world had to bail out troubled financial institutions at the cost of public money. The US government rescued the Citi group by guaranteeing \$US306 billion of troubled mortgage assets (held by Citigroup) and inject another \$US20 billion in capital. This fresh capital and a guarantee for its troubled mortgage assets (some US\$300 billion), helped Citigroup to avert a possible collapse (Solomon, 2008). In September, 2008 the US government committed \$US700 billion toward rescuing the leading financial institutions and injecting liquidity into the US economy. Similar steps were taken by the UK and other European Union countries costing a huge amount of public money (Baaquie, 2009). The US downturn is sweeping across the world- from China to Chile, from Germany to Japan and from UK to Australia. It has also affected the traditional economic powers of the North Atlantic and the emerging economies of the Asia Pacific, i.e. every nation, every government and every economy is affected (Rudd, 2008).

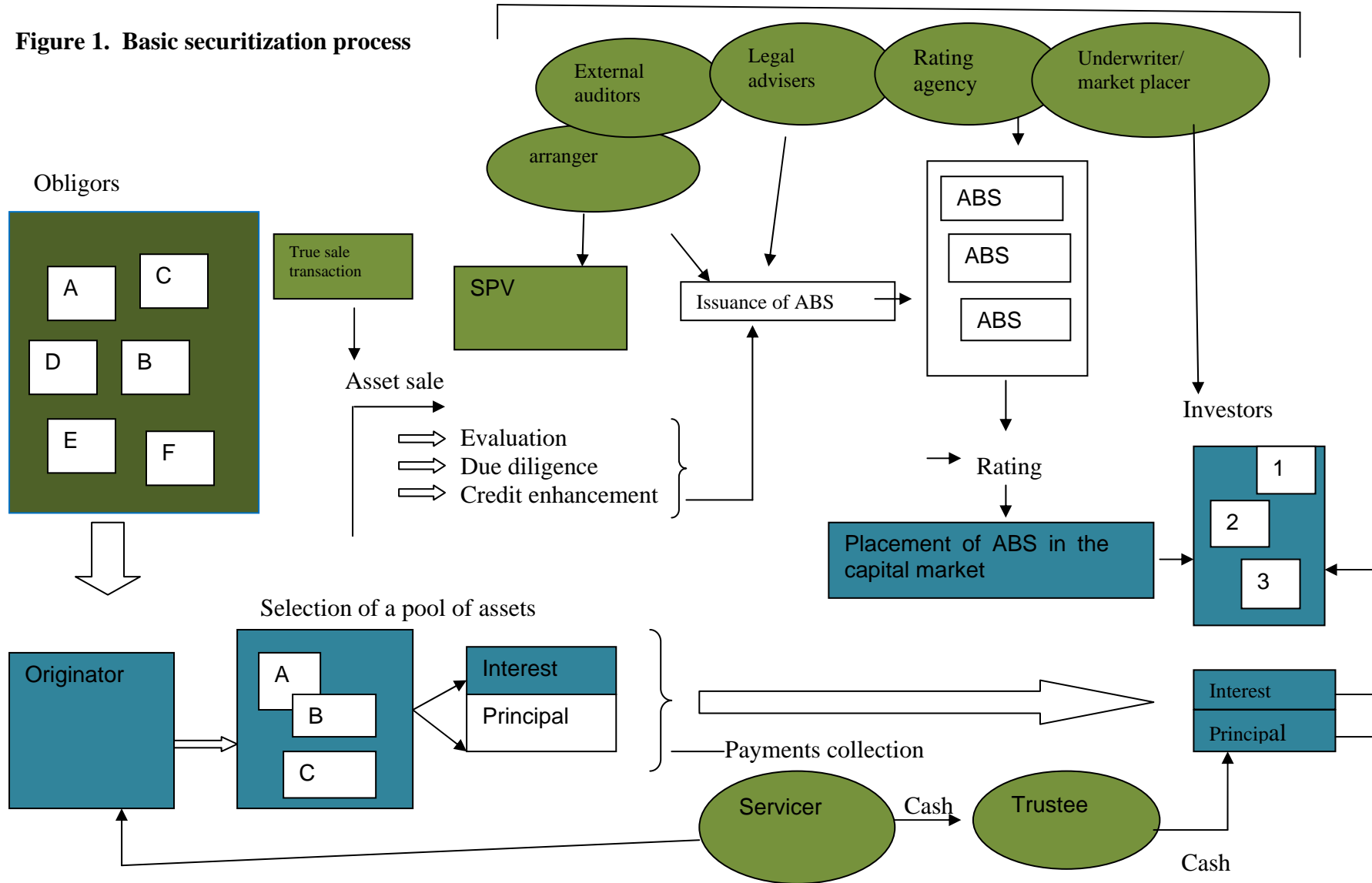
In transforming illiquid assets into marketable securities, different actors are involved with varied roles. These actors include: borrowers, loan originator, special purpose vehicle(entity)(SPV/SPE), rating agency, credit enhancer , underwriter and investors. Among others, rating agencies' role is vital in making securitized assets marketable and attractive to investors. It is often a regulatory compulsion to have securitized assets credit rated. As per Italian Securitization law, a rating is required only when ABS are sold to the private investors. Regulatory compulsion is also found in other countries. Credit rating agencies are often accused that they played a vital role in subprime saga by giving debt parcels far higher ratings than they deserved (Brummer, 2008). This study examines how far the allegations against the rating agencies do stand correct. Keeping that view in mind, this paper also analyses the role of credit rating agencies in the securitization and subprime saga.

