

2009

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Recommended Citation

Claire Hill, *Why Did Anyone Listen to the Rating Agencies after Enron?*, 4 J. BUS. & TECH. L. 283 (2009), available at https://scholarship.law.umn.edu/faculty_articles/79.

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Why Did Anyone Listen to the Rating Agencies After Enron?

I. INTRODUCTION

ENRON WAS RATED INVESTMENT GRADE BY Moody's, Standard and Poor's, and Fitch until four days before it declared bankruptcy¹—scarcely a ringing endorsement of the agencies' acumen.² And even before Enron (a term I will generally use in this essay to include the other contemporaneous scandals of the time), the rating agencies had come in for significant criticism.³ Some commentators had long described their ratings as worthless;⁴ others, only slightly more charitably, characterized the agencies as offering a work-product that was 'good enough for government work' but scarcely cutting edge.⁵ Yet many investors are now saying that in buying mortgage-backed securities and collateralized debt obligations comprised in part of those securities, and in appraising the quality of swap providers and insurers, they relied on the rating agencies.⁶ How can this reliance be reconciled with what preceded it?

This essay is part of a larger project on why subprime investors didn't demand a (much larger) lemons premium.⁷ In this essay, I argue that an adaptive trait—incorporating new data that potentially conflicts with one's pre-existing worldview

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1. STAFF TO THE S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC & PRIVATE-SECTOR WATCHDOGS 73, 115 (Comm. Print 2002), available at <http://hsgac.senate.gov/100702watchdogsreport.pdf>.

2. I will use the term "rating agencies" to refer to the most prominent such agencies, Moody's, Standard and Poor's, and Fitch.

3. See, e.g., Frank Partnoy, *The Siskel & Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 654–64 (1999) [hereinafter Partnoy, *Siskel & Ebert*].

4. See, e.g., Frank Partnoy, *The Paradox of Credit Ratings*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 66 (Richard M. Levitch et al., eds., 2002) [hereinafter Partnoy, *Paradox of Credit Ratings*].

5. For a general discussion on views of the capabilities of rating agencies, see Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43 (2004) [hereinafter Hill, *Rating Agencies*].

6. See, e.g., *Making Sense of the Madness*, FORTUNE, Dec. 22, 2008, at 66, 66–73.

7. See Claire A. Hill, *Why Didn't Subprime Investors Demand A (Much Larger) Lemons Premium?* (working paper on file with author); see also Claire A. Hill, *Who Are the Villains in the Subprime Crisis and Why It Matters*, 4 ENTREPRENEURIAL BUS. LAW J. (forthcoming 2009).

so as to preserve as much of that worldview as possible—proved to be maladaptive in this circumstance.

It is not viable to thoroughly revisit one's pre-existing worldview at every possible disconfirmation—doing so would be paralyzing. Indeed, it is also a reasonable and probably necessary prior belief that one's pre-existing worldview is sound, and based on sufficient evidence. Again, the contrary is virtually unimaginable. The result is that if possible, we interpret new data in a manner consistent with our pre-existing worldview.⁸ We can do so in a variety of ways. One way, the one I will discuss here, is to conclude that the worldview was too simple—it set forth a general rule which we came to understand has exceptions (or more or likelier exceptions than we had believed). Or, there may be some broader revision, in which we rearticulate the prior belief in a way that accommodates the evidence.

How did this phenomenon work when the rating agencies failed so miserably with Enron? A simplified version of the story is as follows. Before Enron, the pre-existing worldview among many market participants was that rating agencies were, if not comprised of rocket scientists, sound enough.⁹ There was considerable evidence for this view. While it was challenged by Enron, Enron could be accounted for as the product of massive fraud, concealed by complexity.¹⁰ Indeed, Enron was notoriously complex—some of its executives were among the most sophisticated of the 'rocket scientists,' developing transaction structures dazzling in their intricacy.¹¹ But complexity was not sufficient, it was thought, to totally stymie the rating agencies; after all, rating agencies had been successfully rating complex mortgage-backed (and other asset-backed) securities for many years at that point.¹² It was therefore plausible to believe that for the rating agencies to get it significantly wrong, both massive fraud and complexity were necessary and that neither was

