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The major private credit rating agencies — Moody's, Standard & Poors, and Fitch — were significant contributors in creating the housing bubble and subsequent financial crash of 2007-2008. The ratings agencies are supposed to be in the business of providing financial markets with objective and accurate appraisals as to the risks associated with purchasing any given financial instrument. Instead, they consistently delivered overly optimistic assessments of assets that either carried high, or at the very least, highly uncertain risks.

Moreover, the reason these agencies consistently understated risks was not simply that they were relying on economic theories that underplay the role of systemic risk in guiding their appraisals, though this was an important factor. The more significant influence was market incentives themselves, which pushed the agencies toward providing overly favorable appraisals. That is, giving favorable risk appraisal was good for the ratings agencies' own bottom line, and the ratings agencies responded in the expected way to these available opportunities. The most effective solution would be to create a public credit ratings agency that operates free of the perverse incentive system that distorts the work of private agencies. We thus propose the creation of such an agency and a corresponding set of regulations linking the agency to the operations of financial markets. Most important, we propose that all firms issuing securities that are to be traded publicly in U.S. financial markets be required to obtain a rating by the public agency before any trading could be legally conducted.

Perverse Incentives for Private Agencies

With the benefit of hindsight, the misjudgments of the agencies are now widely recognized. The economics journalist Roger Lowenstein recently offered this appraisal in the *The New York Times:*

> Over the last decade, Moody's and its two principal competitors, Standard & Poor's and Fitch, … [put] what amounted to gold seals on mortgage securities that investors swept up with increasing élan. For the rating agencies, this business was extremely lucrative. Their profits surged … But who was evaluating these securities? Who was passing judgment on the quality of the mortgages, on the equity behind them and on myriad other investment considerations? Certainly not the investors. They relied on a credit rating (4/27/08).

Of course, the reason investors "relied on a credit rating" is that they assumed the ratings agencies were committed to providing objective and accurate risk appraisals. Indeed, the evaluations provided by the agencies are the basis for how investors price assets, which in turn has a major impact on how investment projects get financed, or even whether or not they get off the ground. For example, on average between 1950-2007, a bond that was rated as AAA by Moody's paid out an interest rate that was almost one percentage point below a BAA rated bond. If, for example, a $10 million bond has a maturity of 10 years, this interest rate differential amounts to a $1 million difference in debt servicing. In the midst of the 2008 financial crisis, the spread between AAA and BAA bonds rose to almost three percentage points, thus increasing the debt servicing spread for the same $10 million bond to $3 million.

In principle, the incentives in the marketplace are supposed to operate to push the agencies toward providing objective and accurate appraisals since, in principle, the only valuable product the agencies are offering in the marketplace is their credibility. As such, if an agency is failing to provide the market with credible information, one would expect they would be punished in the market — market competition should drive out the incompetent firms and reward those that are indeed providing credible information.

In fact, however, a large gap exists between this ideal set of incentives that should guide the activities of credit rating agencies and the actual incentives they face. In practice, the reason the ratings agencies operate with a strong bias to provide favorable ratings on financial instruments is simple: The agencies are hired by the companies that they are evaluating. Companies therefore choose to hire agencies that they think are more likely to provide favorable ratings, which in turn enhances the companies' ability to sell their financial instruments. The agencies, in turn, recognize this bias in how companies will select a rating agency. The agencies therefore lean as much as possible toward providing favorable ratings to improve their market share and increase their profits.

Securitization Worsens the Problem

This perverse set of incentives facing ratings agencies becomes compounded by the outsized importance of securitized assets as a share of overall market activity. Securitizing assets basically consists of bundling mortgages and other traditional loans into securities with a range of risk profiles — e.g., one bundle of mortgages would carry relatively low risks and returns, while a second bundle would offer both higher risks and returns. In any case, in financial markets dominated by securitization, the primary way to earn money is not for a bank or other financial intermediary to hold onto loans and collect interest as the loans are serviced by the borrower. Rather, it is for the bank to earn fees by selling their individual loans to entities, such as Fannie Mae or Freddie Mac, that want to bundle the loans into securities. Fannie and Freddie will themselves earn another round of fees through selling their bundled loans on the market. Others repackage these securitized assets into new and complex financial products. Still more fees can be earned by selling insurance policies on these financial assets. This latter action is the core idea behind credit swaps.

Here is where it becomes clear how the incentive system frames the activities of the ratings agencies. Without a positive appraisal, many of the mortgage-backed securities will not be marketable. But with a favorable appraisal in hand, opportunities to earn fees emerge at all points in the chain of securitizing, insuring, issuing new derivatives, and trading.

In addition, the very features that make securitized assets marketable also amplify the significance of the credit ratings agencies. What makes securitized assets distinct from the underlying bundle of loans is that the risks associated with the underlying loans have been reconfigured, repackaged, and presumably clarified for market participants — all in behalf of making these repackaged assets more desirable on the market than the underlying loans. As such, unless a ratings agency offers a favorable evaluation of any such repackaging of the underlying risks, market participants will see no advantage to buying the securitized asset as against the underlying loan. This only adds to the pressure for credit rating agencies to view securitization initiatives in a favorable light.

