Assessing the role of regulation and corruption in capital market failures: the case of credit rating agencies and structured finance

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Abstract

This paper seeks to explain why rating agencies failed to rightly assess the creditworthiness and risks associated with the issues they rated in the structured finance market previous to the financial crisis of 2008. In doing so, it advances the argument that on the one hand the regulatory framework governing capital markets in the USA settled a pervasive combination of factors that allowed CRAs to disregard the quality of their ratings. As theory predicts, the rules providing incentives and constraints to participants in the market of structured finance influenced the way actors behaved. On the other, this paper also argues that the unreliability of the structured finance ratings delivered by CRAs was not only product of the rules of the game governing this sector of capital markets but was also related with practices of corruption that penetrated the relationship between debt issuers, rating agencies and investors.

Key words: Credit Rating Agencies, Capital Markets, Structured Finance, Regulation, Corruption

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List of Abbreviations

ABS Asset Backed Security

CDO Collateralized Debt Obligation

CRAs Credit Rating Agencies

FCIQ Financial Crisis Inquiry Commission

NRSRO Nationally Recognized Statistical Rating Organization

RMBS Residential Mortgage Backed Securities

SF Structured Finance

SIV Special Investment Vehicles

SPV Special Purpose Vehicles

..The causes of wealth are something totally different from wealth itself. The power of producing wealth is therefore infinitely more important than wealth itself; it ensures not only the possession and the increase of what has been gained, but also the replacement of what has been lost..

Friedrich List, *The National System of the Powers of Production and the Theory of Value*s

Chapter 1

Introduction and research design

Since the recent financial crisis unfolded, one key element contributing to the crisis identified by observers and scholars was the role played by credit rating agencies (CRAs). Credit rating agencies are for-profit enterprises whose business resides in the assessment of the creditworthiness of borrowers. Through the use of different mathematical and statistical models and methodologies, CRAs assess the likelihood of debt being repaid.

While they have been providing their services to investors and issuers -or lenders and borrowers- for around a century, since the early 21st century they have been involved in controversy given the contested reliability of their ratings. This was particularly evident in their failure to anticipate Enron's bankruptcy in 2002, maintaining investment grade ratings on its securities up to just one week before the financial scandal broke down (Quote).

Evidence from the recent financial crisis could suggest that lessons from Enron's episode were not properly addressed. Six years after that warning, credit rating agencies were once again involved in a major financial turmoil. Through their ratings, credit agencies played a pivotal role in shaping the allocation of capital in capital markets, determining to a large extent where investors could and should put their money. However, it turned out

that the ratings provided by the agencies were rather inaccurate and did not capture the real risks associated with the issues they were evaluating.

The aforementioned has implied losses of billions of dollars, given the fact that many investors –obliged by regulation to rely on ratings- invested their money on "investment grade" securities that ended up having junk status. Such was the case for example of the California Pension System, which invested more than a billion dollars on three structured investment vehicles (SIV) graded with the highest rating by Moody's, S&P and Fitch, the three main rating agencies. Eventually these SIV failed to repay the principal and interest to lenders, generating millionaire or even billionaire losses.

Furthermore, in contrast with the somehow isolated Enron episode, a review of the financial crisis shows that rating agencies incurred in widespread failures, especially in the field of structured finance. For example, of the total "AAA rated subprime-mortgage-backed securities issued in 2006, 93 percent — 93 percent! — have now been downgraded to junk status" (Krugman 2010).

Evidence of the acknowledgment that something went wrong and needs to be corrected with regard to how CRAs operate can be found in the ongoing studies and reform proposal developed by important agencies. In this sense, for example, the Securities and Exchange Commission commissioned in 2008 an examination of selected CRAs (Moody's, S&P and Fitch), which mentions how the "rating agencies performance in rating (…) structured finance products raised questions about the accuracy of their credit ratings generally as well as the integrity of the ratings process as a whole (SEC 2008:2)".

In a similar fashion, the Financial Crisis Inquiry Commission (FCIQ), created by the

Fraud Enforcement and Recovery Act of 2009, has the duty to carry out a comprehensive examination of, among others areas, the ones referring to "credit rating agencies in the financial system including, reliance on credit ratings by financial institutions and Federal financial regulators, the use of credit ratings in financial regulation, and the use of credit ratings in the securitization markets", as well as "financial institution reliance on numerical models, including risk models and credit ratings" (FCIQ 2009).

Additionally, the Permanent Subcommittee on Investigations (2010) of the US Senate Committee on Homeland Security & Governmental Affair has just held on April 23 2010 a day long hearing under the title "Wall Street and the Financial Crisis: The Role of Credit Rating Agencies", whose insights, as well as the ones from the previously mentioned agencies will provide inputs to this research.

Besides the ongoing inquiries in the US, other multilateral institutions have also engaged in research, reflection and to some extent political action on the matter. For example, on its Declaration on Strengthening the Financial System, the G-20 has also acknowledged the necessity of examining the role that rating agencies play in financial markets, recognizing its centrality as market participants but also the need to enhance regulation and oversight of their activities (G-20 2009).

This is also the case of the Bank for International Settlements and the International Organization of Securities Commissions, both of whom have produced reviews and examinations regarding credit ratings oversight, regulation and on their role within the financial sector, particularly on the market of structured finance (BIS and IOSCO, 2007, 2009).

In short, the need to reform the status quo with regard to the functioning of financial markets and particularly of the rating agencies it is now acknowledged by relevant actors on the matter, which include government agencies, legislative bodies, multilateral organizations and scholars. But reforming the status quo, it is acknowledged too, requires also a better understanding of what went wrong and why. In this sense, designing a better future functioning of the financial sector, the capital markets and in particular of the role that rating agencies plays in both, require us to analyze and understand, based on empirical evidence, which were the shortcomings of the previous design.

Considering the aforesaid, this research paper has the objectives, research questions and core statements that follow.

2. Objectives

2.1 General

- To contribute to the improvement of the institutional design or regulatory framework governing the functioning of capital markets of structured finance products, especially with regard to the role of credit rating agencies

2.2 Specific

- To examine what are credit rating agencies and how they perform their function within capital markets

- To analyze the main shortcomings of the institutional design/regulatory

framework with regard to the incentives and constraints that they provide to credit rating agencies

- To evaluate to what extent corruption played a role in the faulty Structured Finance ratings provided by rating agencies previous to the financial crisis

3. Research Question

3.1 Main research question

In the context of structured finance's capital market, why did the Credit Rating Agencies fail to fulfill their main mission of assessing creditworthiness of issuers and providing a reliable rating based on the risks associated to issues?

3.2 Sub research questions

Which shortcomings in the regulatory framework can be related to the failure of credit agencies in providing reliable ratings?

In any, which were the characteristics of structured finance markets that contributed or allowed rating agencies to delivered unreliable ratings?

Within the structured finance market, to what extent did corruption play a role in the faulty ratings provided by CRAs?

4. Argument

The argument of this paper is twofold.

a) First, one of the reasons behind the bad performance of Credit Ratings Agencies was a flawed regulatory framework. In particular, the shortcomings of the institutional design governing capital markets that allowed CRAs to fail as they did refer mainly to the combination of the three following elements:

i. Legislation granted a semi-regulatory status to rating agencies, providing them with power and authority similar to that of a public entity.
ii. Second, regulation (and regulators) did not take care of the rating agencies' business model of issuer-pays, which entailed a inherent conflict of interest, specially in the context of structured finance products.
iii. Finally, in spite of being granted a semi-regulatory status and embracing a business model with an inherent conflict of interest, legislation explicitly protected rating agencies from any kind of liability related with faulty ratings.

Seen independently, the previous elements may not seem as harmful as they were. However, the combination of the three previous elements within the ill-designed institutional setting allowed CRAs to follow negligent patterns of performance.

b) The second reason that led CRAs to provide faulty ratings lays in their own corrupted actions. Legislation entrusted rating agencies with power to act as gatekeepers or gate-openers to access capital markets; rating agencies had the monopoly to define which issues had investment grade and which did not, therefore determining where banks, pension funds and other institutional investors could invest (law establishes that these kind of entities can only buy investment-grade issues).

