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Rating Agencies and Reputational Risk

WHEN I WAS INVITED TO SPEAK AT THE UNIVERSITY OF Maryland School of Law and the *Journal of Business & Technology Law* Conference on the Subprime Meltdown, I had been asked to discuss the role of rating agencies in the subprime meltdown.¹ As I thought about what I would like to say in the midst of the worst financial crisis of our generation, perhaps the worst since the Great Depression, I asked myself, how well do I understand the breadth and depth of the crisis that we find ourselves in? Major pieces of legislation are being passed at breakneck speed, including the Emergency Economic Stabilization Act of 2008,² which is supposed to bail out our entire financial system and which comes on top of the Fannie Mae and Freddie Mac bailout legislation enacted over the summer.³ Revelations about poor risk management in the financial services industry are also popping up with disturbing regularity.⁴ Keeping up with all of the details on all fronts is just not possible.

When I realized that we are not yet able to put all of the details in perspective, I decided to take a step back from a technical approach to the conference's subject and discuss more visceral topics, topics that derive from our shared fundamental social expectations. These topics are:

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1. The three leading rating agencies are Standard & Poor's, Moody's Investors Service, and Fitch Ratings Ltd. Until recently, they effectively had an oligopoly in the market for credit ratings. See U.S. SEC. & EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 1-5 (2008) (reviewing recent history of rating agency industry through passage of Rating Agency Reform Act in 2006 which opened up industry to further competition) [hereinafter SEC SUMMARY REPORT]; David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 1016-22 (2006) (discussing development of rating agency oligopoly).

2. Pub. L. No. 110-343, Div. A, § 2, 122 Stat. 3765 (2008) (codified at 12 U.S.C.S. §§ 5201-5261 (LexisNexis 2008)).

3. The Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (codified at 12 U.S.C.S. §§ 4501-4642 (LexisNexis 2008)).

4. See, e.g., Liam Plevin & Susanne Craig, *The Financial Crisis: Congress Grills Former AIG Chiefs—Lawmakers Ask Whether Executives Glossed Over Warnings About Risks Insurer Faced*, WALL ST. J., Oct. 8, 2008, at A3; Floyd Norris, *Lehman's Assurances Ring Hollow*, N.Y. TIMES, Sept. 12, 2008, at C1.

- lying;
- cheating;
- stealing;
- trust;
- honor; and
- the difference between right and wrong.⁵

These topics compose the framework that Main Street (and probably many of us in the room) are using to understand the crisis that confronts them. And indeed, it is an appropriate framework, in many ways.⁶ So the good news is that you do not need to be an MIT Ph.D. to understand what this financial services crisis is fundamentally about—it is about, as much as anything else, the same topics that our gut instincts are screaming about.⁷ In academia, we need to give such a visceral subject a more measured name: we call it “reputational risk.”⁸

The Basle Committee on Banking Supervision defines reputational risk as “the risk of significant negative public opinion that results in a critical loss of funding or customers.”⁹ This can play out in many ways: loss of clients who defect to competitors; lack of confidence in the firm that results in a higher cost of credit; increase in hiring and retention costs; reduction in business partners as they shift to competitors; and increases in regulation, litigation, and fines.¹⁰ Big hits to reputation can lead to reduced earnings and increased volatility.¹¹ And, indeed, reputational harm may pose a great threat to a financial firm.¹²

Reputational risk can arise in many contexts: conflicts of interest may be improperly exploited and individuals can be guilty of professional misconduct.¹³ Moreover, firms can have poor “compliance and incentive systems,” poor leader-

5. See Ingo Walter, *Reputational Risk and Conflicts of Interest in Banking and Finance: The Evidence So Far* (N.Y. Univ. Stern School of Bus., Working Paper, Dec. 9, 2006), available at <http://ssrn.com/abstract=952682>.

6. See *id.* (explaining that such visceral topics are good frameworks because they “are probably as close as one comes to ‘constants’ in assessing business conduct”).

7. Corporate greed and irresponsibility are two of the more pressing topics. See, e.g., Bob Herbert, *Beyond the Fat Cats*, N.Y. TIMES, Nov. 11, 2008, at A29.

8. See generally Walter, *supra* note 5, at 5–7.

9. BASLE COMMITTEE ON BANKING SUPERVISION, RISK MANAGEMENT FOR ELECTRONIC BANKING AND ELECTRONIC MONEY ACTIVITIES 7 (1998), available at <http://www.bis.org/publ/bcb35.pdf>.

10. See Roland Gillet et al., *Operational Risk and Reputation in the Financial Industry* 2–3 (Working Paper, Feb. 28, 2007), available at <http://ssrn.com/abstract=967313>; Jason Perry & Patrick de Fontnouvelle, *Measuring Reputational Risk: The Market Reaction to Operational Loss Announcements* 5 (Fed. Reserve Bank of Boston, Working Paper, Oct. 2005), available at <http://ssrn.com/abstract=861364>; Walter, *supra* note 5, at 9–10.