8. For a general discussion of how people react to and accommodate disconfirming evidence, see RICHARD NISBETT & LEE ROSS, *HUMAN INFERENCE: STRATEGIES & SHORTCOMINGS OF SOCIAL JUDGMENT* 167–92 (1980); see also Pam Belluck, *Yes, Looks Do Matter*, N.Y. TIMES, Apr. 26, 2009, available at <http://www.nytimes.com/2009/04/26/fashion/26looks.html>. “When people don’t fit our preconceived notions, we tend to ignore the contradictions, until they are too dramatic to overlook. In those cases, said John F. Dovidio, a psychology professor at Yale, we focus on the contradiction” *Id.* Doing so helps us “find a way to make the world make sense again, even if the way we do it is to say, ‘This is an exceptional situation.’ It’s easier for [a person] to keep the same categories in [her] mind and come up with an explanation for the things that are discrepant.” *Id.*

9. See Hill, *Rating Agencies*, *supra* note 5, at 59–60, 66–67, 71; Stephen A. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 8, 13; Claire A. Hill, *Rating Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV. 1145, n.49 (2003) [hereinafter Hill, *Behaving Badly*].

10. See Hill, *Rating Agencies*, *supra* note 5, at 81.

11. See generally *The Role of Financial Institutions in Enron's Collapse: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Government Affairs*, 107th Cong. 107–618 (2002).

12. See FITCH RATINGS, *STRUCTURED FINANCE, CREDIT MARKET RESEARCH, FITCH GLOBAL STRUCTURED FINANCE 1991–2005 DEFAULT STUDY* (2006), available at <http://www.fitchratings.com/dtp/pdf3-06/5fit0707.pdf>; MOODY'S INVESTORS SERVICE *GLOBAL CREDIT RESEARCH, SPECIAL COMMENT, DEFAULT & LOSS RATES OF STRUCTURED FINANCE SECURITIES: 1993–2005* (2006), available at <http://www.moody.com/cust/content/content.ashx?source=StaticContent/Free+pages/Credit+Policy+Research/documents/current/2005600000426138.pdf>.

sufficient.¹³ Finally, it could reasonably be thought that since (and as a result of) Enron, the regulatory regime and the overall climate had changed to make such massive fraud less likely to occur, or at least less likely to continue unnoticed. In this essay, I explain in more detail the story set forth above, and draw some conclusions.

II. THE ARGUMENT

A. *Prior Beliefs Encounter Disconfirming Evidence*

Imagine a world in which people did not have much faith in their prior beliefs, and hence revisited them thoroughly and often. Daily life would be virtually impossible, given that we probably see potentially disconfirming evidence constantly. Revisiting our prior beliefs constantly is exceedingly time-consuming and, more significantly, potentially paralyzing. I believe that if I put an envelope in the mail slot, or give it to a commercial carrier, it will usually get delivered to the addressee—imagine if I seriously questioned that belief and had to seek other ways of sending mail? Similarly, I believe that if I buy groceries from my local store, I can feed them to dinner party guests without (much) fear of poisoning them—imagine if I felt that I had to test all of the food by sending it to a lab. (And if I had to test the labs too)

We therefore have ways of reconciling the prior belief with the evidence in ways that preserve the prior belief while not denying the evidence. Consider the well-worn example of belief in God notwithstanding that God clearly ‘lets bad things happen to good people.’ The accommodation of this belief and the disconfirming evidence often refers to a grand plan that people do not have access to, which would prove the true goodness of what God has done, or that in a particular instance, God lost against Satan. Moreover, keeping the prior belief in spite of the disconfirming evidence is often characterized as a virtue, the virtue of faith.¹⁴ Consider another belief: that what is reported in a reputable newspaper is generally true. I might see a story in the business press that does not properly capture the corporate law ramifications and conclude that reporters may not always get the technical details in the field correct; that is my way of salvaging my prior belief but nevertheless accommodating the potentially disconfirming evidence. And another: I believe that people generally like desserts. I have a few friends who I have discovered do not, and I now conclude that most people like desserts, except for the few who do not.