The institutional design granted CRAs the status of semi-regulatory entities, and they abused this power and authority for their private gain. In terms of Principal-Agent relations, they were supposed to rate issues in order to provide investors with reliable opinions on the creditworthiness of borrowers. In this sense, legislation implicitly situated investors as principal and CRAs as agents. However, since in their business model issuers were paying for the rating fees, and the fees were paid only if investors bought the issues, CRAs consciously provided flawed (investment grade) ratings to products (that eventually turned out to be junk). In short, CRAs were aware that they were not providing reliable ratings, and still, instead of abstaining from providing faulty ratings, the pursuit of profit (which, were it not at the expense of consciously abusing entrusted power, would be perfectly legitimate) led them to sell faulty ratings, abusing their entrusted power.

5. Methodology

This research is of a qualitative nature, and relies on both primary and secondary data. In order to answer the research questions, it employed a backward inductive logic. This means that the first step was to collect data and evidence, and only once the findings were identified, it proceeded to define the analytical framework.

Regarding primary data, the sources of information included rating agencies documents, legislation, second hand interviews (collected from the web media), legislative hearings and rating agencies internal communications like emails. On secondary data, the process began by a literature review of academic articles, books and publications of institutions involved in the topic.

In addition, a selection of study cases was done. From the general to the particular, this paper chose the structured finance market because it was here that most of the faulty ratings were concentrated. On a particular case, a transaction in SF was selected in order to examine and contrast empirical evidence with the analytical and argumentative approach of the research. In addition, primary data as emails is used to complement the study case.

6. Limitations

This paper studies the regulatory framework governing capital markets, especially on what it considers to be the shortcomings allowing the failure of CRAs in providing reliable ratings. However, it does not question or inquires into the process from which this ill-designed institutional framework arose. In addition, the focus is on the diagnosis of what happened, rather than on proposing measures that should be taken. Therefore, this paper does not include policy recommendations.

Chapter 2: Analytical Framework

In order to answer the research questions, this paper will make use of two main concepts: regulatory framework or institutions, and corruption.

1. Regulatory framework or institutions

Renowned scholar Douglas C. North defines institutions as "humanly devised constraints that structure political, economic and social interaction", which include both formal rules like legislation and informal ones like traditions or taboos (North, 1991:97). In the case of capital markets, as well as in the case of other economic activities, North argues, institutions are created in order to generate certainty, diminish transaction costs, and facilitate economic exchange.

Therefore, in one sense we can speak of institutions as those devices that allow diminishing transaction costs and enhance economic growth (e.g. property rights, rule of law, etc.). Furthermore, if one considers that we live in a world of imperfect information, where information asymmetry is the rule rather than the exception, it turns out that to a large extent the transaction costs will be a function of the established institutions (North, 1991:98).

With regard to transaction costs, it must be specified that they refer to the costs "involved in measuring what is being exchanged and in enforcing agreements". In order for economic transactions such as those of capital markets to happen smoothly, it is necessary to be able to rightly assess not only the physical properties but also the

valuable attributes of goods (North, 1993:160). This is to some extent the need fulfilled by CRAs, as will be shown within the following chapter, where the specific role for rating agencies in capital markets will be discussed in more detail.

However, for the purposes of this research, institutions should be understood as the rules of the game framing the agents' behavior. Together with material or economic realities, formal and informal institutions define the available options to different actors, also determining the feasibility and rate of profit of economic activities. Furthermore, institutions provide the incentive structure of the economy, or for that matter, of certain markets within the economy, shaping the direction towards "growth, stagnation, or decline" (North, 1991:97) In this sense, it is convenient to stress the importance that the incentives provided by rules or institutions have in modeling the behavior of different actors.

To the extent that rules and structure provide incentives and constraints upon actors, regulations can be thought of as institutions, this paper will therefore use both notions in an undifferentiated manner. The emphasis on the institutions and their design aims to invite the observer to reflect on the role of rules in modeling behavior but also on "the part played by institutional structures in imposing elements of order on a potentially inchoate world" (March and Olson, 1984:741,743), as it can be the case of the complex networks of exchange in capital markets.

In this sense, just like "political democracy depends not only on economic and social conditions but also on the design of political institutions" (March and Olson, 1984:738), the functioning of capital markets, the financial sector and the economy in general depends also on the institutional design regulating it. As we mentioned, institutions set

the rules providing opportunities and constraints for different actors, in this case not only market participants but also for other players such as the rating agencies, who have been given the role of gatekeepers –and lately of gate openers- by regulation.

Laffont, for example, sees regulation as "the public economics face of industrial organization", relating it to how governments "interfere with industrial activities for the good or for the bad"[1]. From this perspective, in this paper we would be intending to examine which part of these regulations could be related to the poor performance of CRAs, or in other Laffont's words, which where those governmental interferences for the bad.

As North says, institutions matter because they have certain effects on the agency of actors: institutions –expressed as regulation- impose constraints and opportunities, and order and structure to human activity. Regulations set the environment in which decisions are taken, rewarding some behaviors and punishing others. In Croley's terms, regulations prescribe, proscribe and condition the behavior of individuals, firms and groups (1998:3). Then, regulations can be expected to affect the behavior of rating agencies.

Although in this paper we are not observing the process through which regulation is determined and established (an undoubtedly useful research project) and we are rather looking at the shortcomings of already existing regulation, disregarding the specific processes through which it was engineered, it is convenient to briefly mention the main differences between the public choice and public interest approaches given that they

[1] In a manner similar to North, Laffont poses regulation dilemmas mainly as "a control problem under incomplete information" (Laffont 1994:507,508)

could contribute to an interpretation of the regulations governing exchange within capital markets.

Following Croley's[2] work, we can point out that public choice theory treats regulation as if it were yet another market, where the participants (firms, legislators, citizens, etc.) exchange regulatory goods under the principles of (political) supply and demand. These goods can include subsidies, barriers to entry, tariffs, taxes, etc. From this perspective, regulatory outcomes often reflect mainly the interests of small interests groups and imply an inefficient economic distortion; the underlying principle is that market outcomes will tend to be superior to "regulatory products of an intractable regulatory regime" (Croley 1998: 34-40).

In contrast with the public choice school, the public interest theory argues that many regulatory outcomes could not be understood if there were not minimally concerned with citizens' well being. They see regulation as a tool to correct market failures. However, they acknowledge that interest groups have greater chances than common citizens to influence regulators, who besides their formal duties have also the preference of maintaining themselves as regulating authorities (Croley 1998: 65-69). What is common to the different approaches is the reliance on Olson's work *The Logic of Collective Action* (Olson 1971).

Finally, it is important to highlight that actors' decisions relate to the existing incentive structures that are derived from prevailing rules and institutional designs. It is important

[2] See Croley's *Theories of regulation: incorporating the administrative process* (1998) for a critical and comparative review of each one.

to consider this given the fact that, possibly, much of the rating agencies' behavior could have been related to the institutional engineering governing capital markets and the role of rating agencies in itself. In short, institutions matter because rules structure (exchange) relations between different stakeholders (or market participants for that matter), and determine the behavior of agents, given the fact that they provide the incentives and constraints under which decisions are taken.

So far we have established one dimension of the analytical focus: the role of institutional design in allowing what rating agencies' (or any other participant) can or should do or not do. This analytical approach will be displayed in understanding the context of CRAs' failure to correctly fulfill their main function of assessing creditworthiness of borrowers and the risks associated with securities or issues. The following section will define the concept that complements the analytical framework of this research; explaining no longer the context but rather the specific behavioral path followed by CRAs, which can be labeled as corruption[3].

2. Corruption

Traditionally, most definitions of corruption center on state-society relations both because public sector corruption was thought to be a bigger problem than private one, and because the control of the former is considered a prerequisite for combating the latter (Andving and Fjeldstad, 2000: 14). A major concern behind this perspective or

[3] From a sociological perspective, the analysis of the regulatory framework could be thought of as the analysis of the structure while the study of the rating agencies behavior would represent the agency side. The interaction of both would provide what Giddens calls "structuration". See Giddens, A. (1986). Sititution of society: Outline of the theory of structuration, University of California Press

understanding of corruption relates to the latter as a phenomenon not only deleterious for economic growth (Wang and Rosenau, 2001: 34,) but also as barrier to entry –a protectionist measure- against foreign firms (Krastev, 2004:12).

An additional element contributing to the focus of corruption literature on public or governmental entities could have been related with the underlying idea that only public entities were entitled with power. However, and as it will be discussed with more detail in the following chapter, private actors have begun to perform regulatory and authority functions, and therefore it has been necessary to improve our understanding of corruption in order to encompass realities that go beyond the public sphere. Such is the case of private to private corruption, which occurs "when a manager or employee exercise a certain power or influence over the performance of a function, task or responsibility within a private organization or corporation", acting contrary to the duties of his job (Argandoña, 2003: 255). If the relation were between a private and a public entity, and the former were shaping the policy making of the latter, we may well speak about corruption as regulatory capture (Kauffman, 2009).

