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David Reiss

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Abstract: This book chapter explores how the three largest rating agencies, Standard & Poor's, Moody's Investor Service and Fitch Ratings, exploited their privileged regulatory status to profit from the booming subprime mortgage market at the expense of homeowners. These rating agencies boosted their own bottom lines and assisted predatory lenders by effectively vetoing state consumer protection initiatives. While regulators have identified enhanced investor protection regulation of credit rating agencies as a priority, future regulation must ensure that the systemic biases of the rating agency industry are no longer permitted to trump legitimate state consumer protection initiatives.

RATING AGENCIES:
FACILITATORS OF PREDATORY LENDING IN THE SUBPRIME MARKET

David J. Reiss*

As the credit crisis unfolds, credit rating agencies have been properly identified as playing a central role in causing the crisis and misleading investors. What has been forgotten in this acrimonious environment is that in their quest to increase the market for their services, rating agencies also took positions that were particularly bad for many homeowners.

Standard & Poor's, Moody's Investors Service and Fitch Ratings (collectively, the "Big Three") utterly dominate the credit rating market, particularly that for mortgage-backed securities. The Big Three provide ratings for pools of mortgages that are converted to securities and sold to investors throughout the world, a process known as securitization. The Big Three claim that they are merely editorializing about the credit quality of the securities that the rate and do not take an active role in the structuring of the securities. For their labors, the Big Three are compensated by fees from the issuers of securities that solicit ratings from them.

Certain rating agencies, including the Big Three, are what are known as National Recognized Statistical Rating Organizations (NRSROs). The Securities and Exchange Commission (SEC) first granted NRSRO status in 1975. NRSRO status initially referred to those rating agencies whose ratings could be used in implementing the net capital requirements

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* Professor, Brooklyn Law School; B.A., Williams College; J.D., New York University School of Law. This article is based in part on earlier articles by the author, including *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985 (2006) [hereinafter Reiss, *Subprime Standardization*] (granted award as best academic article on topic addressing consumer financial services law in 2006 by American Academy of Consumer Financial Services Lawyers); *Rating Agencies and Reputational Risk*, MARYLAND J. BUS. & TECH. L. (forthcoming 2009) *available at* http://ssrn.com/abstract=1358316 [hereinafter Reiss, *Reputational Risk*]; *Regulation of Subprime and Predatory Lending*, INTERNATIONAL ENCYCLOPEDIA OF HOUSING AND HOME (forthcoming 2010), *available at* http://ssrn.com/abstract=1371728. Thanks to Philip Tucker and Jason Gang for excellent research assistance.

(the minimum ratio of indebtedness to liquid assets) for broker-dealers, a very modest incorporation of ratings into financial regulation.

As NRSROs, The Big Three have since been granted a privileged status by numerous financial services regulators. This privileged status results from the incorporation of the Big Three's ratings throughout a vast web of government regulation of private companies—requiring or encouraging market players such as broker-dealers, banks, money market funds, insurance companies and pension funds to purchase financial instruments endorsed by an NRSRO.

As a result of their regulatory privilege, the Big Three operate as an oligopoly. The lack of a rating from at least one of the Big Three, which effectively grant regulatory licenses to institutions that wish to issue securities, is the financial equivalent of a death sentence for a residential mortgage-backed securities (RMBS) offering. Thus, the Big Three's NRSRO status makes them gatekeepers to other private financial entities attempting to access the financial markets. While the Big Three thereby bestow significant regulatory benefits upon issuers of securities, they themselves have not been subject to significant regulation of their own activities.

The most vehement criticism of the Big Three is that they do not provide accurate and valuable information to the markets. The Big Three also faced popular criticism for failing to warn of dramatic failures such as that of Enron. Lost within the ongoing debate over the flaws of the Big Three is the fact that they have also taken anti-consumer positions that were aligned with the interests of their own industry and the securitization industry as a whole. In particular, the Big Three took positions against a variety of consumer protection statutes that were intended to assist subprime borrowers and curb predatory lending because such statutes might slow the growth of the subprime RMBS market, thereby slowing the growth of the Big Three themselves.

THE EXPLOSIVE GROWTH OF THE SUBPRIME MORTGAGE MARKET

The way that Americans borrow money to buy homes has changed radically since the 1980s. Before that time, Americans who wanted to buy a home would typically walk into their local savings and loan and speak to a loan officer who would evaluate their application. Usually, only those with a healthy, or "prime," profile were approved. That is, they had a steady work history, a large down payment and no problems with their credit.

