Credit Rating Agencies Continue Their Fleecing of America

July 28, 2011 â€“ The credit rating agencies â€“ these are the companies that rate the risk of various investments â€“ played a large role in the collapse of real estate lending markets in 2007. At least thatâ€™s my opinion, and it shared by a lot of other economists. After being called on the carpet by Congress and the media for their roll in the recession, these same agencies appear to have determined that it is now payback time. They are threatening to downgrade US savings bonds due to the dispute over the debt ceiling that is now consuming Congress and the White House. If that happens, just as real estate lending issues eventually wound up being paid for by consumers who found they owed more on their homes than they were worth, consumers will also wind up paying if they downgrade debt. It is becoming increasingly clear that these agencies are not capable of policing themselves.

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You know them by their names. Companies that include Moodyâ€™s and Standard & Poor's. Prior to the time that American real estate markets began their downward spiral, companies that rate risk of investments decided that they had a formula to allow banks to sell off their subprime loans as low risk investments. While that may sound counter-intuitiveâ€¦ only because it isâ€¦ they managed to convince a lot of investors that they had gotten it right.

What the agencies allowed the banks to do was to take a group of subprime loans and divide them up; much likes shares of stock. Then the bank would take what weâ€™ll call a â€œshareâ€• of one subprime loan and bundle with shares from many o subprime loans. That bundle became a security which was given a low risk for failure by the rating agencies. That rating is what made these securities attractive investments for those seeking low risk investments.

The theory was that if you divided up a bunch of bad loans, the risk could be mitigated by bundling them into a larger group. After all, while the chances that one loan will go bad may be high, the chances that a lot of loans would go bad should be much lower. But the theory was built on a house of cards. It assumed that there would always be easy refinancing options available to borrowers. While it worked out for the agencies for a number of years, investors eventually began to look a little more closely at the quality of the loans that were bundled into the securities that they owned. And when that happened, they stopped purchasing new securities.

As a result, it became nearly impossible to banks to get new money to refinance home loans. Because the banks couldnâ€™t get money, consumers couldnâ€™t refinance. The entire system collapsed under its own weight. At the same time, the roll that the rating agencies played came under scrutiny from federal regulators and the press. All of the companies involved in rating securities tightened their ratings policies.

Fast forward to the debate over the national debt limit. The same companies that rated mortgage backed securities also rate other investments. Investments like American bonds. And the current rating for those bonds is AAA â€“ the highest and best rating available.

But these companies are now stating that they are likely to downgrade their ratings of American bonds over the debt ceiling debate. Publically, they are stating that there are two reasons for their position. The first is the risk that the United

States will default on its debt obligations. With regard to savings bonds, that risk is almost zero; even if the debt ceiling is not increased.

The second reason that they are giving is that if the United States doesnâ€™t come up with a plan to reduce the debt, current spending levels canâ€™t be sustained over the long run and the country will eventually go broke. While that may not be a bad argument, none of these companies were saying anything prior to the current debate. In fact, when the President asked Congress to raise the debt ceiling without any debate at all, these rating agencies were conspicuously silent. That doesnâ€™t make any sense at all if you believe the argument they are making now.

Clearly, these agencies donâ€™t want to make the same mistakes with regard to government bonds that they made with regard to real estate. And they have come under tremendous pressure as a result of their prior failures. But because they were silent when they thought there would be no debate over raising the debt ceiling, but not after they found out that the public was watching the debate closely, their argument doesnâ€™t hold water. That becomes even more true when you realize that all of the proposals currently being considered by Congress and the White House would actually cut spending over the long run; something that should make US debt a more attractive investment.

What the agencies are doing appears to be more political than anything else. Since Congress and the administration made trouble for them a couple of years ago, they can now make trouble for Congress and the administration. That's just an opinion but it is based on the facts surounding this debate. If they downgrade US bonds, the cost for credit card purchases, home mortgages, automobile loans and virtually anything else that we borrow money for will go up. That's not likely to please most voters.

Donâ€™t get me wrong. I do think that Congress and the White House have been engaged in an absolute spending orgy for many years. I also believe that it has to stop. It really isnâ€™t sustainable and will kill off the middle class in the United States if it continues.

With that said, the arguments being made by the rating agencies have holes in them that you could drive a truck through. They seem to be making up the rules for rating investments as they go. That also needs to change. While Iâ€™m not a fan of government regulating private industry, it seems that someone needs to set some standards for the companies that rate investments. And it is now very, very clear that these companies canâ€™t be involved in that standards setting process. After all, they are playing with the economy of the entire country and when they get it wrong, we all wind up paying for their errors.

byJim Malmberg
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