

ABSTRACT

Thomas J. Fitzpatrick, IV & Chris Sagers

Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations

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Abstract by Thomas J. Fitzpatrick, IV & Chris Sagers

During the past forty years, the symbiotic growth of financial innovation, disintermediation, and deregulation created a complex financial environment, a system that has collapsed. At its center was a small group of shadowy but very powerful private corporations, the so-called “credit rating organizations” (CROs), such as Moody’s and Standard & Poor’s. Their purpose was to model risks like those that caused systemic collapse. Despite the literally de jure regulatory gatekeeping powers the CROs possess, there is no significant government oversight of CROs. Instead of oversight, policymakers rely on their faith in the CROs, despite the very little theoretical justification for their existence or for the hope that they produce valuable, and otherwise unavailable, information. This is particularly troubling because regulatory reliance on credit ratings gives such ratings government-mandated value, forces systemic reliance upon them, and protects entry into an unhealthy market. While removing all regulatory reliance upon the CROs would not fix the problems in the market, it is a critical first step.

Fixing the CRO market may not be possible for lawmakers. The inherent problem of informational intermediation is basically one of industrial organization, and, as the article explains at length, it seems very thorny. No policy tool currently in force, and none of those with any serious political feasibility, would come close to dealing with it. Further, more abstract proposals that might be able to deal with it are both fairly politically implausible and raise serious problems of cost and uncertainty. Specifically, the problem is that generation of market intelligence is expensive and may entail some returns to scale, but the product is a public good. Particularly in a comparatively efficient market like the public securities markets, the costs of its production are difficult to recapture without institutional arrangements that pose terrific and negative side effects. In short, the purpose of this article is to argue that capital markets currently contain a much more serious, inherent institutional flaw than has been recognized.