Thrifts (a catchall phrase that includes savings and loans, savings banks and mutual savings banks) were not only the dominant type of residential lender, but they also vertically dominated the residential mortgage market. They originated and serviced the mortgage, typically holding it until it was paid off by the borrower. Now, technological, financial and legal innovations allow global finance companies to offer a range of mortgage services to a broad array of potential residential borrowers.

A mortgage now can be:

(1) originated by a mortgage broker who makes money only from origination;

(2) serviced by a mortgage banker who did not originate the loan and may have bought the right to service the loan from another mortgage banker;

(3) originated with the credit risk taken by one of the secondary market institutions, perhaps along with a mortgage insurance company; and

(4) funded by a mortgage-backed security (MBS) sold into the capital markets, and the MBS can be packaged as a bundle of derivative securities that separate interest rate and prepayment risk among different investors.[†]

"Subprime" lending had been a significant and growing portion of this activity, reaching a peak of 20% of all originations in 2006 before the subprime market crashed. Subprime lending

† *See* Robert Van Order, *The U.S. Mortgage Market: A Model of Dueling Charters*, 11 J. HOUSING RES. 233, 233-34 (2000).

is the extension of credit to those with lower incomes, less wealth and riskier credit profiles than traditional, "prime" borrowers. The secondary market provides much of the liquidity and capacity for growth for the subprime market, with 75% of the subprime market being securitized in 2006. As the mortgage industry moved away from the dominance of heavily regulated thrifts and toward that of relatively unregulated mortgage firms, severe consumer abuses arose in the subprime sector.

Although mortgage default and delinquency rates began to rise in 2006, subprime lenders kept lending. Lenders made loans on very easy terms during initial teaser periods to borrowers with poor credit, low income and low assets. By 2007, the subprime market began to look disastrous as a wave of foreclosures quickly built and swept across the nation. The subprime bubble had gone bust, taking the rest of the credit markets with it.

The subprime market has been far less regulated and standardized than the prime market. As such, it presented an opportunity for those seeking to separate financially unsophisticated borrowers from the equity that they have in their homes. That is, it presents an opportunity to engage in predatory lending. The U.S. General Accounting Office (GAO) has cobbled together a good working description of predatory lending: it is "an umbrella term that is generally used to describe cases in which a broker or originating lender takes unfair advantage of a borrower, often through deception, fraud, or manipulation, to make a loan that contains terms that are disadvantageous to the borrower."[‡] Accordingly, the GAO has defined predatory lending to include the following abusive practices and loan terms: (1) excessive fees; (2) excessive interest

‡ U.S. GEN. ACCOUNTING OFFICE, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 18 (2004).

rates; (3) single-premium credit insurance; (4) lending without regard to ability to repay; (5) loan flipping; (6) fraud and deception; (7) prepayment penalties; and (8) balloon payments.

Predatory practices were present in much of the subprime market, where low- and moderate-income borrowers are concentrated. They are used to prey on unsophisticated homeowners, often those who are not integrated into the sphere of mainstream financial institutions such as banks and credit unions. Most predatory behavior takes place between a mortgage broker or mortgage banker and the borrower. But such thinly funded entities could not exist without funding from secondary market investors. As gatekeepers to the financial markets, the Big Three provided predatory lenders with ready access to investors the world over.

The Role of Rating Agencies in RMBS Securitizations

Real estate has always been considered good collateral because it needs little monitoring compared to other types of collateral, such as inventory, equipment and other personal property. Yet, Wall Street investors had historically viewed mortgages as riskier investments than those assets because they were regulated by a patchwork of local and state laws. It is in large part because of this aversion that, prior to the 1970s, all real estate lending was local. This state of affairs was to change with the birth of securitization and the growth of the secondary market.

For mortgage originators, the securitization of residential mortgages, in particular, is attractive because these mortgages themselves are not easily traded in a secondary market. To be attractive to investors, each mortgage would require its own extensive and expensive evaluation and monitoring, as each typically has its own unique terms and risks. These characteristics would make residential mortgages, which are typically much smaller than commercial mortgages, of limited interest on secondary markets that rely on standardization to reduce the transaction costs associated with conveying assets from one party to another. Since the 1970s, investors have become quite comfortable investing in RMBS because the standardization of mortgage terms overcame many of these problems. Nonstandardized state law relating to lending practices and foreclosures remained, however, a problem from the perspective of the financial services industry, including the rating agencies.