11. Gillet et al., *supra* note 10, at 3.

12. See Robert G. Eccles et al., *Reputation and Its Risks*, HARV. BUS. REV., Feb. 2007, at 104, 104 (“[I]n an economy where 70% to 80% of market value comes from hard-to-assess intangible assets such as brand equity, intellectual capital, and goodwill, organizations are especially vulnerable to anything that damages their reputations.”); Walter, *supra* note 5, at 25–26 (justifying high cost of dealing with reputational risk by explaining that reputational losses can lead to “serious damage”).

13. Gillet et al., *supra* note 10, at 3–4.

ship, and corporate cultures that encourage improper behavior.¹⁴ Harm to reputation may be intangible or occur incrementally, so that it is difficult to identify.¹⁵ Nonetheless, it is more typically the consequence of “management processes rather than discrete events.”¹⁶ And it is more likely to harm firms that present themselves as “reputational standard-setters.”¹⁷ A hit to reputation is likely to be read as a signal that the same behavior may repeat itself at a particular firm.¹⁸

Rating agencies have clearly held themselves out as standard-setters that provide objective and carefully-wrought opinions.¹⁹ Indeed, they claim to be limited by reputational restraints.²⁰ Three of the most important inputs into reputation are *trust*, *transparency*, and *leadership*. These three themes, writ large, can also help make sense of the broader financial crisis.

We take trust for granted in good times, but the financial system cannot function without it. People are only willing to risk large sums of money if they are reasonably certain that the other parties to the transaction can fulfill their obligations. This is true whether you are lending money, buying insurance, or just relying on another party to provide services relating to large sums of money, like a rating agency.

Trust is all well and good, but if you cannot verify what the other party is telling you, trust comes to resemble faith more than anything else. When a financial system rests on faith and suffers from an absence of transparency, you should be worried. A crisis of faith in the financial markets is called a panic.

When times are good in the financial markets, leaders do not really stand out. But when times are bad, leadership is of key importance. Warren Buffett is a great example of someone who is perceived as a straight talker and his credibility has the power to stabilize distressed companies.²¹ The leadership of Fannie Mae, Freddie Mac, and Lehman Brothers did not have such credibility as the markets began to

14. *Id.*

15. Perry & de Fontnouvelle, *supra* note 10, at 4–5.

16. Walter, *supra* note 5, at 4 (emphasis removed).

17. *Id.*

18. *See id.* at 25–26 (noting that repeated scandals can lead to lower market valuation).

19. *See, e.g.*, Vickie Tillman, Letter to the Editor, *Ratings of Securities are Defended and Criticized, Too*, WALL ST. J., Sept. 30, 2008, at A18 (Standard & Poor’s Ratings Services Executive V.P. writing, “[Standard and Poor’s] has long had in place policies and procedures to help preserve the integrity of our ratings opinions. Our analytical and commercial activities are maintained separately, ratings are assigned by committees, and our analysts’ compensation is not determined by the size of any fee.”).

20. *See* John P. Hunt, *Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement* 15–16 (Berkeley Ctr. for Law, Bus. and the Econ., Working Paper, Sept. 5, 2008), available at <http://ssrn.com/abstract=1267625>; *see also* Beatriz Mariano, *Do Reputational Concerns Lead to Reliable Ratings?* 2 (Universidad Carlos III de Madrid, Working Paper, May 21, 2008), available at <http://ssrn.com/abstract=1106653> (explaining importance of reputation to rating agencies).

21. *See* Ben Steverman, *Can Buffett Rescue the Market?*, BUSINESSWEEK, Oct. 2, 2008, http://www.businessweek.com/investor/content/oct2008/pi2008101_890140.htm (discussing how Warren Buffett’s credibility allows him to have “halo effect” on companies he chooses to invest in).

fall to pieces. That lack of credibility is no small part of the problem that those companies faced as they barreled toward insolvency.²²

Rating agencies did poorly when it came to all three of these reputational inputs.²³ Their business model was based on serious conflicts of interest, conflicts that should and did undermine the trust that others had in them. Rating agencies were paid by the issuers who needed their ratings and the profit motive drove the agencies to recklessly expand the market for their services by giving higher ratings than merited to many mortgage-backed securities.²⁴

The rating agencies were also deficient when it came to transparency. They helped investment banks to structure the transactions that they were to rate to an extent not known to the rest of the world.²⁵ They were integrally involved, for instance, in legitimizing subprime debt instruments like the collateralized debt obligation (CDO),²⁶ securities that make up many of the toxic assets that are dragging down the balance sheets of so many financial firms. The rating agencies also claimed that their very sophisticated rating models were reliable enough to predict with great accuracy the risk of default and delayed payment.²⁷ It turns out however, that “sophisticated” was just a way of saying complex and confusing.²⁸ Like many other financial players, it appears that their complex risk management models had some very simple assumptions undergirding them—national housing prices will never go down on a year-to-year basis, for one.²⁹

The leadership at the rating agencies set an ethos that clearly distorted the mission of these firms.³⁰ The rating agencies did not properly monitor their employees

22. See, e.g., Norris, *supra* note 4, at C1.

23. See Reiss, *supra* note 1; see also Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 794–95 (2006) (discussing ratings agencies’ failures in 1990s).