The remainder of the paper is organized as follows. Section 2 provides the conceptual issues of securitization (both ABS and MBS). In section 3, we analyse the reliability and integrity of the ratings with reference to some examples. Section 4 makes a brief review of CRA regulations and recently undertaken regulatory measures. Section 5 comprises a brief discussion on the role of different partners/actors in contributing to subprime crisis, while Section 6 points some suggestions for policymakers to protect investors' interest. Finally Section 7 concludes the paper.

## ASSET SECURITIZATION -CONCEPTUAL ISSUES

There are different steps involved in securitising a package of loans. First the financial institution (say bank) originates and distributes loans to the borrowers. These individual mortgages are then pooled in a bundle and sold (the claims to their repayments) into a special-purpose vehicle (SPV)(a separate entity) controlled by a trustee. This trust (also called bankruptcy remote trust) issues the mortgage-backed securities to institutional investors to fund the purchase. *This trust is an essential component of credit risk transfer, as it protects investors from bankruptcy of the originator or arranger.* The assets thus move from the balance sheet of the loan originator (here the lending bank) to that of the SPV. The lending bank thus removes the loans from its balance sheet and boost profitability as selling loans frees up capital for new business (Moosa, 2008). In issuing the securities, the marketability of these new issues is improved by obtaining good credit rating (such as AAA) from rating agencies (Viney, 2007). This is where the role of third parties (such as an insurance company) in securitization process comes. By augmenting credit enhancement, an outsider insurer can foster securitization (Greenbaum & Thakor, 1987).

**Figure 1. Basic securitization process**



(Source: Tasca & Zambelli, 2005:13)

The process of securitization involves five basic parties:

1. The loan originator or broker (bank or financial intermediary)
2. The loan purchaser (an affiliated trust, also called a SPV)
3. The loan packager (underwriter of the securities)
4. A guarantor (insurance company)
5. Investors that buy the securities (e.g. banks, insurance companies and pension funds)

In most cases, the loan originator (sponsor) usually services the loans in the portfolio, collects payments (principal and interests) from the original borrowers and, passes them on—less a servicing fee (loan originator earns this as revenue) - directly to the SPV or the trustee. The SPV pays from the funds so collected to the ultimate investors holding the securities (Sinkey, 2001, Jobst, 2008). The loan originating institution earns a ‘servicing fee’ for this, which adds to its revenue. Indeed many institutions originate loans with the primary objective of building up a “servicing portfolio” of loans that will generate future fee income for them (Johnson, 2001).