Sometimes the disconfirming evidence cannot be accommodated with the prior belief, or can only be so accommodated with great difficulty, such that the prior belief itself becomes precarious, amenable to disconfirmation itself.¹⁵ In this regard,

13. See Hill, *Rating Agencies*, *supra* note 5, at 78–79.

14. Of course, this description is wildly simplified and glosses over myriad complexities. Still, using the example seems worthwhile because it is a paradigmatic case of the phenomenon that I am describing.

15. See NISBETT & ROSS, *supra* note 8, at 175–79, 188–91.

many economists are finding the traditional views about how markets work untenable, or at least very difficult to maintain, in the face of this financial crisis.¹⁶ Moreover, some prior beliefs are not held deeply in the first instance, and would be abandoned in the face of even non-weighty evidence to the contrary. I ate Tastykake cupcakes as a child in New York, and always believed they were primarily associated with New York; I was recently served such cupcakes at a conference in Philadelphia, and was told that the organizers had sought to serve Philadelphia food. Revising my long-but-weakly held belief was clearly in order, and I have confirmed, as I write this essay, that what I was told in Philadelphia is indeed correct.¹⁷

The dynamic I describe is akin to several described in the psychology literature. Among them are belief perseverance, confirmation bias, and motivated reasoning, as well as a related dynamic critical of motivated reasoning.¹⁸ However, the dynamic that I describe is different in a critical respect. All of the psychological dynamics are largely about ‘mistakes’ or ‘biases,’ situations in which holding onto a belief notwithstanding the disconfirming evidence is unwarranted, or reflects a ‘bias.’ Psychologists have amply demonstrated that there is a general human tendency to hold on to a belief more than the evidence warrants.¹⁹ But what I am describing may or may not have been a mistake—I am agnostic on this point. *Ex post*, listening to the rating agencies as to the value of what are now called “toxic securities” was clearly a bad idea. But *ex ante*, even after Enron, it may not have been—and, I want to argue, there is a good chance that it was not.

Belief perseverance is holding one’s views notwithstanding disconfirming evidence.²⁰

16. See David Brooks, Op-Ed., *An Economy of Faith and Trust*, N.Y. TIMES, Jan. 16, 2009, at A29 (“The [financial] crisis has delivered a blow to classical economics and taken a body of psychological work that was at the edge of public policy thought and brought it front and center.”).

17. Tastykake, Company History, <http://www.tastykake.com/history.aspx> (last visited Mar. 28, 2009) (stating that the company was started in Philadelphia in 1914, and that “Tastykake has become a true Philadelphia success story.”).

18. See, e.g., NISBETT & ROSS, *supra* note 8; see also Craig A. Anderson, *Belief Perseverance*, in ENCYCLOPEDIA OF SOCIAL PSYCHOLOGY 109 (Roy F. Baumeister & Kathleen D. Vohs, eds., 2007) [hereinafter ENCYCLOPEDIA OF SOCIAL PSYCHOLOGY]; Bettina J. Cassad, *Confirmation Bias*, in ENCYCLOPEDIA OF SOCIAL PSYCHOLOGY, *supra*, at 162–63; Natalie D. Smoak, *Beliefs*, in Encyclopedia of Social Psychology, *supra*, at 111; Ziva Kunda, *The Case for Motivated Reasoning*, 108 PSYCHOL. BULL. 480 (1990).

Another such dynamic is subtyping. See generally, DAVID J. SCHNEIDER, *THE PSYCHOLOGY OF STEREOTYPING* 404 (2005). Belluck provides an example:

Even when presented with multiple exceptions to the stereotype, we often keep the broad category and simply create a subtype, [Yale Psychology] Professor Dovidio said. For example, President Obama challenged negative stereotypes about blacks, but some people may have come up with a subtype of blacks—black professionals—rather than challenge the overall stereotype, Professor Dovidio said. “That does it in the simplest and most cognitively energy-saving way.”