Finally, once market traders earn their fees — no matter at what point in the overall market chain of trading the fee is received — they are free to keep their earnings, no matter what happens at some later date to the underlying asset they had successfully marketed. It may be that a household that took out a mortgage ends up defaulting on their obligation. But the bank that made the original loan will not be affected by the default, since they will have long since sold this loan to a market bundler, earning a fee for "originating" the loan in the first place — i.e., finding the borrower and arranging the terms. Almost certainly, the original market bundler will have also sold the loan, also receiving a fee for having provided their bundling services. The same would go for the firm offering insurance on the bundle of securitized mortgages.

Public Credit Agency as Corrective

The fundamental contribution of a public credit ratings agency would be to offer a counterforce to the perverse incentive system facing private agencies.

In some respects, the mission of the new agency would be similar to regulatory bodies such as the Food and Drug Administration (FDA). Just as the FDA assesses health risks associated with new pharmaceuticals before the drugs can be marketed, the public ratings agency would assess the riskiness of financial assets before the securities could be publicly traded. Unlike the FDA, the public ratings agency would be an independent regulatory body. In this respect, the public ratings agency would operate more like the Securities and Exchange Commission (SEC). We propose that the governors of the public agency be nominated by the House Financial Services Committee, the Senate Finance Committee, and the President. Nominees must be approved in Congressional hearings before taking their posts. The governors would direct the day-to-day activities of the ratings agency. However, the agency would report to Congress on an annual basis and would be ultimately accountable to Congress.

Similar to the SEC, which is financed largely through a low-level securities transactions tax and registration fees, the public ratings agency would be financed by cost-recovery fees. Any surplus generated would be taxed at an effective rate of 100 percent and transferred to the Treasury. This would remove any incentives to manipulate ratings so as to increase revenues above cost but would also create a sustainable pool of finance to cover the costs of generating reliable public financial information.

The staff of the public agency would be compensated as high-level civil servants. They would receive no benefits as such from providing either favorable or unfavorable ratings. Indeed, a compensation system could be established whereby the professional staff is evaluated on the basis how well their risk assessments of given assets end up comporting with the market performance of these assets over time. Safeguards would be put in place to dismiss any professional staff members who have conflicts of interest that could compromise the integrity of their ratings.

It is true that providing accurate risk appraisals has become increasingly challenging as securitized markets have deepened. There may well be situations in which the staff of the public agency concludes that an instrument is too complex to provide an accurate risk appraisal. In such situations, it would be the obligation of the public agency to be open with such an assessment — that is, to assess an instrument as "not ratable." Financial market participants could then decide the degree to which they might wish to take a gamble with such an instrument.

A public credit ratings agency operating in this way would dramatically change the incentives for the private ratings agencies as well as the broader array of financial market participants. It would weaken the biases in favor of greater risk and complexity, and move the financial system to operate with a higher level of transparency. The private agencies would be free to continue operating as they wish. But when their appraisals differ significantly from those provided by the public agency, the private agencies would be forced to explain the basis for their divergent assessments.

It is likely that the impact of a public credit ratings agency operating in the market along with the private agencies would dampen the market's enthusiasm for financial innovation. Risk assessments would likely become more cautious. Indeed, this would be part of the intention of such a measure. But this does not mean that the overall economy would become less innovative or dynamic. The dynamism under a more tightly regulated financial market would result through the ways that the newly regulated financial market would be channeling credit into productive areas. In that regard, the public credit ratings agency, along with the complimentary proposals to restore some significant measure of regulation to the markets should, in combination, help financial markets to become increasingly effective in channeling credit to productive activities.

And yet, within this new system of financial regulations including the public credit ratings agency, market participants would be free to evaluate the full range of information and assessments available to them, from the public agency, the private agencies, and elsewhere. It is useful to recall that in the 1980s, Michael Milken of the now defunct firm Drexel Burnham Lambert created the "junk bond" market precisely by insisting that the traditional ratings agencies were overly cautious in their appraisals of corporate bonds. Market participants could make comparable assessments on their own with respect to the appraisals of the public ratings agencies.

However, financial regulations that rely on an independent assessment of risk would be required to use the ratings of the public agency. At present, for example, the Securities and Exchange Commission makes use of the ratings of a select group of private agencies in setting certain regulatory requirements. With the establishment of a public agency, the use of private ratings by the SEC or any other government regulatory body would end.

Amid the most severe economic downturn since the 1930s Depression, we face a massive long-term project of rebuilding a financial system that is capable of supporting a stable and equitable growth path for the U.S. economy. Creating a public credit ratings agency can serve as one crucial tool in facing the challenges ahead.

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