In a similar fashion, for example, the traditional definition of corruption as the abuse of public office for private gain has now been replaced by the wider notion of "abuse of entrusted power" (Eigen 2010), without regard of the public or private nature of such power. This definition improves previous notions in that it implicitly recognizes that no longer only public entities are holders of power and authority, and that it does not incline the analytical focus to governments, allowing for a similar emphasis on those activities performed by private actors.

In spite of the aforementioned, corruption as "the abuse of entrusted power" can still be a vague or contested notion, therefore clarification to distinguish corruption from pure fraud or white-collar crimes is needed. In order to do so, this paper will borrow the work of Diego Gambetta, *Corruption: an Analytical Map*. Gambetta distinguishes corruption from other misconducts (including a pure fraudulent market exchange) in that the former comprises the relation between three agents rather than only two. Expanding the Principal-Agent problem, for corruption to exist Gambetta identifies as truster (T), a fiduciary (F) and a corrupter (C) (2002:35).

The truster T could be an individual or an organization, "relying on the expectation that people in certain (fiduciary) positions are bound to follow given rules" and somehow act on behalf of the truster. For the case of capital markets, the truster could be either a market participant like a pension fund that by law has to trust and rely on ratings, or the regulators that granted semi-regulatory status to CRAs, expecting, as Gambetta says, that they will behave in a certain reliable manner. In terms of Principal-Agent analysis, the truster would represent the Principal.

A second actor involved is the fiduciary F, who would be acting on behalf (as the Agent) of the truster (the Principal). In this case, rating agencies would be performing as fiduciaries. Legislation (or regulatory agencies for that matter) has delegated to them the authority to determine the creditworthiness of borrowers Furthermore, CRAs have been granted the power to decide which are the issues in which important market participants such as pension funds can invest. As will be showed in chapter 4, CRAs do not only bridge informational gaps among market participants but have also be entrusted with power as "purveyors of regulatory licenses", opening and closing the gate to enter capital

markets (Partnoy 2009:2). But in short, "F may be anyone who agrees to act on behalf of T" (Gambetta 2002:35).

The third participant required for corruption to exist is the corrupter (C), who can be anybody whose interests are affected by F's actions". In this case, securities' issuers would be in this position, given the fact that in order for them to access important markets participants' funds, a determined action of CRAs is needed: in this case, an investment grade rating.

A few other considerations are needed in order to make the understanding of corruption more precise. First, "a corrupt exchange between F and C can occur if, and only if, a certain relationship between T and F pre-exists", and "the relationship of trust between T and F gives F the power over the resources that interest C" (Gambetta 2002: 36,37). As chapter four will show, capital markets' regulations establish a pre-existing relationship between the supply side of the market (investors bounded to ratings by legislation, the trustees) and CRAs (the fiduciaries).

Second and lastly, conceptually corruption can be seen within a wider set of strategies that the corrupter employs in order to get the fiduciary to unduly favor the former. This wider set of strategies could include pressures of different nature, like blackmail or any sort of intimidation (financial, political, even physical). However, when coercion as the aforesaid cases occurs, "it does not make it less of a case of corruption but less of a free exchange" (Gambetta 2002:39).

Having explained the analytical framework that will be employed throughout this research paper, the next chapter will provide a conceptualization of CRAs and an understanding of structured finance.

Chapter 3: conceptualizing rating agencies and understanding structured finance

This chapter will introduce the Credit Rating Agencies to the reader, highlighting their function within the allocation of capital in capital markets. It will also explain what structured finance is, showing how its high degree of complexity makes investors strongly dependent on CRAs.

3.1 Conceptualizing CRAs

3.1.1 What are CRAs and where do they come from?

The history of Credit Rating Agencies dates back more than a hundred years. However, the way their perform and function has been subject to transformations over this period.

The origin of rating agencies dates from the early 20th century. In 1900 John Moody published his first "Manual of Industrial and Miscellaneous Securities", which provided "information and statistics on stocks and bonds of financial institutions, government agencies, manufacturing, mining, utilities, and food companies". After the stock market crash in 1907 Moody's was forced out of business, but he came back two years later with an improved idea: rather than only collecting information, he would provide an analysis of securities and their investment quality (Moody's, 2010). S&P followed a similar track forming its Standard Statistics Bureau in 1906, and beginning to rate corporate and municipal securities in 1922 (S&P, 2010).

3.1.2 How do CRAs perform their functions?

In principle, rating agencies are independent third parties that provide a judgment on the creditworthiness of borrowers. Through the work of rating agencies, all financial institutions, corporations, municipal governments and states are evaluated with regard to their ability to meet long-term (e.g. bonds) and short-term (e.g. commercial paper) obligations (Sinclair, 1994a:150).

In the functioning of capital markets transactions, CRAs intervene to overcome information asymmetries between borrowers and lenders, estimating the ability of the former to repay principal and interest within established periods (Kuhner, 2001:2). In this sense, rating agencies function as intermediaries providing information to investors at a lower cost than if the latter had to do its own investigation; in doing so, CRAs "evaluate financial claims according to standardized quality categories" (Mollers, 2009:478). Through their risk assessment methodologies, CRAs help to overcome information asymmetries and contribute to the efficiency of global capital markets; therefore, they can be thought of as "market surveillance mechanisms" (Sinclair, 2003:148).

Credit Rating Agencies work as organizations that help to diminish transaction costs, and although they do not have the legal authority to enforce contracts, they do have the legal and (at least until now) the market-reputational authority to estimate how reliable a borrower is. In this sense, CRAs are a basic element providing support, order and structure to exchange in capital markets. They perform the double role of organizations (as players) and institutions. Their function as player relates to the pursuit of profit, while their role as an institution derives from their know-how and the way it shapes the allocation of capital in capital markets.

In practice, under the current issuer pays model (in place since the 1970s), CRAs meet with bond issuers, ask them for information, and through the use of different (mathematical) models and methodologies they analyze the data provided by the issuer, finally coming up with an "opinion" (represented by a rating symbol like AAA or BBB) that synthesizes the chances of that debt being repaid. In particular, rating agencies place attention to cash flows in relation to service debt obligations, and evaluate the company's (or government) liquidity with regard to repayment schedules. Additional information like historical and prospective data (e.g. ten-year financial projections), balance sheets, alternatives for financing, capital spending analysis and contingency plan may also be included (Sinclair, 2003:150).

3.1.3 Why have CRAs acquired so much relevance in recent decades?

In spite of a long existence dating back over a hundred years ago, the role of credit rating agencies has changed as the Global Political Economy has experienced changes. This is related with three main features of the global political economy of the last three or four decades: growth and high integration of cross-border capital markets, the reallocation of authority, and financial disintermediation.

3.1.3.1 Growth and integration of global capital markets

On the side of the growth and integration of global capital markets, economic changes beginning in the 1970s with the downfall of the Bretton Woods system and amplified in the last four decades have played a role in enhancing the centrality of CRAs. . While the

post World War monetary regime "cemented the demise of the global capital markets" and inaugurated an era in which the world's most important economies were connected mostly by basic bilateral agreements on trade and finance, since the 1970s private capital movements began to acquire a high scale and since the 1980s they grew in an accelerated manner (Obstfeld & Taylor, 2004:16). Cerny (1993) argues that financial capital stopped being the servant it had been during the Bretton Woods system and began to act as the master or predominant sector within global capitalism.

3.1.3.2 Relocation of power and authority

In a somehow parallel process that was intensified with the end of the Cold War, the world has witnessed a relocation of authority, in which the traditional state-centered system has been replaced by a multi-center system of global governance that assigns lesser power and authority to sovereign governments and greater power to private actors. This relocation of power has also taken place along the lines of granting authority to those entities most able to effectively perform certain tasks (Rosenau, 1992:256), and in this sense, new actors have emerged as private sources of policy making or regulation. Such is the case of the rating agencies, which based on the specific knowledge they have and on their reputation of being able to effectively assess the creditworthiness of borrowers have emerged as private semi-regulatory actors (Sinclair, 1994a).

3.1.3.3 Financial disintermediation

While it can be argued that bonds and capital markets have existed for at least four centuries, when the Dutch, loyal to their sophisticated economic ethos (Weber,),

"revolutionized domestic and international finance by inventing the common stock" of the Dutch East India Company and having a government bond market since the early 17th century (Sylla, 2001:2-3), the fact is that for most of the 19th and 20th century financial transactions were done with the intermediation of banks.

