One of the best quotes from the credit crisis comes from the credit analyst's email from one of the big 3 rating firms: "Let's hope we are all wealthy and retired by the time this house of cards falters." ... I've come to the conclusion that the lion's share of blame for the recent financial catastrophe belongs squarely at the top of the ladder, most notably the rating agencies. If only the RATING FIRMS had properly rated all these securities that Wall Street was churning out, the magnitude and reach of this entire mess could have been greatly reduced. While the actual danger of these "toxic" assets could have not been known for certain beforehand (not expecting ratings firms to predict the future), their potential danger could and should have been assessable through adequate, accurate, and honest underwriting. The excuse that they were "very complex" is not valid...if you don't understand something, that's even more reason to NOT assign a secure rating on it! Using a life insurance example, you cannot predict exactly when someone will die, but you certainly can accurately gauge the risk by knowing age, health, habits, etc. To give a 65-year old overweight smoker with diabetes and a coke habit a "preferred" risk rating is absurd! Of course, insurance companies would never do that b/c they are on the hook for the claims, so they have great incentive to accurately gauge risk; whereas ratings agencies just give the rating, collect the fees, and then it's not their problem anymore!

Think about this: instead of slapping a high rating on an MBS and thereby giving it a trustworthy cash-equivalent stamp, if these vehicles had been accurately and properly underwritten and they instead had much lower ratings, the purchasers of them would have treated them completely differently. Instead of stocking up on them, they would be much more moderate in their allocation, and their global presence would be much lower among financial institutions; instead of having these vehicles produce relatively low yields b/c of perceived safety, they would have generated higher (junk-like) yields commensurate with their risk; instead of having CDSs on these priced relatively cheap, insurers (e.g. AIG) would've charged higher premiums and set aside greater loss reserves. Given these "if's", when the housing bubble popped, the global fallout would have been much much less and the credit crisis itself could have been largely avoided. That's not to say a economic contraction/recession coulda/shoulda been avoided, as that's the normal cycle after the run-up we experienced. But the complete breakdown and failure of credit markets that resulted in equities markets imploding and institutional collapses and systemic failures and trillions of dollars of capital being flushed down the toilet coulda/shoulda been avoided.

And while intense heat has been applied to virtually every other participant in the party, ironically you don't hear much grilling of the rating firms, who are actually the most responsible for the financial sector systemic breakdown (in my opinion). This is the most insane part of all of this...while there were a couple of rather small rule changes issued at end 2008, it's hardly the overhaul that's required to prevent this from happening again. One suggestion to hold them accountable would be to somehow tie agencies' ratings to the credit default swaps pricing. Like maybe the rating firms themselves would actually be required to issue (fully or participating with other parties) the CDSs on the entities they are rating! Since they would be on the hook for paying any default claims on the things they're rating, they would greatly incentivized to rate them accurately so the default insurance that they are selling and backing is priced properly. Instead of just being 3rd-party rate-for-pay machines, they would be more like insurance companies, whose profits are directly tied to their ability to accurately assess risk.

I'm sure there are a lot of logistical details way beyond my knowledge for orchestrating a change like this, but this principle (of more closely tying the ratings firms own well-being to the validity and reliability of the ratings they issue) is a good place to start. I'm curious if anything like this is being considered, or if this is not a feasible option.

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