Do rating agencies need regulation?

In The Big Short, Michael Lewis describes several of the key players in the creation of the credit default swap (CDS) market, who sought to bet against collateralized debt obligations (CDO) on Real Estate and therefore who ended up profiting from the financial crisis of 2007-2010. Nonetheless, when the Real Estate bubble actually burst, the Real Estate prices did not go down immediately as the rating agencies did not change their rating even if they should have. The key players of the big short almost did not obtain their reimbursement even if they were the ones to come up with the accurate conclusion on the Real Estate market. Rating agencies (Moody's, Standard & Poor's, Fitch) were deeply responsible for what happened in 2008. Independent agencies are expected to inform savers and investors about the risk associated with borrowers. They failed to properly assess the risks assumed by financial institutions. Boudewijn de Bruin argues that they did not even try to do it as they are paid by their own clients to give them a credit rating which can only result in a **conflict of interests**. They are in a way both judges and parties. Nonetheless, their memorable failure in 2008 did not prompt their doom. This can only mean one thing: they do have a purpose. But does this purpose give them too much power? Is deregulation the answer or is there a deontological and ethic approach that could help resolving the conflict of interests between rating agencies and financial institutions?

Rating agencies have a normative purpose, an almost legal role that can pose an unethical threat. They are responsible for setting a bar between investment grade and high yields investments. Boudewijn de Bruin argues that working in an oligopoly structure, rating agencies have the power to do their own justice because some financial institutions (funds, banks) cannot invest in high yields investments and are limited to investment grade investments. Does this normative purpose give too much power to rating agencies ? In Black Mirror, the famous science fiction anthology television created by BBC journalists, one episode imagines a world where people can be rated by others according to their behaviour in society. This episode pictures an alternative present with a dark and satirical tone. What is unethical in this episode is to rate others without giving them the reasons. But is giving a rate to a company or a country, without really knowing about the evaluation methods used by rating agencies, is utterly different? They have the power to make it illegal for a financial institution to invest in a country or a company. Rating agencies are sometimes accused of having speeded up the bankruptcy of Greece, and of plunging the whole Euro Zone in a new systemic crisis. The three notches downgrade of Greece by Standard & Poor's was extremely severe. It resulted in an increase of interest rates to unsustainable levels (above 10%) and rendered ineffective the efforts undertaken by the Greek Prime Minister who tried to not resort to any financial aid from the Euro Zone and the International Monetary Fund (IMF). The relevance of rating agencies in terms of sovereign risk assessment is also questioned. The agencies are far from having the same expertise in the field of public finance as in the field of companies where they enjoy privileged access to financial information. As it was already the case during the Subprime crisis, they were also blamed of conflict of interests during the Greek crisis. Can the rating agencies take the risk to quarrel with the United States and England ? Many economists maintain that by applying the rating criteria used for Greece, Portugal or Spain, English, American and French debts already no longer deserve their AAA.