Financial intermediation refers to "borrowing by deficit units from financial institutions rather than directly from the surplus units themselves". Hence financial intermediation implies that those with surplus deposit funds in financial institutions (typically banks) that then the latter lend at their own risk to those with a deficit or need of funds. Financial intermediaries usually charge borrowers interest rates higher than those they pay to lenders; the difference on this spread provides them with a profit but also with the resources required to cover the transaction costs related to information asymmetries: searching –bringing together lenders and borrowers-, verification of the borrower's financial conditions, monitoring of the loan and enforcement of the contract (Mathews and Thompson, 2008:35,38).

In spite of the aforementioned, since the 1980s there have been increasing changes in the way financial markets work. The development of information technologies, financial innovation, the globalization of capital markets and a "rightward movement of government which has fostered deregulation" have all contributed as proximate causes of the "the changing structure of financial institutions" (Santomero, 1989: 324). This process of change has "led to the disempowerment of traditional intermediating institutions, notably banks, and the empowerment of others, such as debt security rating agencies" (Sinclair, 1994a: 136).

Rating agencies have become preeminent given the informational problems posed by the financial disintermediation that has occurred over the last three decades: the growth of securities markets (specially bond markets) has implied that lenders and borrowers no

longer converge through banks –the traditional financial intermediaries- but rather meet and perform financial transactions in impersonal (electronic) markets sustained by information technologies (Sinclair 1994a: 140-142). Under these new market structures, rating agencies substitute banks and other intermediaries in the task of evaluating the creditworthiness of borrowers (states, corporations, etc.) (Sinclair 1994a: 143). This will be clearly illustrated in the next section of this chapter.

Having provided a basic conceptualization of CRAs and the causes of their emergence as central actors within capital markets, let us now proceed to explain the case of structured finance.

3.2 Understanding CRAs and Structured Finance

3.2.1 What is Structured Finance?

This paper argues that the Structured Finance market had some characteristics that made it more susceptible to be abused my market participants. In this order of ideas, this section intends to provide the reader with an understanding of what made SF special and why potential conflicts of interest were more prone to become actual conflicts of interest and even corruption.

Until the late 1990s, issuing bonds was the preferred method to raise funds used by governments, corporation and municipalities, in which case repayment to bondholders was dependent on the cash flow of the issuer. However, since the late 1990s and especially since early 2000, financial innovation began to develop new ways of raising funds, as was the case of issuing "securities backed by a pool of loans or receivables", referred to as asset backed securities (ABS) (Fabozzi 2005:27). As opposed to traditional

bonds, in the case of ABS the source of repayment does not depend on the cash flow of the issuer; rather it depends on the pool of loans or "receivables" and on the guarantee of third parties (insurance companies) that will secure that debt is repaid in case the pool of assets fails. In this sense, asset securitization means creating a pool of assets that back the security, while "structuring" refers to the "process of redistributing the cash flows and the risks of the pool of financial assets" that back an ABS (Fabozzi 2005:27).

At the heart of Structured Finance (SF) there is securitization, "an alchemy that really works" according to capital markets' scholar Steven Schwarcz. Through securitization, "a company partly deconstructs itself by separating certain types of highly liquid assets from the risks generally associated with the company". Based on this deconstruction, the company can isolate certain assets from the company's associated risks and then use them to raise funds in capital markets at lower interests rates. In principle, this allows companies to retain savings from lower capitalization costs and investors to earn from holding safer investments (Schwarcz, 1994:134). However, some other authors argue that the main force behind securitization was the companies' desire to take risk off their balance sheet (Quote).

The assets that "originator" companies put aside are usually rights to payments denominated "receivables", which in order to be securitized are transferred to a new - legally separate corporation, commonly referred to as "Special Purpose Vehicle" (SPV). The SPVs are thought of as the mean to isolate the receivables from the "originator" company's risks, including their creditors in case of bankruptcy. In order to define if a company should engage in this kind of financial alchemy, the expected savings from cheaper capital should be contrasted against the costs of securitizing the assets (Schwarcz, 1994:135,137).

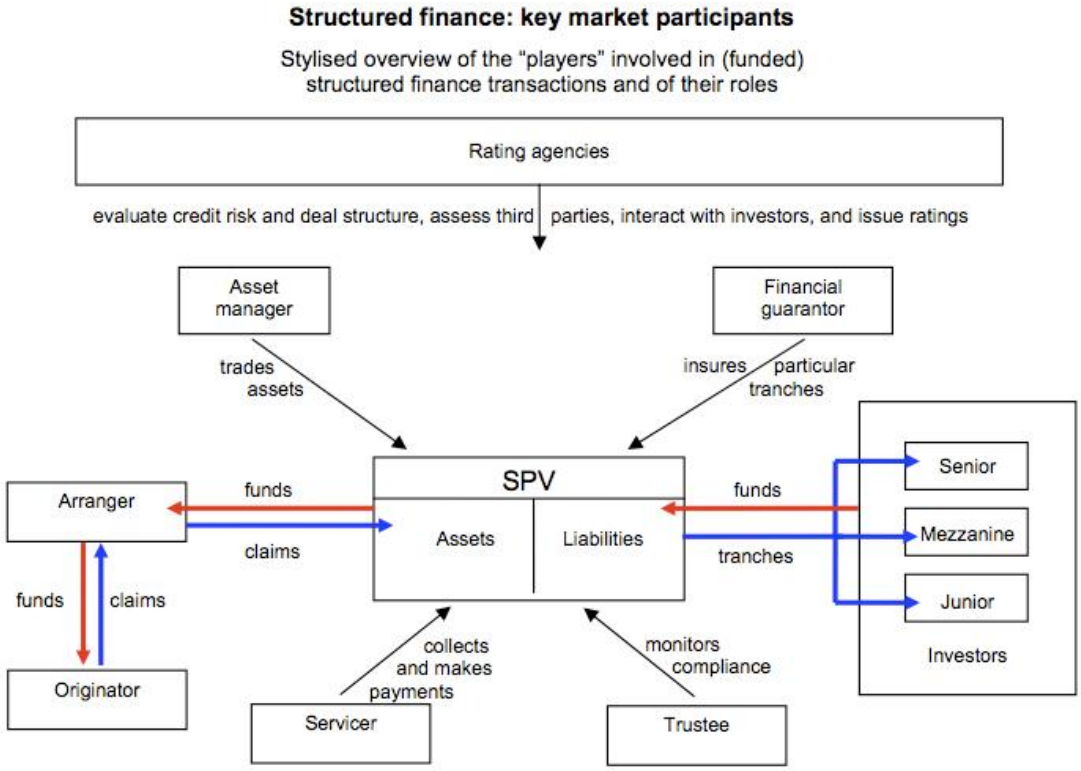
In short, the three main characteristics of structured finance are: a) pooling of assets, b) delinking of the credit risk of the originator and the credit risk of the asset pool through the creation of a Special Purpose Vehicle, and c) tranching of the liabilities backed by the pool of assets. The tranching is what distinguishes structured finance from pure securitization, and it allows distributing "cash flows from the underlying asset pool to different investor groupings" (CGFS 2005:1,5). In other words, tranching allows for the creation of "one or more classes of securities whose rating is higher than the average rating of the underlying collateral asset pool or to generate rated securities from a pool of unrated assets" (Fender and Mitchell 2005:69) (See also their article for a detailed technical discussion of rating challenges and complexities with regard to structured finance). Finally, it is important to mention that SPVs usually have no furniture or offices; rather, they are legal entities that will come to practical existence only once deals have been achieved.

3.2.2 The role of rating agencies in structured finance

As it can be noticed from the previous paragraphs, structured finance is more complex than other financial instruments like bonds or non-tranched securities; creditworthiness of the issuer is more difficult to asses given that it is not a single company but rather a pool of different (tranched) assets. So, on the one hand, given the complexity, "investors face relatively high costs in assessing the structure and risk profile" of structured finance, and on the other, issuers want their products to be rated so they can reach investors "bound by rating-based constraints". The combination of the two aforementioned situations has implied that from the very beginning, structured finance has "largely been a rated market" (CGFS 2005:2,3). In the words of some scholars, "by having these new securities rated, the issuers created an illusion of comparability with existing "single-

name" securities. This provided access to a large pool of potential buyers for what otherwise would have been perceived as very complex derivative securities" (Coval, Jurek et al. 2009:3) Figure 2.1 provides an idea of the market participants and their relations.