Belluck, *supra* note 8. Typically, subtyping is a mistake. The stereotype is incorrect; subtyping allows us to preserve it. That being said, it is certainly possible that a particular instance of subtyping is not a mistake—that the stereotype really is largely valid.

19. See, e.g., NISBETT & ROSS, *supra* note 8. “People tend to persevere in their beliefs well beyond the point at which logical and evidential considerations can sustain them.” *Id.* at 192.

20. Anderson, *supra* note 18, at 109; Smoak, *supra* note 18, at 111.

*Beliefs are important foundations of attitudes and behavior, but they can be extremely difficult to change. Often, people will vehemently maintain their beliefs even in light of disconfirming evidence. This phenomenon is known as belief perseverance. Belief perseverance typically occurs because people base their beliefs on information that they find logical, compelling, or attractive in some way. Therefore, even when beliefs are seemingly disconfirmed by new evidence, the foundation for what the person believes may still exist. At times, the belief will still be maintained because of the remaining support of the explanation behind it.*²¹

Typically, what is stressed in accounts of belief perseverance is clinging to one's beliefs more strongly than is warranted. The text quoted above is from a prominent social psychology encyclopedia's entry on "beliefs."²² The entry on "belief perseverance," immediately preceding, notes that "[p]eople tend to hold on to their beliefs even when it appears that they shouldn't."²³ The entry acknowledges that it is not always clear when people *should* hold onto their beliefs in the face of disconfirming evidence. But the overall tone nevertheless makes clear that the term "belief perseverance" generally refers to a mistake. The entry ends with the following: "[r]esearch also has investigated ways to reduce belief perseverance. The most obvious solution, asking people to be unbiased, doesn't work. However, several techniques do reduce the problem. The most successful is to get the person to imagine or explain how the opposite belief might be true."²⁴

Another relevant dynamic is confirmation bias,²⁵ "one example of how humans sometimes process information in an illogical, biased manner."²⁶ The entry continues as follows:

One explanation for why humans are susceptible to the confirmation bias is that it is an efficient way to process information. Humans are bombarded with information in the social world and cannot possibly take the time to carefully process each piece of information to form an unbiased conclusion. Human decision making and information processing is often biased because people are limited to interpreting information from their own viewpoint. People need to

21. Smoak, *supra* note 18, at 111.

22. *Id.*

23. Anderson, *supra* note 18, at 109.

24. *Id.* at 110.

25. Cassad, *supra* note 18, at 162.

Confirmation bias refers to processing information by looking for, or interpreting, information that is consistent with one's existing beliefs. This biased approach to decision making is largely unintentional and often results in ignoring inconsistent information. Existing beliefs can include one's expectations in a given situation and predictions about a particular outcome. People are especially likely to process information to support their own beliefs when the issue is highly important or self-relevant.

Id.

26. *Id.*

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*process information quickly to protect themselves from harm. It is adaptive to rely on instinctive, automatic reflexes that keep humans out of harm's way.*²⁷

Motivated reasoning, also a pertinent dynamic, has been described in one of the seminal articles as follows: "motivation may affect reasoning through reliance on a biased set of cognitive processes: strategies for accessing, constructing, and evaluating beliefs."²⁸ The article's author notes that what he means by motivation is "any wish, desire, or preference that concerns the outcome of a given reasoning task."²⁹ The article distinguishes between two different motives: one, "to arrive at an accurate conclusion, whatever it may be," and the other, "to arrive at a particular, directional conclusion."³⁰ The phenomenon that I am describing does not cleanly fit into either category, nor does it cleanly fit into the article's conclusion, that "accuracy goals lead to the use of those beliefs and strategies that are considered most appropriate, whereas directional goals lead to the use of those that are considered most likely to yield the desired conclusion."³¹ The article characterizes as "[t]he major and most damaging criticism of the motivational view . . . that all research purported to demonstrate motivated reasoning could be reinterpreted in entirely cognitive, nonmotivational terms," enabling people to "draw self-serving conclusions not because they wanted to but because these conclusions seemed more plausible, given their prior beliefs and expectancies."³² The conclusions that I am describing do not seem 'self-serving' in the way that that term is usually understood.³³ But the general reasoning in the criticism accords with my view: that it is sensible not to be agnostic about one's prior beliefs, but rather, to give them some presumption of soundness. One's prior beliefs might be wrong, but one would generally need some weighty evidence—quantitatively or qualitatively—to come to that conclusion. Being agnostic about one's prior beliefs is not a good way to proceed; we can expect those who give their prior beliefs some weight to do better than those who do not.³⁴