Since the mid 1980s, better technology and more sophisticated investors have combined to make asset securitization one of the fastest growing activities in the capital markets. Securitization has evolved from a non-existent industry in 1970 to a major funding source with an estimated total aggregate outstanding of \$8.6 trillion in 2006 (\$6.5 trillion for MBS and \$2.1 trillion for ABS) and new issuance of \$3.2 trillion in 2006 (\$2 trillion for MBS and \$1.2 trillion for ABS) in the U.S. markets (Wu & Yang, 2007).

Risks often remain with the originating institution (sponsor) because removal of assets (in the case of securitization) from the originator’s balance sheet relies on a “true sale” to a legally remote SPV. If the assets are not truly sold or the sale is not to a legally defined third party, the assets must be reported on the originator’s balance sheet. One important determinant whether a true sale has occurred is whether the sale agreement provides recourse or performance guarantees to the buyer. If recourse terms are present, i.e. loans sold with *recourse*, the assets continue to present contingent risk to the institution (seller), (which under FASB 140 prohibits the removal of the assets from the seller’s balance sheet) and as a result remain in the risk-based capital calculations (Higgins, Joseph & Mason, 2004). On the other hand, when a loan is sold without recourse, the credit risks shifts to the investor holding the securities. Thus the loan originating institution does not bear any future default losses on loans sold without recourse<sup>1</sup>. Regulators allow an institution that sells loans without recourse to remove them from the calculation of risk-based capital purposes. It is thus clear that although securitization helps to avoid capital constraints, it does not hold true to loans sold with recourse (Johnson, 2001).

## **HOW FAR RATINGS GIVEN BY CRAs ARE DEPENDABLE AND RELIABLE**

A credit rating is a rating agency’s credit quality assessment of a debt issuer or a specific debt obligation. Credit rating is a key informational tool that investors (especially small investors as opposed to sophisticated investors<sup>2</sup>) use in evaluating and selecting the investment. However, there are differences of opinion regarding the informational value of ratings. Arguments are there that credit ratings are valued not because of their informational

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<sup>1</sup> Recourse means that if any of the securitised assets defaults, the buyer then has a claim on the originator. If recourse is provided, an asset’s risk is not effectively removed from the lender’s balance sheet (i.e. it still must be backed by capital (Sinkey, 2001).

<sup>2</sup> For relatively sophisticated investors, ratings “merely complement” their own analysis and modelling.

content, but rather because numerous laws and regulations refer to ratings issued by a “nationally recognized statistical rating organization” (“NRSRO”) and give more favourable regulatory treatment to the holder of a security that is rated highly by an NRSRO than a security that is lower or not at all (Kettering, 2008). Issuers get their issues credit rated, in part, to comply with regulations. Almost all agencies base their ratings on the relative, not absolute, probability of default. Credit rating agencies increasingly focus on structured finance and new complex debt products, particularly credit derivatives, which now generate a substantial share of their revenues and profits. With respect to these new instruments, the agencies have become more like “gate openers” than gatekeepers (Partnoy, 2006:60). The rating agencies, at the height of the housing boom, had conferred the AAA (highest) rating on bundles of mortgage-backed securities, despite being clueless about the poisonous mixture of debt inside those bundles. Those securities later were downgraded to BBBs, the second lowest grade (Brummer, 2008:50). The poor quality ratings by the CRAs are partly due to poor methodologies. Ackermann (2008:333) observes, “the methodologies employed by rating agencies have been found wanting in connection with the assessment of the default probabilities of structured products.

Rating agencies had played a vital role in assessing the quality of the pool of obligations being securitised and in creating and marketing “tranches” of claims to cash flows from the underlying mortgages or other debt (Goodhart, 2008). It has been found that in most of the cases, rating agencies did a poor job of assessing the default risk of securitized bonds and other instruments based on subprime residential mortgage (Hunt, 2008). Rating agencies stamp higher ratings<sup>3</sup> to ABS than they deserve with a view to maximise their personal gain. Providing rating to securitised assets seems to be the rating agencies’ most profitable business line. For instance, Moody’s generates over 40% of revenues from structured finance ratings, for Fitch it is the most important business and growth driver (Fimalac Group 2006, pp. 32-33 and Moody’s Corporation 2006, p. 7 in Fabian, 2007). The CRAs charge almost three times as much for securitised assets (MBS/ABS)/rating as they do for corporate bond work (Moody’s August 2007 Investor Presentation).