Figure 3.1 Structured finance: key market participants



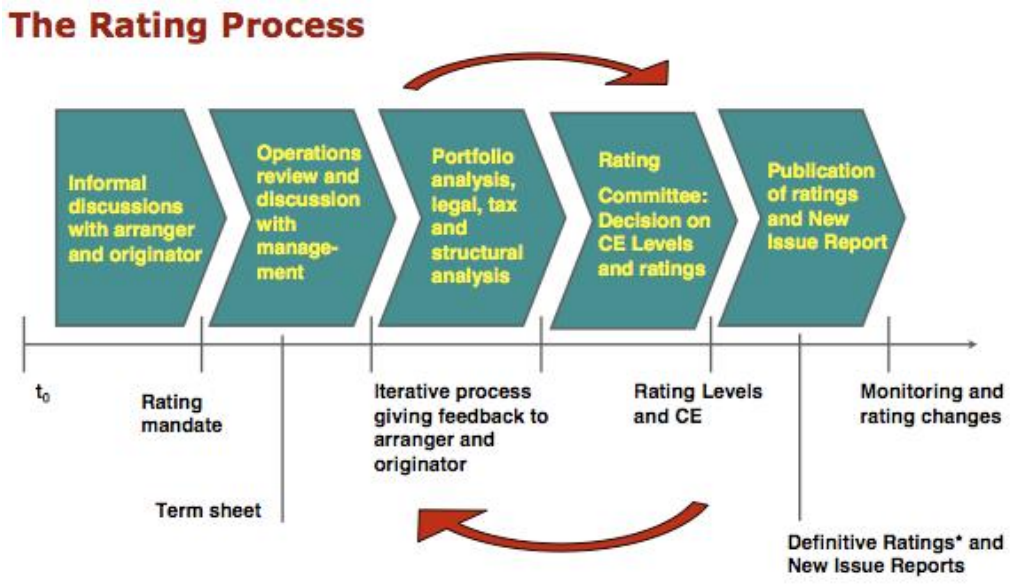
Taken from CGFS 2005, p.70

As it can be implied from the previous paragraphs and the above figure, rating agencies play a particularly important role in bridging information asymmetries among participants in the market of structured finance; the complexity of this kind of transactions –derived from asset pooling and tranching- somehow forces investors to rely on ratings more heavily than for other kind of securities where the underlying risks can be more easily assessed (Fender and Mitchell 2005:68).

Based on the aforementioned, Mason and Rosner imply that in the case of structured finance, Credit Rating Agencies have surpassed their common passive role of only rating

the undertakings and have become active actors somehow being part of the underwriting team, defining and structuring the characteristics of the SPV. Furthermore, it has to be kept in mind that in the structured finance marketplace, rating agencies approvals are a key element determining the marketability of the product (Mason and Rosner 2007:14). The acceptance of the CRAs participation as underwriters of the issues has important implications in terms of how liable they are. So far rating agencies have claimed to be merely publishing an opinion that under the First Amendment cannot be held liable. However, the abandonment of the traditional role as raters and the beginning of their role as active participants with a stake in the underwriting means "their liability could become tied to any liabilities of any other underwriter of the transaction" (Mason and Rosner 2007:15) Figure 2.2 shows the structured finance rating approach of a particular rating agency, where the interaction between issuers and rating agencies can be observed.

Figure 3.2. Structured Finance Rating Approach



Source. Moodys www.moodys.com

This chapter has conceptualized CRAs and provided an understanding of SF products. The next chapter will then review what the paper considers to be institutional features related with CRAs failure.

Chapter 4: Institutional features related to the failure of CRAs

This paper has already made the claim that CRAs, while being private entities in the pursuit of profit, also perform functions of a regulatory nature. In addition it advanced that two other elements regarding the rules governing capital markets refer to the protection against liability enjoyed by the CRAs and the business model that has an inherent conflict of interest. The analysis will be placed on how rules (or regulation for this matter) prescribe the functioning of capital markets, and particularly the role and protection that the institutional design (expressed also in legislation) give to rating agencies. The chapter begins with the authoritative role regulation grants to NRSROs.

4.1 CRAs semi-regulatory status

This section will briefly provide the elements and facts that sustain the statement about CRAs as authoritative or semi-regulatory actors. It has been mentioned that CRAs existed for most of the 20th century; however, their role and centrality has increased dramatically as changes in the last thirty years have occurred in global capital markets, the allocation of authority within structures of global governance, and financial (dis)intermediation. The aforementioned changes have had a parallel reflection in the regulatory status granted to CRAs, which has also been subject to reform.

With regard to the relationship between the bond market and the CRAs, a major turning point came during the 1930s after the Great Depression, when bank regulators prescribed that banks could not invest in speculative securities "as determined by `recognized rating manuals´", therefore forcing them to hold only "investment grade"

bonds (White, 2010:5), that is, bonds that received a high rating by rating agencies. This regulation is still in place and it has expanded to pension funds and savings institutions.

From 1931 onwards, the CRAs in the US have been explicitly part of financial regulations governing or restricting the acts and decisions of banks, pension funds, insurers and mutual funds (King and Sinclair 2003:354), becoming embedded in federal and state laws and private contracts. In the US (and after the II Basel Accord also in other countries), ratings are used to determine exposure to risk, including net capital requirements and investment options to pension funds. However, as regulation has continued and expanded the role of ratings, Partnoy argues that rating agencies evolved from actors bridging informational gaps to "purveyors of regulatory licenses (…) a key that unlocks the financial markets. Credit rating agencies profit from providing ratings that unlock access to the markets, regardless of the accuracy of their ratings" (2009:2).

Based on the aforementioned, it can be established that government regulators in the US granted a regulatory power to CRAs in the sense that important market participants could purchase only those bonds and securities holding certain ratings provided by NRSROs. Therefore, issuers unwilling or unable to get an investment grade rate on their bonds would find it hard to access capital markets; in this sense, many authors speak of CRAs as de facto gatekeepers… and in recent years, as gate openers.

However, the regulatory power of CRAs is not limited to determining which securities have an investment or a junk grade but goes further: under the current legislation, CRAs also have the power to determine what actually constitutes an investment grade. During the hearing "Wall Street and the Financial Crisis: The Role of Credit Rating Agencies", by the Permanent Subcommittee on Investigations of the US Senate on April 23, 2010,

Cifuentes, former executive of Moodys, provided an insight that justifies a long quote:

> "The problem that we have is more serious than we believe. Congress has given the rating agencies also the right to define what AAA or BBB for that matter means… so in effect has gave rating agencies the right to legislate… which is a little bit crazy (…let me give an example…) suppose you pass a law stating in Washington DC that you cannot build a tall building... but you forget to define what tall means and now you have a private company that will define what a tall building is… it may define a five story and next year change to a ten story building. Nobody knows what a BBB means… all you know is that if you are an insurance company you cannot buy anything below a BBB and if you are a pension fund and the asset is downgraded you may be force to sale. But nobody knows what a BBB means and it does not matter because rating agencies can change the definition of what BBB means and that is the extraordinary state of affairs, (…) they are legislating all the time"

From the previous evidence, it can be asserted that CRAs do have the authority to determine who may enter capital markets and under what conditions. Furthermore, CRAs do not only have the prerogative to define which bonds are of investment grade and which ones are junk, but also have the (implicit) right to define what investment or any other grade means. In this sense, it is possible to conclude this subsection mentioning that CRAs are private actors that pursue profit but still they perform as regulatory entities.

4.2 Lack of liability

Being liable means being responsible for your actions. In this sense, according to Frank Partnoy, holding actors liable has proven to be historically an effective instrument to encourage accountability among actors functioning as gatekeepers, as is the case of CRAs: "In general, gatekeepers are less likely to engage in negligent, reckless, or fraudulent behavior if they are subject to a risk of liability" (2009:14). However, still today after the financial crisis unfolded, rating agencies' acts are not subject to legal accountability (liability) even if proven negligent.

This paper argues that the regulations exempting CRAs from liability constitute part of the ill-institutional design that allowed the faulty ratings to emerge as they did. But, when it comes to CRAs, what does lack of liability exactly mean? In order to answer the question it is necessary to review what the rules say. In particular, we need to review three pieces of legislation: Section 7 and 11 of the Securities Act of 1933 and the Regulation 456(g) of the same legal ordinance[4].