Psychologists Nisbett and Ross note that:

[i]t seems possible that the behavior of subjects, inappropriate as it is from the standpoint of rationality in the inferential contexts studied, may arise from pursuit of important, higher order epistemic goals. Two such possible superior-

27. *Id.*

28. Kunda, *supra* note 18, at 480.

29. *Id.*

30. *Id.*

31. *Id.* at 481.

32. *Id.* at 480 (citations omitted).

33. Merriam-Webster's Collegiate Dictionary defines self-serving as "serving one's own interests often in disregard of the truth or the interests of others." MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 1062 (10th ed. 1997).

34. Even psychologists who accept the general view that beliefs preserve more than logic and evidence warrant think that "such perseverance serves goals that may be more fundamental and important than holding correct views of particular issues." Nisbett & Ross, *supra* note 8, at 167.

dinate goals are (a) the importance of stability to beliefs and belief-systems, even despite occasional logical inconsistency and (b) real-world constraints on time, which may prohibit the careful and dispassionate perusal and integration of all new evidence pertinent to any particular belief. The possibility that subjects were acting in accordance with such higher order goals should make us reluctant to assume that their behavior is as inappropriate as would be implied by narrower considerations of the justification for a particular belief, in a particular context, at a particular time.³⁵

This passage follows a discussion of the (strength of) the evidence that people hold onto beliefs more than they should, and is succeeded by a passage noting that people may not have “such higher order goals” in doing so.³⁶

Paradigmatically, in the typical cases studied by psychologists, there is no determinate ‘right answer’ as to whether the prior belief at issue should, or should not, be maintained. By contrast, there was no such answer at the time investors needed to determine whether or not, and to what extent, to listen to rating agencies. (There is now!³⁷) In such a case, the evolutionary/higher-order reasons why revisiting prior beliefs often is a bad idea might very well carry the day, especially where it is possible, as it was with the rating agencies post-Enron (and pre-crisis), to accommodate the evidence tending to disconfirm the belief at issue with a continued, albeit modified, adherence to the belief. In what follows, I will demonstrate how this dynamic—according significant weight to one’s prior beliefs even in the face of some disconfirming evidence—explains why anyone would listen to the rating agencies after Enron.

B. *The Rationale*

The major rating agencies—Moody’s, Standard and Poor’s and, more recently, Fitch—have been a fixture of investment decisions for quite some time. Many scholars have recounted the history; the scholars have some disagreements, but not as to the fact that for many types of securities, almost all the issuances are rated. Ratings, and rating agencies, are thus an important fact of life for those making investment decisions.³⁸

35. *Id.* at 191–92 (citation omitted).

36. *Id.* at 192.

37. At least as to highly complex securities. Rating agency ratings of companies and their senior debt are still being mentioned as though they were informative, and they probably are. See, e.g., *Moody’s Downgrades Lincoln National Senior Debt*, FORBES.COM, Mar. 19, 2009, available at <http://www.forbes.com/feeds/ap/2009/03/19/ap6191054.html>.

38. See generally Hill, *Rating Agencies*, *supra* note 5; Richard Cantor & Frank Packer, *The Credit Rating Industry*, FED. RES. BANK N.Y. Q. REV., Summer–Fall 1994, at 1, 2; Richard Sylla, *An Historical Primer on the Business of Credit Rating*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 19–40 (Richard M. Levitch et al., eds., 2002).

