Reforming the Selection of Rating Agencies in Securitization Markets: A Modest Proposal

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Introduction: RMBS and the Financial Crisis
One of the roots of the 2008 financial crisis was a deterioration of rating agency standards, which contributed to the widespread defaults in the residential mortgage-backed securities (RMBS) sector. In this paper we suggest a change to the rating agency selection process that removes much of the incentive for rating agencies to lower their standards so as to expand their business.

In its simplest form, our proposal is similar to the process that applies to judging panels at some Olympic events: The most lenient judge is dropped. In the context of rating agencies, the most lenient rater is dropped, or the rating fee is withheld. Our proposal would apply not only to RMBS, but also to commercial mortgage-backed securities (CMBS), collateralized loan obligations (CLOs), and other asset-backed securities (ABS), such as auto and credit card receivables.

If rating agencies’ incentives for competitively lowering their standards are diminished, the argument for increased direct regulation of the agencies by the Securities and Exchange Commission (SEC) is similarly diminished.

Background: Development of Mortgage Securitization
RMBS are made up of pools of thousands of residential mortgages, divided into classes with different maturities and ratings. Mortgages with guarantees by Federal agencies (Ginnie Mae, Fannie Mae, and Freddie Mac) backed the initial RMBS in the 1970s. The credit ratings of these securities were almost always AAA/Aaa.

In the 1990s, a market developed for “private label” RMBS that were composed of residential mortgages that were not backed by a government guarantee. Credit rating agencies initially rated various classes of these securities from AA/Aa2 to B, depending on the seniority in the structure. Rating agencies based evaluations on various criteria, including legal

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structures such as bankruptcy remoteness; but the main variant across deals was the amount of “credit support” or “subordination” that was available to a class.

If a mortgage in a RMBS defaults, goes through foreclosure, and takes a loss, the administrator for the deal applies the loss to the least senior class or tranche of the security. Additional losses from other mortgage defaults are similarly applied until that tranche is gone, and then the next most junior class, up the seniority structure, is written down. (The structures for CMBS, CLOs, and ABS are similar to RMBS.) In the 1990s, the senior-most class of most securities made up 70% of the deal, with 30% of the collateral subordinate to it. In other words, the pool of mortgages could withstand a loss of up to 30% without impacting the principal payment on the most senior class.

**Market Evolution: Credit Support Falls over Time**
Moody’s and Standard & Poor’s were initially the two dominant rating agencies that rated RMBS. Subordination levels were fairly steady, and the top rating was AA/Aa2, not AAA/Aaa. Most deals have at least two ratings, so the two major agencies could each maintain nearly a 100% market share. As the private-label market grew and profits from rating securities increased, the market had new entrants, such as Fitch Ratings and Duff & Phelps. Market share began to fall for Moody’s and S&P, as the new rating agencies often had slightly looser standards (less subordination).

As competition for market share increased, all rating agencies began to refine models, which almost always resulted in declines in subordination. Many of the early ratings were too conservative, as underwriting standards in the 1990s were fairly strict and senior classes could withstand default rates of up to 75% (under the assumption of a 40% loss on foreclosed loans). But subordination continued to drop even when underwriting started to weaken with the growth of the subprime sector and home prices were rising to record levels. Many of the rating agency changes were justifiable on an individual basis, but cumulatively these changes resulted in massive drops in credit support.

By the time of the 2008 financial crisis, subordination levels for the most senior AAA/Aaa class had fallen to as low as 2%, meaning that 98% of a collateral pool of unrated, and likely well below-investment grade, mortgages could receive the highest rating of AAA/Aaa, which previously had been reserved for only a handful of corporations and countries. The rating on 98% of the pool rose to higher than S&P’s current (since 2011) rating of the full faith and credit of the U.S. government. Support had fallen from near 30% for lower-rated AA/Aa2 bonds 20 years earlier. Bankers also created
AAA collateralized debt obligations, or CDOs, out of small slices of BBB and lower-rated classes, further leveraging the ratings.

**Market Share Incentives Lead to Lower Subordination**

Competition among multiple rating agencies was clearly a factor in driving down credit support levels. In the current issuer-pay model, issuers select the rating agencies and pay them directly for their rating. Issuers in the years before the financial crisis mostly sought two or three ratings and asked for credit support estimates from four to six rating agencies. Issuers typically chose the lowest support that was “bid” by either S&P or Moody’s, since many institutional investor guidelines required a rating from one of the two largest agencies for a purchase. Another rating chosen was usually the most lenient rating from among the other estimates.