Section 7 of the Securities Act establishes that with regard to securities, "any accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him" must provide its explicit consent to the security once this is registered, or in other words, it must endorsed and be present as backing the formal registration.

Section 11, entitled "Civil Liabilities on Account of False Registration Statement" determines those who can be held responsible or liable for the issuing of any given security. In other words, it determines whom a person acquiring the securities can sue. That includes all those signing the registration mentioned by Section 7, as well as directors and partners of the issuer and any other underwriter of the security. As it can be noted, rating agencies cannot be held liable for their participation in any security, given that they are implicitly excluded by law. Otherwise, they would need to be somehow included in this piece of legislation.

In addition to the implicit protection that Section 11 provides them, Regulation 456(g) also gives them explicit protection in the sense that it provides the exemption for "credit ratings provided by nationally recognized statistical rating organizations ("NRSROs")

[4] These three regulations date to several decades ago, and the logic of capital market then vary significantly from the current landscape. For a more detailed discussion on this, refer to SEC 2009.

from being considered a part of the registration statement" (SEC 2009:3), mentioned in Section 7 and included as liable actors in Section 11. In other words, Section 11 provides implicit protection while the regulation 456(g) does it explicitly.

Put simply, the rules of the game established that no matter what their behavior may be, CRAs couldn't be held liable for anything related with issues and securities. Furthermore, these pieces of legislation neglect the fact -demonstrated in the previous section- that rating agencies have abandoned their typical passive role and have now become actively engaged in the process of underwriting securities.

In addition to the protection against liability established by the above-mentioned regulations, CRAs tend to refer to their ratings as opinions protected by the First Amendment. However, as we showed in previous sections, ratings are more than merely opinions. Ratings are a central element ordering and defining the allocation of capital at a global scale. And in this sense we could say that insisting that a rating is solely an opinion does not erase the fact that the rules of the game place ratings as much more than that. This has generated a schizophrenic[5] situation as captured by the standard disclaimer of S&P ratings and a US federal regulation on savings banks.

On the one hand, the standard S&P disclaimer reads "any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision", and on the other, a US Federal regulations establishes that an insured state savings association "may not acquire or retain any corporate debt securities not of investment grade", which means a security that has not

[5] The Merriam Webster Dictionary (2010) defines on its second entry schizophrenic as contradictory or antagonistic qualities or attitudes. See http://www.merriam-webster.com/dictionary/schizophrenic

received a high rating by an NRSRO. In other words, regulation says that investors must by law rely on ratings in order to define their investment portfolio and on the other CRAs claim that nobody should base their investment decision on the ratings they produce. Whom should we believe?

The combination of the previous elements –legal protection against liability and appeal to the First Amendment- has implied that CRAs have been barely affected by legal suits. Based on this litigation track record, Partnoy affirms that it "the fact that the rating agencies have published unreasonably high rating should not be surprising" (2009:14).

Having made the case of two features of the institutional design that allowed the CRAs failure to occur -first the semi-regulatory status granted to credit rating agencies and second, the lack of liability-, it is now necessary to show how a third element may well have contributed to this scandalous failure in the market of structured finance products: namely, the CRAs business model and the inherent conflict of interest that regulation did not foresee and correct.

4.3 Conflict of interest

The Merriam Webster dictionary (2010) defines conflict of interest as "a conflict between the private interests and the official responsibilities of a person in a position of trust". Kumpan and Leyens expand the definition by proposing that a conflict of interest arises "when a person who has a duty to act in another party's interest has to decide how to act in the interest of that party and another interest interferes with his ability to decide according to his duty". The authors also state that as social and economic relations gain complexity, the potential for conflict of interest increases given the fact that it becomes

more necessary to rely on third parties for the provision of several different services, as is the case of capital market (Kumpan and Leyens 2008:72-73), where most transactions require the participation of financial intermediaries (notably rating agencies) that bridge information asymmetries between market participants.

With regard to capital markets, then, the International Organization of Securities Commission affirms that a conflict of interest "arises where the interests of a market intermediary may be inconsistent with, or diverge from, those of its clients, investors, or others", and recognizes that "conflicts of interest are common in the activities of market intermediaries because of the different roles that an intermediary" plays (IOSCO 2007:6). Furthermore, it reminds us that conflict of interest can be potential or apparent (as in the case of CRAs for almost four decades) or actual (as, we argue, happened since the early 21st century).

Given the closeness with the case of rating agencies, it is also convenient to point out what Kumpan and Leyens call "conflicts between third party interests", that refer to the cases where intermediaries (in this case CRAs) serve clients on "different markets sides, such as an issuer and investors" (2008:81). Having provided a general understanding of what a conflict of interest with relation to capital market looks like, let us now proceed to show the particular case of the rating agencies.

Since their creation and until the early seventies, the products of rating agencies (mostly in the form of publications) were sold to or bought by investors. Credit rating agencies would draft publications such as manuals and statistical compendiums that later would be acquired by subscribers, who had to pay a fee in order to receive the aforementioned documents; investors would buy these publications in order to get better information on

where to place their money. Given the aforesaid, this business model was labeled as an investors-pays model.

However, since the early seventies, credit rating agencies changed to an issuer-pays model. Lawrence White identifies four possible reasons for this change. First, the development of new technologies (including the photocopying machine) posed a treat to CRAs because investors could more easily free ride on their products. Second, important bankruptcies in the seventies (as the one of Penn-Central Railroad) made issuers aware about the possible need of assuring investors the safety of their bonds, and willingly of pay for the ratings that could demonstrate the low risks. A third possible reason is that rating agencies "belatedly realized" that financial regulation meant bond issuers needed "the blessing of one or more NRSRO in order to get those bonds into the portfolios of financial institutions, and the issuers should be willing to pay for the privilege". A fourth and inherent reason could be that this kind of transaction involves both sides of the market, and therefore the definition of who is supposed to pay can be "quite idiosyncratic" (White 2009:7,8)

Regardless of which and to what extent the aforementioned reasons contributed to the change in the business model, the fact is that the new issuer-pays scheme implied an inherent conflict of interest, which, has to be said, was potential for three decades but became actual since the early 2000. As we noticed at the beginning of this section, CRA ratings serve both sides of the market: both borrowers and lenders make use of their products. And also, as we mentioned, the business-pays model was in place since the early seventies. The question arises then: why did the conflict of interest inherent to this model affect capital market transactions well after its establishment and not before?

Based on the evidence presented in the previous chapter, this research argues that the reason behind the transit from potential to actual conflict of interest lies in the complexity underpinning new financial products, especially structured finance. Although a detailed account of this kind of financial products was developed in the previous chapter, the following paragraphs will highlight some features of SF regarding its relation to conflict of interests, highlighting those characteristics that allowed the transit from potential to actual conflict of interest.

In this sense, the Securities and Exchange Commission (2008) notes that since 2002 there was a considerable increase in the number and complexity of new financial products, as was the case of Residential Mortgage Backed Securities (RMBS) and Collateralized Debt Obligations (CDO), many of which become underlying assets of structured finance. It has to be recalled that, in contrast to other types of issues like bonds where investors can have more clarity, in structured finance products it is difficult for investors to know and understand the integration and associated risks of this type of issues. Furthermore, unsolicited ratings were not available for these undertakings.

Besides the complexity that makes it harder for the investors to independently evaluate, a second factor that exacerbated conflict of interest relates to the highly concentrated issuers' market, which granted them more influence on rating agencies. For example, according to the SEC, from a sample of 642 structured finance deals, only twelve arrangers or issuers accounted for 80% of the deal "in both number and dollar volume", concentrating the "sources of the rating agencies stream income" (SEC 2008:32). In other words, large amounts of potential income were dependent on rating issues concentrated in a few hands.