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What do investors think of rating agencies? I have argued that pre-Enron, investors thought of the major rating agencies as providing some, although not cutting-edge, information.³⁹ At a time, securities issued without both Moody's and Standard and Poor's ratings were discounted by the market.⁴⁰ Some scholars, most notably Frank Partnoy, have argued that ratings were used principally, if not exclusively, to meet regulations applicable to some institutional investors such as pension funds and insurance companies.⁴¹ He therefore argues that ratings have no informational value.⁴² While it is true that regulation did require some investors to purchase mostly rated securities, investors favored securities rated by two rating agencies over those rated by one such agency, even when the applicable regulation only required one rating.⁴³

Ratings might provide information indirectly, rather than because the rating agencies correctly analyze the securities being rated.⁴⁴ Rather than reflecting a security's value, they might to some extent cause the security to have the value they assign.⁴⁵ If a company can issue AAA rated debt, that company's borrowing costs will be lower, increasing the value of the company and the debt. Moreover, the information might consist, in whole or in part, of the signal that the company obtaining the rating knew what markets wanted it to do, and, in the case of companies obtaining two ratings where only one was required, was willing to undergo more scrutiny than required.⁴⁶ Still, none of this undermines the point that investors could think ratings were by and large accurate, without thinking particularly highly of the rating agencies' work product and the people who produce it.⁴⁷ My own view, argued for in my article on the subject, is as stated above: nobody thought the rating agencies had lots of rocket scientists among the people making the ratings, but they were thought of as sound enough. It is rather like the detective who eventually gets his man through dogged, albeit uninspired, efforts. A rating was necessary, for all the reasons mentioned above, but not sufficient.⁴⁸

39. See *supra* note 9.

40. Hill, *Rating Agencies*, *supra* note 5, at 66 n.117 ("One finding is that where Moody's and Standard and Poor's both give the same rating, investors accept less of a return than they do where there is only one rating, or a rating by either Moody's or Standard and Poor's accompanied by a second rating from Fitch.").

41. Partnoy, *Siskel & Ebert*, *supra* note 3, at 690-92, 698.

42. *Id.* at 698.

43. Hill, *Rating Agencies*, *supra* note 5, at 66.

44. *Id.* at 71.

45. *Id.*

When rating agencies downgrade an issue and the issue later defaults, the failure may very well have been caused by the downgrade. . . . And the same may be true prospectively. Because ratings have so much influence on the terms on which a company can get financing, they may be self-fulfilling.

Id.

46. *Id.* at 73. In abiding by the two-ratings norm, an issuer signals that it has nothing to hide. *Id.*

47. *Id.* at 72.

48. *Id.*

Then came Enron. The rating agencies had, of course, been shown to be spectacularly wrong before Enron.⁴⁹ One notorious instance, involving the default of the Washington Public Power Supply System, was aptly referred to as ‘whoops.’⁵⁰ Other debacles in the rating agency hall of shame have included Executive Life, the “Asian Flu,” Orange County, and National Century Financial Enterprises (NCFE).⁵¹ The press did not spare the rating agencies; one article in *Euromoney* after the Asian Flu, *Rating Agencies Caught With Their Pants Down?*, included a fabulously evocative cartoon.⁵² But all of these instances could be characterized as exceptional—some involved crooks, notably NCFE,⁵³ and one involved a cascade of recessions in Asia (the Asian Flu).⁵⁴ Orange County involved complex derivatives,⁵⁵ but not ‘when everyone was doing it.’ It also arguably involved high-pressure sales tactics used by Merrill Lynch on somebody who was perhaps not the savviest investor, the elected treasurer of the county.⁵⁶ As the Los Angeles Times delicately put it,

