Comment: Rating the Law – How Financial Agencies are Assessing the Legal Risks of Financial Transactions (B. du Marais et al.)

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I. Introduction

Financial instruments today often are issued along with assessments of their quality by credit rating agencies (“CRAs”). The assessments are in the form of ratings (A, B+, B, etc.). These ratings are based on (a) the risk that the issuer of an instrument will default; and (b) the effectiveness of debt collection conditional on default. The effectiveness of debt collection, in turn, is a function of (c) the quality of the law that will be applied to assess the parties’ rights and obligations; and (d) the efficiency of the legal system in which the instrument will be enforced. The higher is the rating, the lower is the interest rate the issuer must pay.

Professor du Marais and his colleagues analyze the way CRAs condition their ratings on the effectiveness of debt collection. Three such agencies are studied: Standard and Poor, Moody’s and Fitch. The method used was to conduct interviews of “stakeholders”, the CRAs, “top managers of all kinds of issuers”, and staff of the regulators. All of these interviews were conducted in France.

The paper does not distinguish clearly between the quality of law to be applied and the efficiency of the collection system. It is unclear whether the CRAs

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make this distinction clearly themselves. In any event, the paper has two positive conclusions: (a) CRAs prefer statutes to cases. That is, they give greater weight to a desirable legal rule that is contained in a statute than to the same rule that is the product of high court opinions; and (b) CRAs give greater weight to instruments that will be controlled by and enforced in the legal systems of England and the US than to the French legal system and systems similar to it. The CRAs’ preferences are consequential, amounting to several interest rate points for an issue.

The paper claims that the CRAs are making a mistake. In the authors’ view, CRAs are using “doubtful indicators”, and their preferences reflect “unscientifically based biases”. As a consequence of these deficiencies, CRAs “are undervaluing the bonds and securities issued in markets belonging to the less preferred legal traditions”.

This paper is in the line of papers that make serious studies of private institutions that affect the law and markets.¹ These institutions have not received sufficient scrutiny, so this paper is welcome. In my view, the paper’s positive findings are valuable but its normative critique needs more work. Thus, this Comment should be taken as a request for further research. My remarks are in three categories: market responses; ratings criteria; and data issues.

II. Markets

There are two market issues: arbitrage and incentives. Regarding arbitrage, the paper claims that issuers that use disfavored legal systems pay excessive interest rates because their instruments are rated as more risky than the instruments actually are. Purchasers, however, should demand these instruments because a purchaser can realize a high interest rate but pay an artificially low price. The price of the undervalued instruments thus will be bid up until the interest rates they pay are appropriate to the risks they pose. Put another way, systematic underpricing is not sustainable in markets with sophisticated players. Therefore, if the CRAs’ ratings are lower than they should be for the disfavored legal systems, arbitrage will insure that the issuers of instruments in those systems will not suffer an interest rate penalty.

The paper thus should explain why arbitrage does not solve the problem it identifies. To be sure, CRAs may appear to be black boxes, but there are many

years of history of instruments issued under various legal systems, and the purchasers are smart. If instruments issued under French law, say, routinely outperform their ratings, purchasers will have high demand for French instruments. Perhaps regulation prevents some purchasers from buying low rated instruments, but not all purchasers are regulated. Without a discussion of arbitrage, therefore, it is unclear that there is a problem here.

Regarding incentives, assume that asymmetric information exists between the issuers and the purchasers of financial instruments: that is, the issuers are better informed about default probabilities than the buyers. The function of ratings is to reduce the information asymmetry. The rating agency, an informational intermediary, communicates information about default to the buyers. As the information gap between issuers and buyers falls, the buyers have less need to discount an instrument’s expected returns. Thus, holding the level of risk constant, an accurate ratings system increases the prices – i.e., reduces the interest rates – of instruments.

Turning to incentives, a CRA cannot make profits unless issuers will use it; the issuers choose the CRAs. Every issuer wants its instrument to have a high rating, but a CRA cannot systematically overrate the instruments it certifies. If it did, the uninformed purchasers would bid down the price of every instrument, regardless of its quality. Then even instruments whose high ratings are justified will be underpriced. Consequently, high quality issuers have a strong incentive to avoid a CRA that overrates. A CRA therefore must make some low ratings in order to attract issuers. It would seem best for a CRA to attach those low ratings to weak issues. Competition among the CRAs for issuers together with smart buyers therefore creates incentives for CRAs to rate every instrument accurately. The paper does not discuss incentives, so it does not contest this conclusion.