Nonstandardized state law makes it more difficult for the Big Three to rate RMBS; it can also make RMBS less attractive to the Big Three's clients, RMBS issuers. Nearly every securitization of mortgage-backed securities is rated by one, and often two, of the Big Three. The rating that the agency provides "is an assessment of the likelihood of timely payment on securities."[§] The rating process is typically initiated by or on behalf of a securities issuer. The issuer provides the rating agency with information regarding the issuer's background, strategy, operations systems, historical performance data and any other information that may be relevant. The issuer then typically meets with the rating agency to explain the proposed structure of the deal, the nature of the underlying assets and the operations of the originator of the assets.

Standard & Poor's, Moody's and Fitch each had its own approach to rating RMBS pools, but they all pay particular attention to the impact of consumer protection statutes on such pools. One key concern is whether a particular mortgage might be the subject of a lawsuit by the borrower and whether the ultimate holder of that mortgage, a securitized pool, might face liability as a result.

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§ Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 15.

The Big Three rate RMBS transactions by categorizing each state statute based upon the nature and degree of the assignee liability and damages provisions of its consumer protection law. In states where there is both assignee liability and unquantifiable damages, various members of the Big Three have refused to rate various transactions containing mortgage loans from such jurisdictions. Thus the Big Three can effectively shut down the entire mortgage market of a state that passes strong predatory lending legislation.

In 2004, New Jersey felt compelled to amend one of its premier consumer protection laws, the Home Ownership Security Act, even though it was enacted with broad partisan support only one year before. The New Jersey law was designed to control a small number of unscrupulous brokers and lenders that originate extremely predatory loans. That same year, Georgia found itself doing the same thing—amending its own antipredatory lending law, the Fair Lending Act, that it had enacted mere months before. Twenty other states would watch and learn from the pressure the Big Three exerted against New Jersey and Georgia, modifying their own pending predatory legislation to meet the Big Three's standards.

Historically, the Big Three had promoted themselves as no more than information-analyzing handmaidens to the invisible hand of the market. Whether driven by bias or merely by their own mandate to protect investors first and foremost, however, it is now clear that the Big Three hold a veto over state legislators who have attempted to stop predatory practices in their jurisdictions. This veto by unelected, unaccountable private corporations is highly disturbing, to say the least.

THE FAILURE OF RATING AGENCY REGULATION

While regulators have incorporated the ratings of the Big Three into their regulations, the Big Three largely escaped effective regulation. Thus, to the extent that they made systemic mistakes or demonstrated systemic biases, they were not held accountable to anyone. The business model of the Big Three has been found to be rife with problems: conflicts of interest, lack of transparency and lack of leadership being some of the most serious.

Their business model was based on serious conflicts of interest, conflicts that should and did undermine the trust that others had in them. The Big Three were paid by the issuers who needed their ratings. As a result, the profit motive drove the agencies to recklessly expand the market for their services.

The Big Three were also deficient when it came to transparency. They helped investment banks to structure the transactions to be rated to an extent not known to the rest of the world. They were integrally involved, for instance, in legitimizing subprime debt instruments like the collateralized debt obligation (CDO), securities that make up many of the toxic assets that have dragged down the balance sheets of so many financial firms. The rating agencies also claimed that their very sophisticated rating models were reliable enough to predict with great accuracy the risk of default and delayed payment. It turns out however, that "sophisticated" was just a way of saying complex and confusing. Like many other financial players, it appears that their complex risk management models had some very simplistic assumptions undergirding them—national housing prices will never go down on a year-to-year basis, for one.

Finally, the leadership at the rating agencies set an ethos that clearly distorted the mission of these firms. The rating agencies did not properly monitor their employees to ensure that they avoided even the most obvious conflicts of interest. Clearly, the Big Three's worst excesses went unchecked by regulators and the public paid the price.

CONCLUSION

The bust of the subprime market in the mid-2000s led to the global financial crisis of the late 2000s. This crisis has virtually ended subprime lending for the current credit cycle. Most subprime lenders have gone out of business or merged with other financial institutions. The remaining financial institutions have tightened their underwriting so that they no longer lend to those with subprime credit profiles. It is likely, however, that subprime lending will return in some form once the credit cycle turns.

Rating agencies were historically considered to be mere commentators on the comings and goings of the players in our free market economy while ensuring that objective information is widely disseminated to all. This view, however, fails to take into account the privileged regulatory status that the SEC and other government regulators have granted to the Big Three. It also fails to take into account the role that the Big Three have in structuring RMBS transactions. Moving forward, effective regulation of the NRSROs must take into account their gatekeeper function, and ensure that their systemic biases are not permitted to trump state consumer protection initiatives.