49. See *id.* at 78–79; Partnoy, *Siskel & Ebert*, *supra* note 3, at 661–62.

50. In 1983, Washington Public Power Supply System, also known as “Whoops,” defaulted on \$2.25 billion in bonds used to finance partial construction of a nuclear power plant, at the time the biggest municipal bond default in U.S. history. Charles P. Alexander et al., *Whoops! A \$2 Billion Blunder*, *TIME*, Aug. 8, 1983, at 58, available at <http://www.time.com/time/magazine/article/0,9171,955183-1,00.html>. Moody’s and Standard & Poor’s were sued by Whoops’s bondholders because they had given Whoops bonds high ratings. *Id.*

51. Hill, *Rating Agencies*, *supra* note 5, at 78–79.

52. *Rating Agencies Caught With Their Pants Down?*, *EUROMONEY*, Jan. 1998, at 51.

53. Press Release, Dep’t of Justice, Former National Century Financial Enterprises CEO Convicted of Conspiracy, Fraud and Money Laundering (Oct. 31, 2008), available at <http://www.usdoj.gov/opa/pr/2008/October/08-crm-975.html>; *National Century Financial Enterprises Executives Donald H. Ayers, Rebecca S. Parrett, Randolph H. Speer, Roger S. Faulkenberry and James E. Dierker Found Guilty in \$3 Billion Fraud Scheme*, *BACKGROUNDNOW.COM*, Dec. 31, 2008, <http://www.backgroundnow.com/blog/background-check/national-century-financial-enterprises-executives-donald-h-ayers-rebecca-s-parrett-randolph-h-speer-roger-s-faulkenberry-and-james-e-dierker-found-guilty-in-3-billion-fraud-scheme/>.

At trial, the government presented evidence that the defendants engaged in a scheme to deceive investors and rating agencies about the financial health of NCFE and how investor monies would be used. Between May 1998 and May 2001, NCFE sold notes to investors with an aggregate value of \$4.4 billion, which evidence presented at trial showed were worth approximately six cents on the dollar at the time of NCFE’s bankruptcy in November 2002. . . . NCFE presented a business model to investors and rating agencies that called for NCFE to purchase high-quality accounts receivable from health-care providers using money NCFE obtained through the sale of asset-backed notes to institutional investors. The evidence at trial showed that NCFE advanced money to health care providers without receipt of the requisite accounts receivable, oftentimes to healthcare providers that were owned in whole or in part by the defendants. The evidence further showed that the defendants lied to investors and rating agencies in order to cover up this fraud.

Id.

54. *Rating Agencies Caught With Their Pants Down?*, *supra* note 52.

55. See Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 365 (“[Orange County Treasurer] Citron’s highly leveraged investments [consisting of complex derivatives and other interest-sensitive securities] ultimately inflicted losses of more than \$1.6 billion on Orange County.”).

56. See Dana Parsons, *Citron on the Witness Stand Was One Way to Court Disaster*, *L.A. TIMES*, June 5, 1998, at B1.

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*Merrill Lynch also came to realize that [Orange County Treasurer] Citron didn't always rely on standard investment techniques. For more than a decade, the treasurer used a \$4.50 star chart, purchased from an Indianapolis astrologer, to help make investment decisions for the county, as well as for local schools, cities and special districts.*⁵⁷

In all of the cases there were ready narratives consistent with a prior belief that the rating agencies were 'good enough.' The rating agencies did not purport to be able to detect lying.⁵⁸ It did not seem so damning not to be able to anticipate macroeconomic events in far-away places. And the rating agencies had quite a good track record, over a long period of time—their ratings, at least on a relative basis, and, it seemed, on an absolute basis as well, had proven largely accurate.⁵⁹