In addition, two interdependent phenomena that make structured finance market different from other capital market transactions must be mentioned because of their relation to conflict of interest. First, unlike, for example, issuers of traditional bonds where enterprises "can do little to change its risks characteristics in anticipation of an issuance", the arranger of Special Purpose Vehicles have a wider margin of maneuver to use "agencies publicly available models to pre-structure deals and subsequently engage" in the rating process. Related with the previous circumstance, the rating process in SF becomes the product of the interaction between issuers and rating agencies, in which the latter inform the former about the "requirements to attain desired ratings in different (…) structures to achieve target ratings" (Mason and Rosner 2007:13)

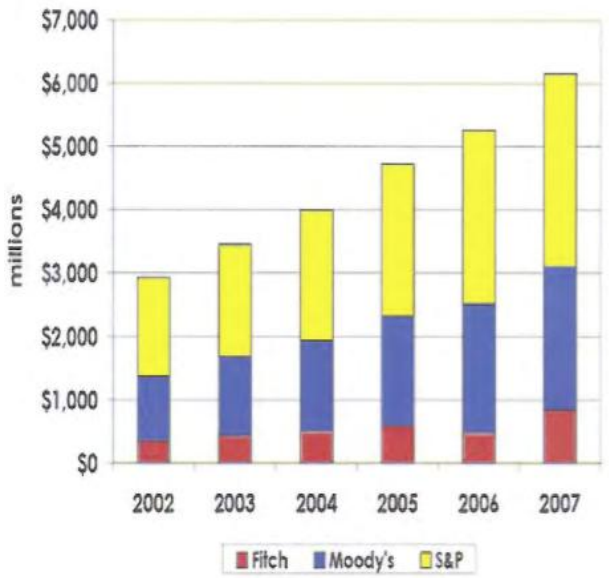
Finally, a third point of contention refers to the income provided by this kind of operations. For example, according to CalPERS, the income that CRAs could get from rating a structured finance product as those bought by CalPERS (this case will be reviewed with more detail in the next section) was between US $500,000 and $1,000,000.00, while a similar deal for a regular bond would have given them an income fee of only $50,000, that is, between ten and twenty times less[6].

In this regard, it can be said that since the early 2000s, Structured Finance began to increase its relative importance within capital markets profits. According to Coval, J., J. Jurek, et al, SF led Wall Street to record levels of revenue and compensations; by mid 2007, there were more than 37,000 structured finance issues only in the US. The rating agencies were not exempted from this process, rather, they were also beneficiaries. For example, in 2006 Moody's reported that 44 percent of their revenue came from SF,

6 This is often related to the fact that often, rating a structured finance product implied also rating the underlying assets.

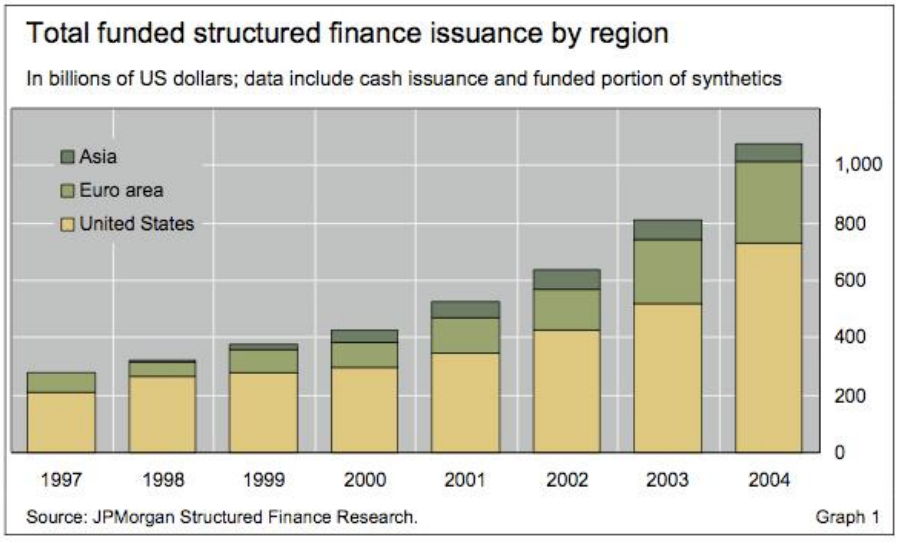
"surpassing the 32 percent of revenues from their traditional business of rating corporate bonds" (Coval, J., J. Jurek, et al, 2009:4). This phenomenon of parallel increase among Structured Finance and rating agencies revenue can be best observed in figures 2.3 and 2.4

Figure 4.3 Revenue of the three biggest CRAs 2002-2007



Taken from: US Senate Permanent Investigation Committee: *The role of the CRAs in the financial crisis. Exhibit*

Figure 2.4 Total funded structured finance issuance by region 1997-2004



Taken from (Fender and Mitchell 2005)

In conclusion, what it is important to notice here is the fact that regulation did not take care of a business model that implied an inherent conflict of interest. And although it can be argued, as S&P does, that any business model imply a degree of conflict of interest[7], the fact remains that regulation did not fulfill its mission of guaranteeing smooth market transactions, and that it allowed for a potential conflict of interest to become actual and very pervasive ones.

The concluding section of this chapter will apply the conceptual framework of corruption to a particular mini-case study and to some other (primary data) evidence. In this regard it has to be mentioned that, as it can be inferred from the previous discussion, there is very thin line between conflict of interest and corruption. Actually, literature has not being able to provide clearly conclusion on this regard. However, based on our definition, we can establish that while corruption requires necessarily three actors, conflict of interest can arise also on bilateral relations where rather than third players there are divergent or contradictory (conflicting) interests, without regard of the number of participants. Having say that, we will proceed apply our notions of corruption to the case of California Pension and Retirement System (CalPERS, a pension fund) and their relation with CRAs and issuers.

7 Furthermore, S&P argues that the benefits of the current model surpass the costs given the fact that it allows all market participants on the supply side –investors- to access ratings at no cost.

4.3 The case of the California Pensions and Retirement System[8]

To analyze this case, let us recall that in a corruption setting there is a trustee T, a fiduciary F and a corrupter C. The trustee (in this case a pension fund) acts assuming that the fiduciary (in this case the rating agency) follows certain rules (rightly assessing the creditworthiness of debt issuers). Finally, the corrupter's interests (in this case the issuers) depend on the actions of F (granting investment grade to the debt that C issues).

CalPERS is the largest public pension fund in the United States, representing 1.6 million of beneficiaries and managing an investment portfolio of global assets valued in US $210 billion. As a pension fund, CalPERS is obliged by US law to invest only in investment-grade securities. In practice this means that it can only buy those securities that are graded as such by NRSROs (e.g. Moody's and S&P).

In the year 2006, CalPERS (the trustee) invested 1.3 billion three structured finance products called Cheyne, Stanfield Victoria and Sigma. At the time of CalPERS' purchases, the senior debt issued by Cheyne, Stanfield Victoria and Sigma received the highest investment grade by Moody's, S&P and Fitch (the fiduciaries).

To show the existence of the fiduciary relationship between CalPERS and CRAs, besides the regulations discuss in previous sections, it must be highlight that "other than the Rating Agencies' evaluation and subsequent credit rating" of these SF products, an investor had no access to any information on which to base a judgment of creditworthiness (CalPERS 2009:4).

[8] Except if otherwise specified, the information of this section provides from CalPERS legal suit against Moody's, S&P and Fitch, See Calpers 2009.

Additionally, for these SF products to be sold in the important market of pension funds, the issuers (corrupter) required the action of eth CRAs (the fiduciaries) in the form of investment grade ratings, which they managed to get. And in this point it is important to highlight that CRAs fees for rating SF products were between ten and twenty times (reaching up to one million dollars) those of other securities like government or corporate bonds. What is more, fees were contingent on the SF product ultimately being offered to investors, therefore CRAs had the incentive to give the highest ratings to the deals underwritten by issuers (in this case corrupters).

In a nutshell, the corrupter (issuer) got the fiduciary (rating agencies) to positively affect the former interests' through the latter's actions (granting investment grade ratings). This rating is at the heart of "the relationship of trust between T and F (that) gives F the power over the resources that interest C". However, those SF products bought by the trustee (CalPERS) after trusting on the fiduciaries' (CRAs) behavior turned out to be junk: one year later the three had defaulted on their repayment obligations.

In cash, the aforementioned implied that C (issuers) were able to get for them T (pension funds) resources (around US$1.3 billion from CalPERS) and the fiduciary got –based on the trust relationship rather on the reliability of its work) between US$1.5 and 3 million in fees. However, T (CalPERS) lost million or even more than a billion dollar.

In order to better illustrate the "behind the curtains" process to which cases as the above mentioned refer, the following section presents primary data as evidence of awareness among C and F regarding the nature of the exchanges in which they were engaging.

4.4 CRAs and issuers internal communications

In order to complement the evidence, this final section will reproduce some internal communications that reflect a degree of understanding and acknowledgment within the CRAs about important limitations of their own ratings, but also how there was indeed a relation between the issuers (the corrupter according to our nomenclature) and the credit rating agencies (the fiduciary).[9]

Let us begin by the evidence from within the CRAs. As the text from box 1 shows, CRAs personnel knew their ratings were flawed to an extent that they were not confident about signing approval.