In a study, it has been found that stamped AAA ratings to about 80 percent of the sub-prime bonds issued by securitising mortgages. These same bonds later came to be called ‘toxic waste’, showing the complicity of rating agencies in the subprime crisis. Credit rating agencies were at the heart of the rise of securitization and securitised assets were at the heart of the Subprime problems (Goodhart, 2008). Depending on the grading given by credit rating agencies, investors invested massively in mortgage backed securities which later turned out to be of little worth. As a result, originator/arranger defaulted to make payments to investors. The investment grade (AAA rating) also attracted a massive inflow of investment from insurance companies and sovereign, pension and hedge funds and others Providing AAA ‘investment grade’ to securities what were essentially junk bond type of instruments, allowing credit standards to collapse, permitting mortgages to people with low or no credit ratings, and all of these with the active connivance of bankers, mortgage brokers, lawyers and rating agencies have all contributed, if not caused the current crisis (Baaquie, 2009). The assigning of investment grade ratings to securities which later turned in to junk bonds raises doubts about their ethical standard and integrity. The inflated ratings assigned by the CRAS turned subprime loans into shiny and lucrative marketable securities, helping securitization market to flourish. Similarly they maximised their business by providing desired ratings by the issuers. In Whitehead and Mathis’ (2007:7) words, “It is no denying the fact that CRAs have an enormous amount of self-interest vested in keeping the structured finance machine going”.

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<sup>3</sup> High ratings on such securities had an inordinate effect on markets, and that when a large number of borrowers started to default on subprime mortgages in 2007, the low quality of the ratings was revealed (Hunt, 2008).

The complex financial products (created through the process of securitization such as MBS) were marketed successfully because they offered high yields and were initially rated highly (as a good debt with little risk of default) by the rating agencies such as Standard & Poor's and Moody's. In Moosa's (2008 p.1) view, "This is certainly a fiasco, because the rating agencies are paid for their services by the issuers (not the buyers) of the securities, which means that it is in the interest of the rating agencies and their clients (the issuers) to rate the assets highly and dump them on unsuspected (and perhaps naïve) customers, who use these securities as a means of saving for rainy days". Not only naïve customers, sophisticated investors such as hedge funds and banks also acquired them.

Structured products credit ratings are fundamentally different than ratings of traditional debt, since each structured product is a portfolio of securities which often have received their own, individual credit ratings by CRAs (Frost, 2006). In the case of traditional debt, pre-rating dialogue between the rating agency and the issuer is of limited importance, because an issuer usually is unable to adjust its creditworthiness before issuance. On the contrary, rating of securitized debt is characterized by extensive pre-rating dialogue. In the dialogue the issuer expresses the desired rating, and the rating agency indicates whether the structure and level of credit support proposed by the issuer will suffice to achieve the desired ratings. The rating agency requires the issuer's counsel to provide opinions, pertaining to the risk that the securitization structure might be deemed property of the Originator's estate in the event of the Originator's bankruptcy (Kettering, 2008). Credit ratings are useful complements to investors' own credit risk analyses because CRAs have substantial expertise and are independent. Ratings are especially important for structured financial products as this kind of transactions are typically ratings-driven.

### ***Incorrect Ratings Help Flourishing Securitization Market***

Investors have relatively detailed information on the issues in the corporate bond sector. So they do not have to rely solely on the credit rating agencies' reports. By contrast, in the structured finance product market, investors do not usually have access to the required information themselves. Investors therefore have to depend on third party assessment. The information asymmetry between loan arranger/originator and investors in securitized assets makes the CRA ratings even more important as these ratings provides indications about the default probability of asset classes. Investors are less able to assess the true quality of the bonds backed by current and future revenue from the converting (bundled) assets. An assessment of the quality of securitized assets and the individual tranches thereof by impartial third parties is valued highly by the investors (Brabander, 2009). Given the significant role the rating agencies play in securitization process, special care and transparency is warranted (called for) from CRAs. Evidence of ratings agencies' activities does indicate otherwise.

