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OP-ED COLUMNIST

Berating the Raters

By PAUL KRUGMAN

Let's hear it for the Senate's Permanent Subcommittee on Investigations. Its work on the financial crisis is increasingly looking like the 21st-century version of the Pecora hearings, which helped usher in New Deal-era financial regulation. In the past few days scandalous Wall Street e-mail messages released by the subcommittee have made headlines.

That's the good news. The bad news is that most of the headlines were about the wrong e-mails. When Goldman Sachs employees bragged about the money they had made by shorting the housing market, it was ugly, but that didn't amount to wrongdoing.

No, the e-mail messages you should be focusing on are the ones from employees at the credit rating agencies, which bestowed AAA ratings on hundreds of billions of dollars' worth of dubious assets, nearly all of which have since turned out to be toxic waste. And no, that's not hyperbole: of AAA-rated subprime-mortgage-backed securities issued in 2006, 93 percent — 93 percent! — have now been downgraded to junk status.

What those e-mails reveal is a deeply corrupt system. And it's a system that financial reform, as currently proposed, wouldn't fix.

The rating agencies began as market researchers, selling assessments of corporate debt to people considering whether to buy that debt. Eventually, however, they morphed into something quite different: companies that were hired by the people selling debt to give that debt a seal of approval.

Those seals of approval came to play a central role in our whole financial system, especially for institutional investors like pension funds, which would buy your bonds if and only if they received that coveted AAA rating.

It was a system that looked dignified and respectable on the surface. Yet it produced huge conflicts of interest. Issuers of debt — which increasingly meant Wall Street firms selling securities they created by slicing and dicing claims on things like subprime mortgages — could choose among several rating agencies. So they could direct their business to whichever agency was most likely to give a favorable verdict, and threaten to pull business from an agency that tried too hard to do its job. It's all too obvious, in retrospect, how this could have corrupted the process.

And it did. The Senate subcommittee has focused its investigations on the two biggest credit rating agencies, Moody's and Standard & Poor's; what it has found confirms our worst suspicions. In one e-mail message, an

S.& P. employee explains that a meeting is necessary to "discuss adjusting criteria" for assessing housing-backed securities "because of the ongoing threat of losing deals." Another message complains of having to use resources "to massage the sub-prime and alt-A numbers to preserve market share." Clearly, the rating agencies skewed their assessments to please their clients.

These skewed assessments, in turn, helped the financial system take on far more risk than it could safely handle. Paul McCulley of Pimco, the bond investor (who coined the term "shadow banks" for the unregulated institutions at the heart of the crisis), recently described it this way: "explosive growth of shadow banking was about the invisible hand having a party, a non-regulated drinking party, with rating agencies handing out fake IDs."

So what can be done to keep it from happening again?

The bill now before the Senate tries to do something about the rating agencies, but all in all it's pretty weak on the subject. The only provision that might have teeth is one that would make it easier to sue rating agencies if they engaged in "knowing or reckless failure" to do the right thing. But that surely isn't enough, given the money at stake — and the fact that Wall Street can afford to hire very, very good lawyers.

What we really need is a fundamental change in the raters' incentives. We can't go back to the days when rating agencies made their money by selling big books of statistics; information flows too freely in the Internet age, so nobody would buy the books. Yet something must be done to end the fundamentally corrupt nature of the the issuer-pays system.

An example of what might work is a proposal by Matthew Richardson and Lawrence White of New York University. They suggest a system in which firms issuing bonds continue paying rating agencies to assess those bonds — but in which the Securities and Exchange Commission, not the issuing firm, determines which rating agency gets the business.

I'm not wedded to that particular proposal. But doing nothing isn't an option. It's comforting to pretend that the financial crisis was caused by nothing more than honest errors. But it wasn't; it was, in large part, the result of a corrupt system. And the rating agencies were a big part of that corruption.