2 This is a standard unraveling result. To put it formally, assume that instruments come in three quality levels: high – $q_h$ –, average – $q_a$ – and low – $q_l$. If a CRA routinely overrates issues, the buyers’ rational response is to offer prices that reflect a downgrade: an issue that is rated high will be regarded by the buyers as average, and so forth. Thus, for example, buyers will treat a high quality issue as if its rating were $q_a < q_h$. If another CRA rates accurately, then the high quality issuer would use it. Consequently, in equilibrium the CRA that overrates will be employed only by the lowest quality issuer; the others will defect to the accurate rating agency. Since it is difficult to make profits serving only the worse issuers, the subject CRA would be compelled to issue accurate ratings.

3 The recent subprime debacle in the US is an exception to this argument. There, issuers, apparently for the first time, packaged mortgage obligations of borrowers who differed widely in their ability to repay. The rating agencies’ unfortunate response to observing the aggregated debts of a highly heterogenous set of borrowers was to overrate the debt issues. In contrast, the debt issues that Professor du Marais and his colleagues study commonly are issued by sin-
III. Ratings Methods

The presumption that CRAs are issuing correct ratings could be overcome in two other ways: by a showing that CRAs are structurally incapable of accuracy, or that CRAs are using mistaken criteria. The paper shows that CRAs have lawyers and consult lawyers. It seems that CRA structures are sufficient to generate the right knowledge. The paper rather claims that the CRAs use mistaken criteria. This claim could rest on two grounds: The CRAs (a) are deciding on the basis of good data, but are aggregating the data incorrectly; or (b) are using the wrong data. The paper seems to make the former claim. That is, the paper claims that CRAs are giving excessive weight to laws that are embodied in statutes, and giving excessive weight to debt issues that are issued in jurisdictions with common law origins.

These claims may be correct, but they require more argument. As to the first, statutes are passed by legislatures, and legislatures are more representative – more democratic – institutions than are courts. Thus, a CRA may infer from the fact that a policy is enacted in the form of a statute that (a) the law has more democratic legitimacy than the same law if it were inferred from case decisions; and (b) that the state enacting the statute will be serious about enforcing it. In addition, statutes commonly are more difficult to change than case decisions; statutes, that is, are more stable than cases. The CRAs preference for statutory law thus seems justifiable because buyers of instruments understandably prefer legal legitimacy, a commitment to enforce contracts and stability. Instruments with these virtues, that is, should be highly rated.

The preference for Anglo/American legal regulation probably is not a function of these countries’ use of the common law method. In both countries today, commercial behavior is largely regulated by statute. England and America are attractive to commercial parties for three other reasons: Relative to other countries, these countries (a) have a strong preference for freedom of contract; (b) their judges are highly sophisticated commercially; and (c) their bar – the lawyers – have an excellent grasp of business issues. When the issuers of an instrument and the buyers are private parties, they want the state to enforce the contract that is embodied in the instrument they wrote. Consequently, private parties prefer judges who are committed to enforcing what the parties did, judges who understand what the parties did, and judges who are aided by lawyers who also understand what the parties did. Theory suggests, therefore, that in-
struments should have higher expected values when regulated and enforced under Anglo/American law.

To summarize, both the CRAs’ preference for statutory law and their preference for common law jurisdictions seem justifiable to outside observers. The paper thus should devote more time to showing why these observers are mistaken.

IV. Data

The paper claims that the CRAs’ preference for the US bankruptcy system is not well based. Both the US and the French systems are statutory, for example. The CRAs’ preference may be justified on the reasons just given, however. In the US, bankruptcies are administered by bankruptcy judges. While these judges vary in quality, the judges in the leading US bankruptcy districts (Delaware and New York) are well versed in commercial and insolvency affairs, they had been lawyers for leading law firms before their appointment to the bench, and they are fair and honest. Similarly, in England many bankruptcies are administered under the London System. This is a decentralized system that is largely under the control of the creditors. These creditors too are expert and honest.

Turning to data issues, there are two widely used criteria to assess the efficiency of bankruptcy systems. The first is time in the system. The second criterion is net recoveries. For example, a system that nets unsecured creditors 30 cents on the Euro is more efficient, other things equal, than a system that nets unsecured creditors 10 cents. The paper would be more persuasive regarding its disagreement with the CRAs’ preference for US bankruptcy law if it showed that the US system does poorly, relative to other systems, on the criteria of time in the system and net recoveries. This data has not been presented.

V. Conclusion

This paper treats an important subject: the performance of private, largely unregulated institutions whose output has significant public consequences. The paper also uses a well recognized methodology: surveys of the participants in the system. And the paper has illuminating results: that CRAs prefer statutory to case law and prefer common law jurisdictions to others. The paper’s criticism of the CRAs preferences is less persuasive, however. Economic and political economy analyses suggest that the CRAs’ preferences do not cause harm.
and are justifiable. Nor does the paper present data to overcome these views. The authors thus have more work to do.