Rating agencies failed to '**sniff out the rot**' in securitised products such as those backed by subprime mortgages in the US that crashed in value amid home loan defaults (McCreevy in Jones, 2008). Inflated ratings continued to occur since rating agencies were essentially unregulated until the Credit Rating Agency Reform Act of 2006 came into being. The rating agencies rated thousands of securitized mortgage backed assets highly, which they had to downgrade in the wake of the sub-prime mortgage crisis. The rating agencies have been significantly successful in avoiding liability for issuing allegedly incorrect ratings. A 2002 Congressional staff study stated that rating agencies are "officially shielded from liability for all but fraud under the securities law". They are not even made liable for a negligence standard of care for their work (Kettering, 2008).

The SEC staff report cites rating agency internal e-mails to the effect that ratings on structured finance deals were issued even when questions on specific deals were unresolved. It states that an analyst wrote in an e-mail that her firm's model did not capture 'half' of the deal's risk, but that "it could be structured by cows and we would

rate it”, and that a manager wrote, “[O]ur staffing issues, of course, make it difficult to deliver the value that justifies our fees”). (Hunt, 2008:48-49)

Evidence of unethical business practices to maximise rating revenues have also come to broad day light. Inquiries into Ratings industry discovered, “emails were discovered where one analyst, when asked why he was rating a bit of toilet paper, replied, “ [W]e rate everything, even if it is structured by cows, we rate it. If someone will pay you to rate their paper and that is your business, then you rate it” (Collins & Durie, 2008). Partnoy states, ‘the only reason why rating agencies are less at risk for liability than other gatekeepers is that no authoritative body has carefully considered the question of credit rating agency liability (Partnoy, 1999/2006). The credit rating industry is devoid of competition and oversight (the Economist, March 26 2005). Addition competition would have a beneficial impact on the marketplace.

### ***Rating Agencies have abused their Dominant Position***

Reports are also available from some hearing participants that the largest rating agencies have abused their dominant position by engaging in some anticompetitive and abusive practices. For instance, Fitch complained that Moody’s and S & P were trying to squeeze them out of certain structured finance markets through “notching”- i.e. lowering their ratings on, or refusing to rate securities issued by certain asset pools (e.g. collateralized debt obligations), unless a substantial portion of the assets in those bundles were also rated by them (US SEC, 2003).

### **Rating Agencies’ Defence**

Although rating agencies have done a reasonably good job in predicting the probability of default of corporate bonds, their reputation has been tainted due to the occurrence of grade inflation in securitised assets/ pool of obligations being securitised. This might have occurred due to several reasons: one reason is their lack of integrity/dishonesty to maximise their personal gain. Another reason is that there exists a *conflict of interest*. As issuers and underwriters shop around for ratings and unwilling to pay the ratings they considered too low (poor), rating agencies are under undue influence of issuers & underwriters to grade the securitised bonds to the likings of the issuers. Some analysts have argued that the major rating agencies’ business models have inherent conflicts of interest. The *issuer-pays business model* offers a strong incentive to the rating agencies to inflate the rating and be aggressive in their legal judgments about new financial products. Firms could threaten to take their business elsewhere if they are not given the desired rating, or they can offer to pay more in exchange for a higher rating. This amounts to a threat to the independence of rating agencies. Especially, large CRAs’ independence seems to have been compromised by unmanaged conflicts of interest. Moreover, as rating agencies are increasingly offering ancillary services, conflicts of interest may become a much more important issue (Hill, 2004).

In the case of the securitized debt, pressure for higher grade has been particularly intense because the large underwriters of securitised assets could contribute substantial future revenue to a cooperative Rating agency. This increases the scope for undue influence (Goodhart, 2008). Surveys of investors show widespread scepticism of ratings. Evidence also suggests investors or a large proportion of them have little faith in the accuracy of ratings. In 2005, the rating agencies were criticized for rating General Motors and Ford debt investment grade at a time when the market priced that debt at credit spreads equivalent to junk status (The Economist, March 26, 2005p.19). Rating agencies also fail to adjust ratings in time to be of use to investors. In 2001, the dominant rating agencies continued to rate the ordinary debt of Enron Corporation as investment grade until four days before Enron applied for bankruptcy. The situation has however changed since these occurrences. Moody’s publishes “market implied ratings” (MIRs), which reflect the market price of credit for various issues over time (Partnoy, 2006).

