



The Rating Reform Papers - In Search of the Missing Pedestal

“Gaming” the Ratings System, or the Observer Effect

January 8, 2010

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A too literal interpretation of Occam’s razor might encourage one to believe that the rating agencies miscalculated the credit risks inherent in residential mortgaged-backed securities (RMBS) simply because they chose not to accurately analyze their underlying mortgages – often subprime mortgages. We may conjecture they had insufficient data to support their home price assumptions, which allowed only for appreciation. We’ll possibly argue they lacked the expertise to evaluate this complex asset class: that their effective credit ratings oligopoly allowed them to circumvent paying for the resources necessary to estimate the mortgage payoff streams. We might even go so far as to suggest that they knowingly provided the incorrect ratings in order to appease the issuers who were paying them, as a function of the heavily criticized issuer-pay model.

It is clear that their ratings turned out to be inaccurate and failed to account for, or be predictive of, future events. Perhaps this is the correct, complete answer – that they in some form or other *chose* not to accurately analyze the performance of the underlying mortgages. Perhaps this is the convenient answer: it allows us to punish them and to quickly implement a blanket, band-aid solution. And it may even allow us to reach an inner *Gestalt*, or closure, at having completed the circle. But perhaps there’s something else we’re missing here.

In the social sciences any framework or methodology is subject to what is called the observer effect. The observer effect deals broadly with the process by which subjects alter their behavioral patterns on becoming aware of a test’s objectives. The consequence is that behavior induced by the methodology can be different from that on which the historical data was based. The subjects’ response varies based on the incentives of the subjects and the potential complexity of the underlying product.

The problems for ratings become most apparent when the incentives of the subjects (e.g. mortgage bankers) vary significantly from those of the creators of the methodology (i.e. rating agencies). The working assumption, or hope, that models and careful study of the historical data can overcome the misalignment of incentives has been shown to be a fallacy: in our case, poorly incentivized market participants can create products and scenarios never contemplated by historical analysis.

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For simplicity, suppose we have a duopoly of rating agencies X and Y. Rating agency X decides that according to its internal calculations, it will more heavily scrutinize a particular quantitative factor – the borrower’s FICO score – when considering the quality of a mortgage for the purposes of its ratings methodology. Rating agency Y, however, publicly discloses that its methodology predominantly hinges on the loan-to-value (LTV) ratio of each mortgage.

As an originator of mortgage loans or a structurer of RMBS securities, if you have a package of loans possessing high FICO scores, capitalistic tendencies will encourage you to use rating agency X for your rating. The converse is true for low LTV portfolios, where you would likely achieve higher ratings (or equivalently require lower levels subordination at each rating level) according to rating agency Y’s model.

This is a simple example of what’s known as ratings arbitrage, or “gaming the system.” A more complex, more realistic scenario may be that once rating agency X publicly discloses that it considers FICO to be *the* key driver of mortgage performance, mortgage originators or structurers, will seek to put together a bunch of comparatively cheap mortgages representing high FICO score borrowers but with very poor other qualities and bundle those together in an RMBS to be rated by rating agency X. More importantly, originators will likely specifically targeting high-FICO individuals, knowing that they’ll be able to securitize and off-load these mortgages by way of an RMBS to be rated by rating agency X, almost irrespective of the other qualities pertaining to the borrower (e.g. employment history or salary) or the mortgage itself (e.g. loan type or documentation level). All of a sudden, while FICO score *may* have originally been a key driver of mortgage performance, all else equal, these high-FICO pools significantly underperform.

In sum, due to what we call customization (or active adverse selection) rating agency X’s RMBS analysis turns out to have been inaccurate or compromised.¹ The consequence is that if the rating agencies continue to publicly disclose their procedures, they will need to be increasingly adaptive and accurate in our computationally-intensive market, lest their rating models be otherwise gamed. They will have to be nimble and swift, like investment banks. In other words, they will need to be everything they currently are not.²

There seems to be a media-driven drive towards the creation of multiple rating agencies. The thought process is that increased competition drives standards higher. Niels Bohr noted that “the opposite of a great truth is also true.” In this situation, we feel that the flip-side is in fact a greater truth: that as far as creating rating agencies goes, sometimes less is more. Competition among the rating agencies was arguably the key driver in the decline in ratings standards, with rating agencies competing on ratings, among other things, for market share. Higher ratings translate into increased market share, which is crucial for publicly-traded companies. More importantly, the more models and options available, the easier it is to arbitrage the system and find the least conservative rating agency to rate each particular pool of assets.

We do not contend that there ought to remain three big rating agencies, nor that Moody’s, S&P and Fitch need remain the key providers. What we are saying is that having three or five accurate rating agencies is more appealing than having 30 rating agencies, *even if they’re all accurate*. Certainly, from a regulatory perspective, three would appear to be easier to manage. The SEC has been harshly criticized for its supervisory role of the “Big Three.” How comfortable are we that they can effectively monitor 30 different rating agencies, each having its own methodology and potentially unique ratings scale?

¹ The “problem” of customization is not limited to the selection of the portfolio itself, but may include adverse selection of the securitized vehicle itself, or counterparties to the structure. Like the product itself, the problem is multidimensional.

² This is to say nothing of the possibility of any artful, intentional misrepresentation of a mortgage’s quality, which may for one circumvent more appropriate, or conservative, rating agency treatment: for example, Peter Wallison’s *Wall Street Journal* opinion piece “[The Price for Fannie and Freddie Keeps Going Up](#)” speaks to Fannie and Freddie’s “mislabeling of mortgages” as prime, when they may have been better classified as Alt-A or subprime.

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This opinion piece constitutes one article in a series of articles on rating agency reform, entitled “In Search of the Missing Pedestal.” Articles written under this series can be found at <http://ratingsreform.wordpress.com>.

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