Article

The sub-prime mortgage crisis: what went wrong?

by Mohammed B Hemraj

This brief article will examine how lack of competition, conflicts of interest and derivatives had played a part in the sub-prime mortgage crisis.

LACK OF COMPETITION

The sub-prime crisis has revealed weaknesses in the methods and models used by credit rating agencies (CRAs). Lack of competition has played a part. CRAs operate in oligopolistic markets that offer limited incentives to compete on the quality of the ratings produced and this contributed significantly to the market turmoil. The oligopolistic position of the CRAs has brought about a lack of competition in this sector (see N Camanho, P Deb and Z Liu, "Credit Rating and Competition", Financial Market Group, London School of Economics and Political Science, July 2012, http://personal.lse.ac.uk/costanet/cra_paper.pdf).

In reality, CRAs often possess information that is not widely available to market participants. The uninformed investors who depend on financial markets clearly rely on the ratings generated by the major CRAs – see J R Macey, "Polarisation of American Corporate Governance", VLBR, Vol 1, No 1 (Spring 2006) at 21.

The credit ratings had failed, from the investors' viewpoint, to reflect early enough the worsening market conditions, which required the CRAs to adjust their credit ratings in time following the deepening market crisis. In addition, CRAs attempted to downplay the role that they play in corporate governance. They did this, in Macey's words, "by claiming that, because their ratings are grounded on analysis of information generated by the companies themselves, they are not in the business of searching for and exposing fraud".

In the US, the CRAs had performed badly in their ratings of a whole host of debt issues, which included Orange County, Mercury Finance, Pacific Gas & Electric, Enron, WorldCom and most recently General Motors and Ford, which Macey says "amply illustrates the point, as do a plethora of academic studies showing that credit ratings changes lag the market".

CONFLICTS OF INTEREST

CRAs had compromised their independence through conflicts of interest by not setting or adhering to appropriate codes of conduct, and this put in doubt their ability to self-regulate themselves (Shearman & Sterling LLP, Financial Institutions Advisor and Financial Regulatory Group, Client Publication (November 18, 2009) p 1). The CRAs have gone to great lengths to minimise the expectation gap, relating to what they do and what the investors' think they do, by explaining that credit ratings are opinions about relative credit risk and that they are not investment advice recommendations – to buy, hold or sell. Such a claim notwithstanding, ratings had a direct impact on the markets and the wider economy (see M Elkhaury, "Credit Rating Agencies and their Impact on the Developing Countries", United Nation Conference on Trade and Development, Discussion Paper, No 186 (January 2008), http://unctad.org/en/Docs/osgdp20081_en.pdf. The CRAs have also made serious mistakes (see eg R Kovacheva and S D Dimitrova, "MEPs Will Propose a Temporarily Ban on State Credit Ratings," (November 23, 2011) http://www.euinside.eu/en/news/meps-will-propose-a-temporarily-ban-on-state-credit-ratings).

A statement from the European Commission quoted by R Marston in "What is a rating agency?" (February 5, 2013; http://www.bbc.co.uk/news/10108284) states that the mistakes relate to a CRA having a "financial interest in generating business from the issuer that seeks the rating; this could lead to assigning a higher rating than warranted" in order to ensure repeat business from the issuers. To avoid this CRAs must follow stricter rules, be more transparent about their ratings and be held accountable for their mistakes (see eg K Scannel, "Reform aim to improve transparency of rating," *Financial Times,* October 13, 2011, http://www.ft.com/cms/s/2/c5a1a1ba-f53c-11e0-9023-00144feab49a.html#axzz2OYPPsi8s).

DERIVATIVES

Derivatives played a crucial role in bringing down the global economy. The fundamental premise of derivatives is that a person or a firm can insure an investment they want to go up by betting it will go down. The simplest form of derivative is a short sale: a person or a firm can place a bet that some assets they own will go down, so that they are covered whichever way the asset moves. In December 2007, the Bank for International Settlements reported that the world's derivatives trades amounted to a staggering amount of US $681 trillion – 10 times the gross domestic product of all the countries in the world combined.

Credit default swaps (CDS) were the most widely traded form of credit derivative. They are bets between two parties on whether or not a company will default on its bonds. CDS thus resemble insurance policies, but there is no requirement actually to hold any asset or suffer any loss, so CDS are widely used just to speculate on market changes (see further E Brown, "Credit Default Swaps: Evolving Financial Meltdown and Derivative Disaster Du Jour", *Global Research* (December 5, 2012) http://www.globalresearch.ca/credit-default-swaps-evolving-financial-meltdown-and-derivative-disaster-du-jour/8634). Even by the standards of financial engineering, these structures are highly complex and ultimately not well understood.

Banks and lenders in the past have resorted to innovations to try new ways of raising money. An example is that of commercial paper, which has become an essential in day-to-day business in the US. Since 1980 the annual commercial paper issuance has gone from US $124 billion to US $1.6 trillion in 2008 (see J Surowiecki, "The Trust Crunch", *The New Yorker,* October 20, 2008). Most of these loans are unsecured – companies do not put up collateral but simply promise to pay the loans back out of cash flow – so only well-established, financially solid companies can tap the commercial paper market. As commercial paper loans are short term and are made only to companies with sterling credit ratings, they are assumed as riskless. Lenders (most notably money-market funds) have been willing to lend at low interest rates.

CONCLUSION

Lack of competition within the CRAs results from the Big Three (S&P, Moody's and Fitch) providing 95 per cent of the ratings demanded by the market, and the situation will remain unchanged the foreseeable future. Similarly, the conflicts of interest will remain, as issuers of debt instruments pay CRAs for rating their products. In addition, nothing can stop banks and lenders from continuing to innovate in order to raise money. As rating is compromised, what is required is deterrence in the form of CRAs being made liable if they could have, but chose not to, issue reliable ratings.

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