Ratings agencies take the position that they rate structured financial products based on mathematical models whose results depend heavily on assumption regarding default probabilities of portfolio components and their correlations. These assumptions are based on historical performance. In the case of subprime loans and other financial derivatives, the historical data were very limited. So they could not factor in the potential risks attached with the underlying assets of MBS as they had no experience or information on how mortgage backed portfolios/securities behave in difficult times. In effect real estate prices in the US rose continuously until 2005 and there were no nationwide depression in housing prices in decades before the 2007 housing bust (Brabander, 2009, <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1985> retrieved 15 January, 2009). They also assert that the potential conflict of interest created by the *issuer-pays business model* is not a problem at all because [n]umerous studies have found that any potential conflicts of interest attendant to the model either have not materialized or have been effectively managed. [source: See *Assessing the Current Oversight and Operation of Credit Rating Agencies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (March 7, 2006) cited in Hunt, 2008 p. 17]. As far as conflict of interest in the ratings system (arising out of issuer-pays model) is concerned, the agencies argue that the issuer-pays model "promotes the wide and free dissemination of information to the market quickly" and facilitates subsequent market scrutiny of the ratings (Hunt, 2008:34). Rating agencies often take the conventional defences (to liability or to defend them in court cases) that they lack duty to aggrieved investors with whom they are not in any meaningful contractual privity, and the unreasonableness of investors' reliance on ratings when investors are warned that they(ratings) are merely opinions and not investment advice. This conventional argument of rating agencies is quite potent under traditional principles of tort law (Kettering, 2008).

## REGULATIONS FOR CREDIT RATING AGENCIES

The International Organization of Securities Commissions ("IOSCO"), (an organization comprised of national and regional securities regulators) issued the "Code of Conduct Fundamentals for Credit Rating Agencies" (the "IOSCO Code") with a view to promoting investor protection by safeguarding the integrity of the credit rating process while seeking to improve the quality of credit ratings and their usefulness to investors. The IOSCO released its new code of conduct for credit rating agencies (CRAs) in July, 2008 to specifically address issues related to the activities for structured finance products. The code of conduct (issued by IOSCO) regarding transparency and disclosure in relation to CRAs' methodologies, conflicts of interest, use of information, performance and duties to issuers and **the public are not mandatory, rather optional (www.StructuredFinanceNews.com // August 4, 2008)**. Before the current initiatives, the Sarbanes-Oxley Act of 2002 ordered the SEC to hold hearings on rating-agency performance. After several hearings, and an SEC initiative to revamp its rules, Congress enacted the Credit Rating Agency Reform Act of 2006. The 2006 Act empowered SEC to regulate rating agencies in several areas(such as inspecting CRAs, although the commission would have no say over their rating methodologies (Hunt,2008:14). The Act however, abolished the SEC's authority to designate credit-rating agencies as "nationally recognized rating agencies (NRSROs)." Instead, a credit-rating company with three years of experience that meets certain standards would be allowed to register with the SEC as a "statistical ratings organization." This would open up the credit rating industry to more competition. The law is aimed at curbing alleged abusive practices such as the practice of sending a company unsolicited ratings with a bill; notching, which occurs when a CRA lowers ratings on asset-backed securities unless the firm rates a substantial portion of the underlying assets; and tying ratings to the purchase of additional services (Leone,2006).

