"Credit Rating Agencies - The Companies Behind the Smoking Gun" Proposal

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Abstract

In the years leading up to the market crash of 2008, the United States housing market was booming and housing prices were on the rise. This tempted many individuals to live outside their means and take on mortgages that they could not feasibly afford. Banks enabled this risky behaviour by lending money without any proof they could pay it back. This "bubble," as many called it, all came crashing down in September of 2008. This burst in the housing market brought the United States into one of the worst financial crisis since the Great Depression. Companies such as Fannie Mae and Freddie Mac, AIG, General Motors, and others were on the brink of failure and many individuals lost their homes to foreclosure or bankruptcy. Overall, the market dropped 41 percent over an eight week period. [5]

Recently, the cause of this market crash was determined after a two-year federal investigation of the executives and important individuals in the financial sector. They found that the tipping point was when rating agencies such as Standard & Poor's and Moody's received pressure from eight major banks to gave these bad mortgages a good rating. [6] This brings up a clear ethical dilemma: should private companies, like S&P and Moody's, be in charge of the rating and regulation of these financial markets when a clear conflict of interest exists.

1 Facts

1. Rating agencies such as Standard & Poor's, Fitch, and Moody's rate "credit worthiness" based on a rating scale, such as 'AAA', 'BBB', etc. [7]
2. The SEC (Securities and Exchange Commission) regulates these rating agencies under what it calls "nationally recognized statistical rating organizations" (NRSRO's) [7]
3. The three agencies, Standard & Poor's, Moody's Investor Service and Fitch Ratings control about 40 percent of the market. [**?**]
4. These agencies are paid by the issuers they rate, meaning the banks, investors and mortgage brokers. [10]
5. During the five years leading up to the housing market crash, mortgages were packaged as AAA rated securities and safe as government bonds. Of these packaged securities, 90 percent of them were downgraded to junk status between 2006 and 2007. [6]
6. Eight banks, including Goldman Sach's, JPMorgan, and UBS AG pressured these rating agencies to "weaken their standards" in order to boost business and achiever greater market share [6]
7. Over the first half of the 2000's, these rating agencies, specifically Moody's which is the only publicly traded agency, saw its revenues increase by over 500 percent. [10]

2 Research Question

Is it ethical for companies to rate and act as "gatekeepers" for industries in which they stand to benefit/profit based on the ratings they give?

3 Extant arguments

It is not ethical to have private rating agencies rate and package credit:

- These rating agencies reports are not accurate due to outside pressure from banks and poor rating standards.[6] [4] [9]
- Because the rating agencies are paid for their ratings by the banks who give them the credit to rate, there is a conflict of interest. [10]
- These rating companies performance before and after the crash brings up questions of their success and validity in rating this credit. [6] [8]

It is ethical to have private rating agencies rate and package credit:

- The SEC regulates and has given approval to the three major rating agencies under NRSRO. [7]

4 Applicable analytic principles

- Using the code of ethics from Goldman Sachs, there must be ”Fair and Ethical Competition - ... No one at the firm may seek competitive advantage through illegal or unethical business practices” [1]
- They ”shall act consistently with the public interest” [3]
- When doing any kind of business, one should treat people as an end, not a means to an end [2]
- ”Disclose to all concerned parties those conflicts of interest that cannot reasonably be avoided or escaped” [3]
- Do ”not engage in deceptive financial practices such as bribery, double billing, or other improper financial practices.

5 Abstract of Expected Analysis

- The US Financial Industry: An Overview
  - What are Mortgage Backed Securities and what are all the terms thrown around in the news?
  - How is debt rated, traded, and profited from?
  - How did this all end up almost destroying the US economy and costing the US government around 2 trillion?
- Who are the key players in the financial world?
  - The People - Who take out the loans
  - The Banks - Lend the money
  - The Rating Agencies - Categorize and package the debt
  - The Others - What happens after and who takes it over.
- The Problem with the current system
  - Talk about the 2008 financial collapse and the housing bubble that burst.

  - Show how the people involved were the cause of it.

- Because the actions taken by individuals in the financial industry directly affect the everyday lives of most people, those involved must be held to a higher ethical standard.

  - Rating agencies must be reevaluated and heavily regulated
  - Banks must treat people as ends, not as a means to an end [2]
  - Because this is an issue that heavily affects a wide range of people, most of which do not understand the difference between the stock market and the supermarket, normal standards of ethics are not enough to make sure past actions are not repeated.

References

[1] "Goldman sachs code of conduct and ethics." [Online]. Available: http://www2.goldmansachs.com/our-firm/investors/corporate-governance-old/corporate-governance-documents/revise-code-of-conduct.pdf

Used as an example of the financial sectors code of ethics

[2] "Kant's moral philosophy." [Online]. Available: http://plato.stanford.edu/entries/kant-moral/

Used to help back ethical decisions made

[3] "Se code of ethics." [Online]. Available: http://www.acm.org/about/se-code

Software engineering code of ethics, where much of the ethical judgement is derived from.

[4] W. Alden, "Rating agencies repeatedly caved to banks' demands and helped cause crisis, report finds," April 2011. [Online]. Available: http://www.huffingtonpost.com/2011/04/14/rating-agencies-financial-crisis_n_849410.html

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[5] M. Ashbaugh, "Closing out the historic 2008 market crash," Dec. 2008. [Online]. Available: http://www.marketwatch.com/story/closing-out-the-historic-2008-market-crash

MarketWatch report of the after effects of the financial crisis of 2008

[6] Z. Faux, "Moodys, sp caved in to ratings pressure from goldman, ubs over mortgages," April 2011. [Online]. Available: http://www.bloomberg.com/news/2011-04-13/moody-s-s-p-caved-to-mortgage-pressure-by-goldman-ubs-levin-report-says.html

Bloombergs report on the rating agencies poor credit ratings

[7] S. M. J. Jonathan S. Sack, "Rating agencies: Civil liability past and future," Nov. 2007. [Online]. Available: http://www.maglaw.com/publications/data/00144/_res/id=sa_File1/07011070002Morvillo.pdf

The history of credit ratings and the ethics behind many of the agencies today

[8] A. Klein, "Smoothing the way for debt markets," Nov. 2004. [Online]. Available: http://www.washingtonpost.com/wp-dyn/articles/A5573-2004Nov22.html

The history of Moody's as well as how the debt markets got started.

[9] C. on Homeland Security and T. C. Governmental Affairs, Carl Levin, "Wall street and the financial crisis: Anatomy of a financial collapse," April 2011. [Online]. Available: http://levin.senate.gov/newsroom/supporting/2011/PSI_WallStreetCrisis_041311.pdf

Official government report on the investigation into the 2008 financial crash

[10] F. Partnoy, "How and why credit rating agencies are not like other gatekeepers," May 2006. [Online]. Available: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=900257

A discussion of how credit rating agencies are different than most other regulatory agencies that exist in other markets. He also goes into the conflict of interest that exists.