Is deregulation the answer ? As mentioned in the first paragraph, I agree with Boudewijn de Bruin that there are issues with rating agencies but I still do not think that deregulation is the proper response. The deregulation of financial markets in general revealed some weaknesses through history. The 1929 crisis was the result of deregulation and no distinction between investment and deposit banks, which triggered massive bank runs and credit crunches. After the 1929 crisis, one of the first regulations adopted was the Glass-Steagall Act to separate commercial and investment banks in order to prevent banks from investing short-run household deposits in long-run risky securities. In the 1980's, the global banking system was decompartmentalized and deregulated and the subprime financial crisis of 2008, exposed, once again, the weaknesses of the global deregulated banking system. From the securitization of subprime loans to the failure of deregulation, through the excessive risks taken by financial operators or the systemic nature of certain banking establishments, various explanations have been provided to explain the crisis and especially to understand what measures should be put in place in the future, both to prevent and contain such dysfunctions. The same applies here. I believe rating agencies remain important and are useful in setting a shared framework. I think that complete cancellation of their current roles and their transformation into a public agency dedicated to validating public information would not be sufficient. Evaluating a corporate or a country necessarily contains a subjective part, which a public entity would never be able to manage. Indeed, anticipation influences action which in turn modifies the criteria of anticipation, playing the game of self-fulfilling or self-invalidating forecasts. This goes back to Robert Lucas's criticism: the assessment of a debtor at a given moment affects his ability to borrow and very quickly changes the criteria that should prevail in his assessment. This phenomenon is the result of information asymmetries developed by George Akerlof in 1970. These asymmetries, regarding the relationship between debtors (who know the degree of risk of their project and their aversion to risk) and financial institutions (which have an imperfect knowledge of the risk of the project and of the debtor himself), can lead to a phenomenon of anti-selection. High interest rates imposed by banks discourage low-risk borrowers who prefer to finance themselves with securities; in the end, banks only keep risky borrowers. The second threat is moral hazard: once the credit has been obtained, it is possible for the borrower to act differently from what had been initially planned, and not to "respect" his or her risk assessment.

Should we then adopt tighter regulations ? Maybe we should. For example, a company or a country should have the right to appeal the decision of rating agencies and an independent court could evaluate and assess the decision taken. Alternative funding methods for the activity of rating agencies could also be a solution to resolve the conflict of interests. However, tighter regulations even if necessary, are not sufficient. Obviously, the question of ethics and deontology arose today. The Subprime crisis was not only financial but immoral as well. Mortgage brokers were mandated to encourage targeted categories to borrow in order to acquire their homes: ethnic minorities, the poor, retirees, the disable (ninja :no income no job no asset). Some banks could then take advantage of the eventual and probable seizure of the goods acquired and make a profit. How to assess a proper judgment on this event? Should we follow a consequentialism, a deontological or a virtue ethics approach? According to Spinoza, the same action deserves, beyond its "performance" and its effects, a different moral evaluation, based on motivation or intention, which is equivalent, for him, to the causal determinations of the mind. Tighter regulations (for both rating agencies and financial institutions) are important and prevent us from acting the wrong way, but do not have an impact on our intention to do the right thing. For example, I believe that many insider trading cases can be associated to the daycare experiment. Schools decided to charge parents if they came late to pick up their children and the result was that even more parents were late. Without fees, parents tried to be polite and to come early, but if they are charged, they do not have the moral obligation to come on time anymore (almost like paying for a service). Likewise, insider trading cases continue to happen as, in the worst case, companies can pay a fine, so it is no longer associated to the idea of being fair. If you put the decision in another type of structure you get different results. We know that moral is rarely selfless in economics. You must "pay" to prevail, in other words, to be profitable. Sad and cynical observation, but lucid observation. Perhaps then we must rely on the reliability of borrowers, creditors and rating agencies themselves, on greater financial responsibility of financial institutions and companies in terms of transparency of information on risk exposure (as stated in the text!), on the emergence of investment funds qualified as ethical, to encourage these same companies to attract savings by other means than the only return. Even if I consider that tighter regulations are necessary instead of complete deregulation, I agree with Boudewijn de Bruin that we should count on more responsibility. And in fact, after 2008, banks and funds stop relying *only* on rating agencies analysis. Every bank or funds has its own credit team that can provide another rating for countries and companies.

The text of Boudewijn de Bruin was very interesting and points out many issues faced by rating agencies. The Subprime crisis in 2008 completely shook the global banking system and rating agencies were deeply mistrusted after it blew out. A complete deregulation however, also has its drawbacks and has proved to be very perilous over the years. And even if tighter regulations are not sufficient, let us not forget that responsibility is impossible without regulations. As we are witnessing during the ongoing pandemic, without social restrictions in the whole world, it would be hard to decrease the number of infected if we were acting individually and behaving only on our willingness to do the right thing…