The 2006 CRA Reform Act and the SEC's 2007 rules under the Act represent the culmination of the "post-Enron" regulatory effort. The said Act and rules are enacted with a view to addressing the issue of methodological transparency by requiring NRSROs to make public their rating procedures. The SEC decides not to require disclosure of rating methodologies, but rather to require disclosure of a description of rating procedures and methodologies (Hunt, 2008 p.23). SEC also proposed rules in 2008 (2008 proposed rules) to enhance methodological transparency. The proposals calls for agencies to disclose how frequently credit ratings are reviewed, whether different models are used for reviews as opposed to initial ratings, whether changes to models are applied retroactively/retrospectively to existing ratings (Hunt, 2008 p.24). Similarly, the European Parliament called on the European Commission (EC) to assess the need for legislation to deal with the CRAs (The Committee of European Securities Regulators [2004] in Frost, 2006). The issues cited by the EC are CRAs' *potential conflicts of interest*, transparency of CRAs' methods, CRAs' access to inside information, and alleged anticompetitive or unfair practices.

### **Measures Undertaken**

Rating agencies play a pivotal role in the financial world as their grades can be key factors in determining a company's ability to raise or borrow money, and at what cost which securities will be purchased by banks, pension funds or local governments. The Credit Rating Industry is widely accused for its controversial role in the subprime mortgage debacle and ensuing credit crisis. The Policy makers/ US Federal regulators (5 member US SEC) have undertaken a number of initiatives intended to address perceived problems with such ratings- reducing conflicts of interest, enhancing competition and promoting more transparency, etc. In addition, rating agencies will be required to disclose statistics on all their upgrades and downgrades for each asset type. They also will have to disclose how much verification they performed on the quality of complex securities in determining ratings for them. The provision also prohibits employees working on ratings from engaging in discussions about fees or receiving gifts from corporations or underwriters that are over \$25 in value. One measure approved would prohibit a credit rating firm or its affiliate from issuing a rating on a security when it also advises, underwrites or sponsors the structuring of the security under consideration. Rating agency must provide the agency and public with more details about their ratings. One key regulation requires rating agencies to make publicly available on their website the data and history behind 10% of their ratings. After nearly a century of policing itself, the industry came under SEC oversight through a 2007 law. European Union regulators, who last month put forward strict new rules for the rating agencies that would hold them liable for their opinions. (Sydney Morning Herald, 4 December, 2008) <http://marketpipeline.blogspot.com/2008/12/sec-oks-conflict-of-interest-credit.html>).

The 2006 Act and 2007 rules attempted to address the issue of methodological transparency by requiring NRSROs to make public their registration material, including their rating procedures. The SEC decided not to require disclosure of rating methodologies, but rather to require disclosure of a description of rating procedures and methodologies.

### **DISCUSSION**

The subprime crisis arising from securitization show us that the CRAs contributed partly in mounting the subprime crisis through low quality ratings. We argue agencies are partly liable as there are evidences that reveals that they failed to demonstrate due integrity and in some cases, inflated ratings in making securitized assets easily marketable. It is however, difficult to prove without beyond doubt if poor performance on their part is driven by profit

motive (intended to deceive) or inaccuracy of models and methodologies in predicting default probability of mortgage backed securities. CRAs may issue low-quality ratings without any intention to mislead anyone or it may not. Apart from revenue motive (corporate greed) and lax monitoring, the methodologies that CRAs followed in assigning ratings to novel financial products seems to have also contributed towards poor ratings. Wray (2008:57) notes, "...there are systemic problems with the credit ratings assigned by the CRAs". The systemic problem lies in the quantitative risk models that CRAs used for ratings. These models relied on the assumption that past performance was a good indicator to future performance. This required the structure of the economy and the financial system to remain constant, which were not. In the case of new financial instruments (securitised bonds), CRAs issued ratings on the basis of models which were based on data from a few years' experience – and the period was an unusually good period for house prices. These models did not incorporate systemic risk attached to the fluctuation of value of the underlying assets (housing bust) of the MBS. As a result, when the housing price collapsed, the default probabilities as rated by the CRAs turned out to be inaccurate and the default rates far exceeded than the ratings indicated.