Although the long-run reputation of a rating agency for providing accurate estimates of the creditworthiness of debt securities should generally guide an agency’s estimate of the necessary subordination/support levels for a security, it is possible that short-run concerns as to the loss of market share and the attendant reduction in profits might overwhelm the longer-run cautions.

For example, suppose that an issuer/investment bank submitted a pool of mortgages for evaluation to four rating agencies with the following subordination percentages for a top rating:

- Fitch: 7%
- Duff: 7.5%
- Moody’s: 8%
- S&P: 8.5%

The issuer would likely choose Fitch and Moody’s, since Fitch has the lowest subordination of all agencies, and Moody’s has the lowest of the largest two firms.

If issuers continued to submit similar pools, Fitch and Moody’s would have close to a 100% market share, while Duff and S&P’s share would fall to close to zero. Duff and S&P had an incentive – at least for the short run – to develop new models that would let them reduce subordination estimates below those of competitors. After a few months, a similar pool to the one described above might get the following rating agency response:

- Duff: 6.5%
- Fitch: 7%
- S&P: 7.5%
- Moody’s: 8%
The issuer would then shift its business to Duff and S&P, while the market share for Fitch and Moody’s would drop to zero. Fitch and Moody's would then have an incentive to revise their models to undercut competitors.

Subordination estimates for securitizations are often near the minimum that is required to obtain a desired rating, and potentially leave less room for error than is true for traditional corporate ratings. Unlike corporate ratings, issuers can structure securitizations to obtain the maximum amount of bonds in the AAA class. In contrast, to rate a corporation, rating agencies evaluate income, debt, expense, and management quality to obtain a rating that will most likely be in the middle of a range of a rating.

In these examples, the final subordination level is the highest among the rating agencies chosen, since the pool must meet the standards of the agency with the strictest requirement. In the first example, if the issuer chose Fitch and Moody’s, the final credit support level would be 8% to satisfy both agencies. Choosing multiple agencies provides some protection against a model or computation error that would otherwise cause the use of an outlier as a final rating level. It also in the short run reduces the risk for a rating agency to estimate a lower level of subordination than the current norm, since the agency knows that the issuer is likely to not use the new low estimate, but the next-to-lowest level. In this sense, this parallel to a “second-price auction” could lead (perversely) to a “race to the bottom”.

A Proposal: Creating Better Incentives
A problem with the current rating system is that it rewards low credit support levels with market share, which creates an incentive for the rating agencies to produce models that justify results that are consistent with the agency’s desire to gain market share. In addition, a computational or modeling error that produces a lower subordination level might get through unchallenged.

We propose the following alternative system for ratings of securitizations:

1. Issuers may choose any number of rating agencies to submit credit support levels for each rating. An agency may choose not to be part of the process.

2. The issuer must pay a “breakage fee” – i.e., a bid-preparation fee – for each estimate.

3. The issuer may select any group of agencies to rate a deal, the same as the current system. Upfront fees are a credit on the rating fee.
4. If chosen to rate, the agency with the lowest credit support level at the end of the evaluation process receives only the breakage fee instead of its full fee, similar to the current treatment of the most conservative agencies that are not chosen to rate by the issuer. If chosen, the agency would not receive any surveillance fees. Possible alternatives to the restriction of payment to the agency are: (1) Barring the agency with the lowest credit support from rating the issue; (2) Taxing the fee (including any surveillance fees) of the most aggressive agency at a rate up to 100% or more; (3) Preventing the use of the most lenient agency’s rating for any regulatory purposes, such as the determinants of capital requirements for banks and other prudentially regulated financial institutions.

5. If two agencies tie, each would receive only the breakage fee.

6. If one agency is an outlier – say, more than two standard deviations from the mean level – the agency cannot rate the deal.

7. All final submitted credit support levels are kept confidential until the rating is public, at which time all bids are made public.

The reduction in payment to (or elimination of) the low subordination bidder creates an incentive not to undercut competitors. The issuer has the choice over which agencies rate a deal. A rating agency that raises credit support too much to avoid being the low bidder runs the risk of elimination for being too high.

