Credit Ratings Agencies: The 19th century's other "Gangs of New York"

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[2]Credit rating agencies (CRAs) have recently gained attention from the SEC [3] and others [4] due to their possible role in the financial crises of 2008. This attention to CRAs presents an opportunity to reflect on the role of CRAs in capital markets and how they arrive at particular kinds of evaluations of credit and risk. A recent paper [5] by Bruce Carruthers [6] and Barry Cohen of Northwestern University develops a history of CRAs, demonstrating that while credit markets have changed dramatically since the 19th century, many of the constraints faced by CRAs, as well as the complaints and accusations levied against them, have not.

It is commonly argued that CRAs perform a critical function in contemporary credit markets: given a lack of available information on the creditworthiness of particular firms or financial instruments, investors depend on these agencies to resolve information asymmetries, with the result of freeing up credit markets. Anyone who has had to evaluate companies, bonds, or structured financial instruments, is accustomed to unique features of rating systems: a grade (Aa, Baa, etc.) is given to indicate the relative safety of an investment or creditworthiness of a counter-party, but the sources of information and method for arriving at a rating are obscured—with the advantage of simplifying decision making, but the downside of losing potentially important information. Additionally, the categories are ordinal ranked, such that the distance between two categories is unknown: the distance (measured in creditworthiness or risk) between "AAA" and "AA" is not the same as the distance between "AA" and "A." And the rating is not represented as being factual and quantitatively precise, but rather as an "opinion" of creditworthiness.

Dry Goods

[7]Why have all these different rating systems converged on a set of shared features? In their recent working paper, Carruthers and Cohen explore the history of CRAs in the U.S., tracing their origin to dry goods wholesalers in the 19th century New York City. As networks of trade expanded in the U.S. from the regional to the national level, dry goods wholesalers faced a dilemma: when trading within local networks, they could rely on reputation and familiarity with the business party the extended credit to, but how could they evaluate the creditworthiness of distant businesses? This dilemma threatened to freeze the expansion of trade and credit networks in a rapidly developing country.

A standard narrative tells us that the predecessors of today's credit rating agencies, the mercantile agencies, stepped in to fill this vacuum, resolving information asymmetries and promoting the growth of national capital markets. But a closer look at these agencies, the dilemmas they faced, and their own competition with each other reveals a much more complex picture. In 1841, the Mercantile Agency (which later became R.G. Dun), was founded and began providing information to New York wholesalers. The first reports were not the alphabetical categories that are common today, but were written and verbal reports, and full of qualitative information about specific firms. Beginning in the 1850's Bradstreet, a competitor of Dun's, started publishing reference books in which summaries of firms' creditworthiness were listed. Another competitor, McKillop's Commercial Agency joined the fray in 1860.

Unpaid Correspondents

[8]But where did this information on creditworthiness come from? R.G. Dun initially relied on unpaid correspondents to provide background information on firms. This information was then transformed into a categorical rating, but the methodology behind this transformation was never made public. In early reports, R.G. Dun would provide more concrete information on a firm's capital, real estate holdings, and overall creditworthiness. But providing information on capital and real estate posed two problems: 1) it was difficult to gather this information once the number of firms grew into the millions, and even more importantly, 2) this was information that could easily be copied by competitors. R.G. Dun's next step was to drop the information on capital and real estate, instead relying on a one-dimensional system to measure creditworthiness. Later category systems introduced two dimensions, one on firms' general creditworthiness and one on firms' "pecuniary strength," or level of capital.

According to Carruthers and Cohen, credit rating firms faced three constraints in coming up with an adequate rating system:

1. the system must be perceived as useful by clients,
2. the rating must not give away too much information, otherwise competing agencies could poach on their hard work to gather this information, and
3. the rating must not make the agency legally liable—the rating was presented as an "opinion," and agencies were careful to protect themselves from lawsuits from both creditors and lenders who felt they were materially harmed by the rating.

Competition between rating agencies, the emulation of successful innovations, and the demands of investors resulted in the rating agencies settling on the now-standard ordinal rating system.

Enter the "Big 3"

Other firms joined the landscape, including the "big 3" of Standard & Poor's (with an early strength in rating railroad companies), Moody's, and Fitch IBCA. CRAs expanded into areas where sparse information on creditworthiness threatened to lock up credit markets: from their origins in rating wholesalers, these rating systems were applied first to railroad bonds, then corporate bonds and bond issues, and most recently into the realms of structured finance (notably CDOs and MBSs). While each firm has its own proprietary ranking system to reduce an overwhelming amount of information into an easily comprehended grade, they use similar alphabetical categories, and rely on ordinal ranked categories.

Recent complaints [9] against CRAs argue that they have an inherent conflict of interest given that in some instances they are paid by the issuers of the very securities they rate. Deven Sharma of Standard & Poor's has responded to these criticisms with a defense [10] of his industry. In light of Carruthers and Cohen's historical study, the complaints of today echo those of the past. When a highly graded investment fails, who is to blame? Look for legislation in 2010 to address this question.

The National University of Singapore's Risk Management Institute (RMI) has recently announced a non-profit, large-scale credit rating on Asian firms. This non-profit credit rating initiative is being undertaken as a response to the recent financial crisis, with the intent to serve as a academic competitor to the commercial credit rating agencies (CRAs) and spur research in this vital area. The RMI has stated this initiative will provide ratings on 500 Asian firms by 2011.

Although CRAs may shoulder some responsibility for the financial crisis, there is a consensus that they play an important role in capital markets. And as Carruthers and Cohen show us, this certainly isn't anything new.

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