24. See generally Reiss, *supra* note 1 (describing how rating agencies sought to increase the market for mortgage-backed securities ratings); Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions* (May 3, 2007), available at <http://ssrn.com/abstract=1027475> (describing how rating agencies came to act as part of underwriting team for complex mortgage-backed securities).

25. See, e.g., Michel G. Crouhy, Robert A. Jarrow & Stuart M. Turnbull, *The Subprime Credit Crisis of 07 8–10* (July 9, 2008) (unpublished manuscript), available at <http://ssrn.com/abstract=1112467>.

26. See Mason & Rosner, *supra* note 24, at 13–15 (noting that rating agencies were integral to determining “marketability” of CDOs).

27. See generally SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES § 9.01(2) (Ronald S. Borod, ed., 2003) (providing summary of how rating agencies claim to test MBS collateral under Great Depression worst-case scenario).

28. See Mason & Rosner, *supra* note 24, at 68 (“The ability to repackage [MBS] and call them [CDOs], with no fundamental change to their risk characteristics, in order to achieve an improved bond rating is the fundamental source of ratings arbitrage.”).

29. See Peter L. Bernstein, Op-Ed., *What Happens If We’re Wrong?*, N.Y. TIMES, June 22, 2008, at BU5.

30. Aaron Lucchetti, *McGraw Scion Grapples With S&P’s Woes—Chairman Helped Set Tone in Profit Push as Ratings Firms Feasted on New Products*, WALL ST. J., Aug. 2, 2008, at B1 (quoting Harold McGraw III, CEO of Standard & Poor’s parent corporation, McGraw-Hill, “[w]hat we do is provide access to the capital market. . . . If the market wants those kinds of products and the institutional investors want those products, then we move with the market and we’re going to rate whatever.”). See generally SEC SUMMARY REPORT, *supra* note 1, at 23–32 (reviewing conflicts of interest at rating agencies).

to ensure that they avoided even the most obvious conflicts of interest.³¹ There was a culture of understating risks in their ratings.³² They also failed to alert the public as to changes in rating models that impacted the value of their ratings.³³ And they allowed “out of model adjustments” (that is, material exceptions) to their ratings of certain securities which again threw the value of the ratings into question.³⁴

As a result, at the peak of the boom, they collected fees and did insufficient work to earn them. As with all recent financial crises, there is the obligatory smoking gun internal email: one rating agency employee wrote to another that a transaction “could be structured by cows and we would rate it.”³⁵ Understaffing appeared rampant at the agencies. Again, an employee emails another a harmful admission: “staffing issues, of course, make it difficult to deliver the value that justify our fees.”³⁶

This take on the rating agencies can be played out with nearly all of the financial services sectors that were addressed at the conference: government sponsored enterprises like Fannie and Freddie, commercial banks, and investment banks, to name just some of the leading ones. And that is why, to a large extent, we have gone from firm level risk to systemic risk—the short term incentives in each of these industries led to a sacrifice of long term health for all. For rating agencies, reputational harm will likely lead to increased regulation. European regulators are likely to take the lead in this regard, but the SEC may act as well.³⁷

As news of the credit crisis gets more and more complex, with detail piling on detail, it is important to remember that a fundamental understanding of our situation often derives from the fundamentals. Reputation matters, as does its key components: trust, transparency, and leadership. The systemic risk posed by numerous firms failing to maintain their reputations will lead to a new era of regulation that will impose more obligations on firms that could not live up to the ones that they themselves had espoused.

31. SEC SUMMARY REPORT, *supra* note 1, at 23–27.

32. One ratings agency manager wrote to another that ratings agencies were continuing to create an “even bigger monster—the CDO market. Let’s hope we are all wealthy and retired by the time this house of cards falters.” *Id.* at 12 n.8.

33. *Id.* at 13–14.

34. *Id.* at 14.

35. *Id.* at 12.

36. *Id.*

37. See Joe Kirwin, *Securities Regulators in EU, Elsewhere Fault Plan to Tighten Credit Rating Agency Rules*, 40 SEC. REG. & L. REP. 1489 (2008); Malini Manickavasagam, *SEC Proposes More NRSRO Regulation, Especially for Structured Finance Ratings*, 40 SEC. REG. & L. REP. 929 (2008); see also Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 57–59 (2004) (noting that outcry from previous, similar financial scandals accelerated regulatory reform efforts aimed at rating agencies).