The proposed system still has the possibility of strategic bids, but would provide two opposing incentives: bid lower to get the deal, and bid higher to avoid fee reduction or inability to rate. Currently, there is only an economic incentive to bid lower. The issuer/banker eliminates high subordination estimates in the current system. Our proposal would also make all bids public, which reduces the need for unsolicited ratings or opinions.

**Concerns and Potential Objections**

Our proposal is not a radical alteration to the current system, as issuers can still select any rating agency and agencies are allowed to publish ratings, although compensation could be reduced. Eliminating the lowest subordination bid is perhaps a cleaner solution and more consistent with other judging systems, but might raise First Amendment concerns, and would limit issuer choice.

Implementation of our proposal requires some government entity to track compliance, but does not need any government participation in choosing agencies. The elimination of the payment to the low bidder is somewhat self-
enforcing, since an issuer would have no reason to pay something that is not owed. Simple audits could insure that issuers are not making side payments to influence the process, and discovery of such payments would result in the barring of both the rating agency and the issuer from further participating in markets.

Another possible objection to our proposal is that credit support is only one dimension of a securitization rating, and we ignore other factors such as structure and legal provisions. While true, most structures and legal documents have become standardized over time and vary little across deals. Subordination amounts have been the only characteristic that has shown a large weakening trend over time. Nevertheless, our proposed system might inspire issuers to weaken other structural features in lieu of lower subordination.

The application of our proposal could become complicated in cases when one rating agency has the lowest subordination level for one class and a higher level for another tranche. We propose that the application of our plan apply on a class-by-class basis. In other words, a rating agency that is not paid for a senior AAA rating could be compensated for a BBB rating if its subordination level were higher than another agency.

Another potential complication is that pools change during the rating process, with potential changes to subordination levels. To prevent endless rounds of bidding, we propose that only the firms that qualify in the initial round be allowed to submit subsequent bids.

The cost to a rating agency of having too lenient ratings before the financial crisis was a potential loss of reputation in the future if defaults rose. This cost is hard to quantify and was likely more than offset by the gain in current revenue from rating fees. More regulation has increased the scrutiny over changes to rating models. While this has decreased the possibility of a downward cycle of lower subordination, competition for market share still exists.

**Application to Other Sectors**

While most of the discussion has been for RMBS, we believe our proposal should be applied to other securitization sectors, including CMBS, CLOs, and some ABS. Each of these sectors has seen some decline in rating standards over time that are likely from increased numbers of rating agencies and competition for deals. We do not advocate that regulators apply our proposal to corporate bond ratings, as that sector has seen much less competition among rating agencies and little evidence of a secular trend to more lenient standards. And, again, for corporate ratings, the opportunities for
manipulating the corporate financial structure so as to achieve (just barely) a rating target are far fewer.

**Conclusion**
The bond markets are largely institutional markets, with professional bond portfolio managers’ representing the bulk of buying/selling transactions. In principle, these professionals should have memories and thus be able to pay attention to rating agencies (or other assessors of creditworthiness) that have good “track records” and ignore those whose past performances in rating the creditworthiness of debt instruments have been poor. In turn, this should motivate the rating agencies to pay attention to their long-run reputations and to foreswear the short-run temptations to cater to issuers’ desires for unduly favorable ratings (and/or minimal subordination levels) in return for getting the issuers’ business.

But, as was learned in 2008 and after, sometimes short-run temptations may overcome the long-run incentives, and those professional bond managers may not be doing enough due diligence of their own. The negative consequences can be substantial, which is why something more may be needed.

The “something more” that the Dodd-Frank Act of 2010 mandated was a substantial increase in the SEC’s regulation of the ten largest credit rating agencies. By contrast, our proposal would not involve any direct regulation of the rating agencies but instead would involve only a restriction at the point at which an issuer selects the agencies and their ratings.

The RMBS sector has shrunk to less than 5% of its annual peak issuance, and other securitization sectors are also much smaller than before the financial crisis. Issuers globally, however, securitized about $600bn of assets in 2015, and are on pace for a slightly lower amount in 2016. There has been discussion of reviving a private-label RMBS sector to replace government-backed issuances. We think that our proposal could help to prevent a future problem that might otherwise arise from the easing of rating agency standards from increased competition.