Unfortunately, given the pressures for getting deals done (and the associated fees that came with it) and do not lose market shares, even in cases as the one from Box 1, ratings were granted to structured finance products.

[9] All the following material was taken either from the hearing or from the exhibits presented as evidence by the US Senate Permanent Subcommittee of Investigations, and it can be accessed at http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=5f127126-608a-4802-ba77-d1bdffdfbe9b. Some fragments are also reproduced by Sam Jones in the Financial Times and can be found at http://ftalphaville.ft.com/blog/2008/10/23/17359/rating-cows/

Box 1 Dialogue among two S&P Rating Committee members

IM Users:
participant=rahul_d_shah@standardandpoors.com "Shah, Rahul Dilip (Structured Finance -New York)"
"rdsshah@hotmail.com"
participant=shannon _ mooney@standardandpoors.com "Mooney, Shannon"
"shannon.mooney@comcast.net"
IM Dialog:
Thursday, April OS, 2007 3:58:42 PM EDT Shah, Rahul Dilip (Structured Finance -New York): **btw -that deal is ridiculous**
Thursday, April OS, 20073:59:05 PM EDT Mooney, Shannon: **i know right ... model def does not capture half of the rish**
Thursday, April 05,20073:59:08 PM EDT Mooney, Shannon: **risk**
Thursday, April OS, 2007 3:59:09 PM EDT Shah, Rahul Dilip (Structured Finance -New York): **we should not be rating it**
Thursday, April OS, 2007 3:59: 17 PM EDT Mooney, Shannon: **we rate every deal**
Thursday, April OS, 2007 3:59:30 PM EDT Mooney, Shannon**: it could be structured by cows and we would rate it**
Thursday, April OS, 2007 3:59:54 PM EDT Shah, Rahul Dilip (Structured Finance -New York): **but there's a lot of risk associated with it -I personally don't feel comfy signing off as a committee member.**

Source: exhibit 30a, Hearing *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies*, Senate Committee on Homeland Security & Governmental Affairs - Permanent Subcommittee on Investigations. Emphasis added by me.

In another similar case, on an email from April 2007, an analysts from S&P states the following:

Box 2: analyst's judgment is dismissed; issue likely to default is rated

Vertical is politically closely tied to B of A – and is mostly a marketing shop – helping to take risk off books of B o[f] A. Don't see why we have to tolerate lack of cooperation. Deals likely not to perform

Vertical was a CDO issued by UBS. In spite of the analyst evaluation, S&P (and also Moody's) rated the issue as investment grade. Six months later, it defaulted. This generated millionaire losses to a hedge fund named Pursuit Partners, who is currently a plaintiff against both UBS and CRAs.

UBS can provide the evidence related with the corrupter (the issuer), not the fiduciary (the CRAs). UBS is global financial services firm "offering wealth management, investment banking, asset management and business banking services" to a wide range of clients. Their marketing reads, "We operate in two locations. Everywhere and right next to you" (UBS 2010). Besides being a financial services firm, UBS performance in this deals fits perfect the definition of the corrupter (C) given in chapter two. Among other activities, UBS (C) issues debt. However, in order to access the most important investors like pension funds (the trustees, T) within capital markets, UBS requires their issues to be rated as investment grade. In other words, UBS' (C) interests are affected by the rating agencies' (F) actions, as required by our conception of corruption. Was UBS aware of its corrupted role behavior? The US Senate found the following email that relates to the rated issues mentioned in the previous box –are similar to the case of CalPERS-, and included in the Senate hearings as exhibit 94n[10].

Box 3: email from UBS, issuer of structured finance products rated by NRSROs

Subject:

Malik, Evan

Tuesday, August 28,2007 12:37 PM

Corcoran, Hugh

Re: 95pts Wine Spec, Best Tignanello since 1997!

Kewl. **Sold some more crap to pursuit. Brock close to getting money in for distressed cdo fund**. Seemmish

Sent from my BlackBerry Wireless Handheld

[10] The email was edited by the SEC, erasing the author to maintain him anonymous

And indeed, as mentioned in the previous box, these issues would default not long after being rated and sold to Pursuit Parterns (trustees) whom expected CRAs (fiduciaries) to behave in a certain reliable manner, but that rather, it turned out, CRAs were benefitting themselves and the issuers (the corrupter) at the expense of investors (the trustees, in this specific case Pursuit).

A final piece of evidence on how things were happening "behind the curtains" is provided by the Statement submitted by Richard Michalek, Former VP and Senior Credit Officer of Moody's Investors Service, to the Permanent Subcommittee on Investigations, whom affirms with regard to the conflicting business model (and the potential for corruption it entails) the following:

Box 4 Fragment from former Moody's VP statement to the US Senate

> The incentives for the "fee-based" structuring investment bank were clear: **get the deal closed, and if there's a problem later on, it was just another case of "IBGYBG" - "I'll be gone, you'll be gone."**
>
> (First quoted to me by an investment banker who was running out of patience with my insistence on a detailed review of the documentation.)

After insisting in the need to carry out rating procedures in a more reliable manner, Mr. Michalek was forced to abandon Moody's.

This section has presented a small real case where T (CalPERS) was affected by the actions of F (CRAs) and C (issuers). In addition, it has showed evidence from which it is possible to infer that cases like the one of CalPERS were result of more than pure misunderstanding or technical failures; they were also product corruption practices: both fiduciaries and corrupters were aware that what they were doing was wrong and implied a

betrayal of confidence (specially on the side of CRAs, the ones entrusted with authority by regulation).

Conclusions

This paper has provided elements to answer the question of why did rating agencies failed to rightly asses creditworthiness and risks associated with the debt issues they rated in structured finance markets previous to the financial crisis of 2008.

The first conclusion is that institutions function as rules that order and structure exchanges and interactions in different dimension of human activity, as is the case of capital markets. Institutions not only increase or diminish transaction costs, but also, understood as rules and regulations, institutions impose constraints and incentives on actors' behavior.

Second, CRAs have acquired a central role in capital markets, providing services that allow them to bridge informational gaps among participants while at the same time locking or unlocking access to this market. The centrality of CRAs has been underpinned by changes in the global political economy, namely: the integration of financial markets and the high mobility of international flows of capital; a relocation of authority from the state towards private actors able to effectively perform certain tasks (for instance assessing creditworthiness); and an increasing process of disintermediation where traditional actors like banks play a diminished role and instead, borrowers and lenders rely more heavily on information technologies and ratings in order to define their investment decisions.

Third, the structured finance market differs from other segments of capital markets because of the grade of complexity it entails. Structured finance products comprise securitization, pooling of assets and structuring of tranches. Therefore, it is hard for investors to independently evaluate the underlying assets and risks associated with this kind of financial product which makes them more dependent on CRAs than in other

markets. In contrast with other kinds of debt issues, CRAs have played a very active role in structuring –and to some extent underwriting- structured finance products.

Fourth, two kinds of factors contributed to the CRAs failure in properly assessing risks associated with issues in the structured finance market. On one hand, features related with the regulatory framework allowed CRAs to act irresponsibly. These features or shortcomings refer to the pervasive combination of the following elements: the institutional design granted authoritative power to CRAs, but at the same time provided them with explicit protection against any kind of liability related with their actions.

In particular, the lack of liability allows CRAs to consciously engage in reckless behavior –that has implied billionaire loses to investors like CalPERS- without being subject to any kind of legal disciplinary measure. Furthermore, in spite of warnings like the one related with Enron, regulation did not display measures to avoid potential conflicts of interest related with the business-model of CRAs. As it was showed, this was particularly important in the context of structured finance.

Fifth, besides the shortcomings of the regulatory framework, a second element contributing to the failed CRAs' performance in structured finance is related to practices of corruption in this segment of capital markets. Issuers and CRAs engaged in practices of corruption where the CRAs not only colluded with the former but also betrayed the trust and power granted to them by regulation and investors. Furthermore, evidence shows that the actors involved in corruption practices –issuers and CRAs- were well aware of this, and therefore it is not possible to appeal to pure technical challenges and misunderstandings and regulatory loopholes when explaining CRAs faulty ratings.

Finally, based on this paper it is not possible to determine which is the best reform path to follow. It is also unclear what the costs and benefit of alternative regulatory

frameworks would be; when it comes to public policy, there are no perfect solutions. Nothing in the public sphere is absolutely just. However, what remains clear is the pervasiveness of the current status quo governing the market of structured finance, where ratings are unreliable and investors can be easily abused.

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