“How Did Increased Competition Affect Credit Ratings?”

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Q: Credit rating agencies were blamed in part for the financial crisis of 2008 because they gave AAA ratings to some toxic investments involving residential mortgages. Did the “big three” agencies—Moody’s, Standard & Poor’s (S&P), and Fitch—deserve the criticism?

A: The credit rating agencies certainly played a role in the series of events that led up to the financial crisis of 2007–2008. Specifically, there were dozens of bonds that were backed by residential mortgages that the rating agencies said were of top quality, that ultimately were not able to pay out in full. Important to add to this statement is that while credit rating agencies played a role in this crisis, their role pales in contrast to the combined roles of politicians, regulators, banks, mortgage brokers, and ultimately the individuals who took on loans well beyond their means.

“As a policy prescription, mandating two ratings, but not more, may provide a relatively simple fix to the structured credit market.” — Milbourn and Becker

Q: There have been calls for reforms of the credit rating system in the past, including calls for increased competition. In 2006, the SEC upped the number of Nationally Recognized Statistical Rating Agencies (NRSRA) from five to 10. What was the argument for more credit rating agencies?

A: The basic argument here is that more competition in any product market is typically a good thing. Automobiles and electronics are examples of products for which more competition leads to the availability of better quality goods at lower prices. Not surprisingly, regulators and the media assumed that this would improve the market for credit ratings.

Our research sought to uncover whether this increased competition in the unique world of credit ratings actually had a positive effect in practice.

Q: Moody’s and S&P have historically been the most widely known and respected credit rating agencies. Your research focuses on the changes in behavior of these two incumbent players when Fitch Ratings, the third largest agency and strongest competitor to emerge in recent years, established its own presence. What effect has the presence of increased competition from Fitch had on ratings?

A: My coauthor Bo Becker and I discovered that increased competition from Fitch actually led to a slight deterioration in the quality of corporate credit ratings issued by S&P and Moody’s. We found ratings migrated toward AAA scores as competition among the agencies increased based on data from 1995–2006.

Q: This is beginning to sound like grade inflation. Were you able to determine the accuracy of the increased number of positive ratings in periods of high competition?

A: Yes, we found that increased competition not only drove up the ratings, it also made them slightly less accurate. With increased competition, we found that there was less correlation between ultimate bond performance and the original rating scores.

Q: Clearly, increased competition is not “leveling the playing field” as some reformers had hoped, according to your research. Is there any way to restore integrity to the credit ratings and the agencies that issue them?

A: To be clear, while the rating agencies have taken some lumps through the financial crisis—with some, but not all actually deserved—all in all, rating agencies actually do a pretty good job and provide valuable information to the financial market. A big takeaway from this research is a reminder to politicians and regulators to be wary of unintended consequences.

Our paper suggests that regulatory interference in the form of calls for increased competition actually reduced the quality of the credit rating product, rather than improving it.

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