Chapter 2

An Optimal Global Regime for Regulating Credit Rating Agencies in the Post Financial Crisis Era—From the Perspective of the Appropriate Role of the Rating Agencies in the Capital Market

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1 Introduction

Credit rating agencies (CRAs) are in the business of providing credit ratings for securities and other debt-related instruments. Theoretically, the purpose of CRAs is to help investors to deal with the problematic aspects of the principal-agent relationship and asymmetric information by providing an easily understandable reference on a particular financial product’s likelihood of default, thus assisting in setting a market price for the product in question.1 However, CRAs have been widely criticized as key contributors to the recent global financial crisis, especially in light of their role in the expansion of the market for asset-backed securities.2 In the case of the subprime mortgage crisis that triggered the financial market meltdown, CRAs gave triple A ratings3 to 75 percent of those subprime mortgages that lost sizable value only months after the ratings were issued. According to a report of the Senate Investigation Committee:

During the first half of 2007, despite the news of failing subprime lenders and increasing subprime mortgage defaults, Moody’s and S&P continued to issue AAA credit ratings for a large number of residential

mortgage-backed securities (RMBS) and collateralized debt obligation (CDO) securities...[Not long after], [b]eginning in July 2007, Moody’s and S&P downgraded hundreds and then thousands of RMBS and CDO ratings, causing the rated securities to lose value and become much more difficult to sell, and leading to the subsequent collapse of the RMBS and CDO secondary markets. The massive downgrades made it clear that the original ratings were...deeply flawed.4

The accountability of CRAs has been questioned by market participants ever since. It is commonly agreed that such poor performance arose from the rating industry’s issuer-pay business model, from which CRAs derive most of their revenues.5 This fact alone indicates that CRAs had a conflict of interest and turned a blind eye to the high levels of risk associated with structured products and derivatives.6

To tackle the problem of conflicts of interest and restore CRAs’ accountability, regulatory regimes worldwide have adopted the disclosure-based approach, which mandates that CRAs must provide additional information regarding potential conflicts of interest.7 Regulators have also attempted to prevent excessive entanglement between CRAs and issuers.8 Nevertheless, the rating industry’s issuer-pay business model is difficult to change because revenues paid by issuers remain CRAs’ primary source of income for rating a wide range of debt issues. This structure increases the possibility that CRAs will be