We also argue that the regulators and policy makers as well as investors are equally liable in allowing securitization market to grow. In our view investors primarily responsible for the losses they suffered by rushing to invest in novel financial products driven by the lust for higher returns. They did not exercise their own-*"due diligence"* in making investments in the risky securitized assets. Similarly, regulators such as SEC and policy makers were not vigilant enough in initiating regulatory measures/preventive measures to constrain unbridled growth of the securitization market. They could have stepped in earlier and initiated at least some of the measures, if not all, which the SEC/other policy makers have recently adopted or in the process of adoption (as we noted in earlier section under "Measures taken"). They were standing idly. The regulators have very recently begun a serious reevaluation of the role of ratings agencies. The subprime crisis tells us that the system of regulation financial markets (particularly securities market) and its players (such as rating agencies, investment bankers, brokers etc) lags behind times. The regulatory framework has not been updated commensurate to the risks and complexity attached with novel structured financial products (e.g. securitized debts/bonds). For instance, The Federal Reserve has powers to oversee commercial banks but little authority over the investment banks, which it has recently bailed out with heavy loans under appealing terms (knowledge@Wharton,2008). Indeed, the regulatory framework in the financial system has failed to catch up the developments in the financial market that resulted in massive growth securitized products and subprime lending that ultimately destabilised the global financial system. The subprime crisis has also dented faith in the international financial system (Moosa, 2008).

## **SUGGESTIONS TO MINIMISE INVESTORS' RISKS IN SECURITISED ASSETS/ MBS**

Rating agencies are widely believed to be partly culpable for the current subprime crisis. This gets ground when it is observed that a financial product (mortgage bond) with a AAA rating collapse easily. It means ratings agencies' either failed or did not exercise necessary integrity in rating novel financial products. As the CRAs are subject to little formal regulation or oversight, and their liability traditionally has been limited by regulatory exemptions and first amendment protections, there is little to hold them accountable for future poor performance (Miller Mathis, 2007). In theory, the best regulator is the market, and one should rely on market discipline; but when the market plainly does not work, state must move in to preserve public interest. In the case of ratings of structured financial products, market did not work to prevent ratings agencies' poor job in ratings. Against this backdrop, regulators/policymakers have already taken a number of (as discussed above) measures to

address the problems associated with ratings quality. We propose the following measures to be taken to improve reliability of ratings and restore investor confidence:

1. The regulators should adopt adequate requirements, such as new requirements to govern how and what amount the rating agencies are paid and to provide for the suspension of their licenses if they indulged in unfair practices for CRAs to ensure transparency, reliability and integrity of their ratings. Similarly, stringent rules should be imposed on investment banks to compel them have enough capital to weather a storm (like subprime crisis) in future.
2. Low-quality ratings may be minimised by subjecting CRAs to disgorgement of profits they derived from issuing ratings on novel financial products should ratings turn out to fall below a specified level of quality and the losses suffered by investors in rated products should be compensated from the disgorged money. The implementation of this proposal would require proper monitoring and effective enforcement of the rules by the enforcement authority.
3. There should have an International Institution to develop and issue standards (like Accounting and Auditing Standards) for the Credit rating Agencies.
4. We place more emphasis to the efforts under consideration for increasing methodological transparency as proposed by SEC in 2008. Rating agencies should be required to review their credit ratings of securitized assets depending on ongoing changes in the value and quality of underlying assets (i.e. in the light of market events) and issue/modify ratings based on the findings of the review. Rating agencies should also be required to make it public how frequently their credit ratings are reviewed, whether different models are used for reviews by contrast to the initial ratings and whether changes to models are applied **retroactively/retrospectively** to existing ratings.

## CONCLUSION

Rating agencies has an important role to play in converting illiquid assets into marketable securities through securitization. In performing its functions, CRAs have shown lack of transparency and in many instances inflated the ratings. Investors incurred huge losses who incorporated ratings (which were poor quality ratings) in to investment decision to price the credit risk of fixed-income securities they bought. To minimise recurrence of such losses by investors (which ultimately result in social losses), *better regulation and close monitoring (by regulators)* is needed through close coordination among issuers, banks, policy makers, regulators, agencies and investment bankers. We do not propose too restrictive regulation (such as imposing negligence liability on CRAs) as that may result in over deterrence, stifling innovation and turn the rating agencies into 'insurers' which they are not.

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