Enron, of course, was quite embarrassing. An investment grade rating for a company four days away from bankruptcy is not so easy to live down. How could anyone listen to the rating agencies again? As noted above, Enron involved massive fraud and complexity. Subprime securities involved complexity but not, it was thought, massive fraud. The generally held view was that rating agencies were equipped to appraise complexity, or at least not be stymied by it.⁶⁰ Even though the low-level analysts might not be 'rocket scientists,' the overall methodology developed by higher-level and more talented people was sound. Moreover, subprime securities were 'natural' descendants of well-known mortgage backed securities, which the rating agencies had been rating successfully for close to thirty years.⁶¹ Rating agencies' websites contained (and still contain) detailed materials describing their methodology for rating mortgage-backed and other structured securities; the materials read as though the standards were very exacting and conservative.⁶² For the first few years during which subprime mortgages were securitized—when hous-

57. See Davan Maharaj & Shelby Grad, *Seducing Citron: How Merrill Influenced Fund and Won Profits*, L.A. TIMES, July 26, 1998, at A1; see also John Greenwald et al., *The California Wipeout*, TIME, Dec. 19, 1994, available at <http://www.time.com/time/magazine/article/0,9171,982029,00.html>.

58. See Hill, *Behaving Badly*, *supra* note 9, at 1150. In this regard, note that Ronald Barone, a Managing Director of Standard & Poor's characterized Enron as a "fraud problem," not a "ratings problem."

59. Hill, *Rating Agencies*, *supra* note 5, at 67 ("[V]oluminous empirical evidence suggests that in the normal course, rating agencies do fairly well in gauging the relative quality of the financial instruments and firms they rate."); see also *supra* note 12.

60. Well before the subprime market developed, and indeed, before the explosion of financial innovation in the 1990s, Henry Hu expressed this view in his article, Henry T.C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 432-33 (1989). Hu expressed confidence in the ability of rating agencies, having "developed specific expertise with respect to complex new financial products and with respect to financial guaranty insurers," to properly evaluate complex securities. The rating agencies' track record with complex securities through the 1990s reinforced this view. See *supra* note 12.

61. See generally Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1119-26 (1996) [hereinafter Hill, *Securitization*]; see also Martin Neil Baily et al., *The Origins of the Financial Crisis*, BROOKINGS FIXING FINANCE SERIES 7-9, Nov. 2009, http://www.brookings.edu/~media/Files/rc/papers/2008/11_origins_crisis_baily_litan/11_origins_crisis_baily_litan.pdf.

62. See, e.g., STANDARD AND POOR'S, U.S. CMBS LEGAL AND STRUCTURED FINANCE CRITERIA (2003), available at <http://www2.standardandpoors.com/spf/pdf/fixedincome/cmblegalcriteria.pdf>.

ing prices were rising exponentially,⁶³ and before underwriting standards reached their nadir—the securitization securities (and the underlying mortgages) performed quite well.⁶⁴ And there were many, huge, reputable market participants involved, participants who had their own considerable reputational and financial stakes in the viability of the securities. There did not seem to be much potential for massive fraud. There certainly were no Skilling- or Fastow-like figures, brilliant designers of financial instruments who, in retrospect, were able to create cash flows out of loan proceeds and “sell” assets they were actually keeping⁶⁵—in short, there were no people able to create a wholly false financial appearance to disguise a disastrous reality. Indeed, structured finance is precisely that, structured. The risks being segregated are precisely those that are not residual risks relating to a company,⁶⁶ which were the very risks that proved so problematic with Enron.⁶⁷ So, investors could tell themselves: this is not another Enron. And surely rating agencies are being extra-cautious after Enron.⁶⁸ Rating agencies cannot be getting it massively wrong. Even if they are getting it a bit wrong, surely AAA securities cannot be junk. And the agencies have always done far better at initial ratings than downgrades: after all, Enron involved downgrades. So, investors had a story to permit them to continue doing what they had been doing, which was to use rating agencies as a valuable input in their investment decisions.

63. Baily, *supra* note 61, at 11 (“From 1991 through the third quarter of 2007, the [Office of Federal Housing Enterprise Oversight] house price index for the U.S. showed increases in every single quarter, when compared to the same quarter in the prior year.”). Most of the professionals involved in creating and packaging the toxic securities work in Manhattan. See Saskia Sassen, *Global Financial Centers*, 78 *FOREIGN AFFAIRS* 75, 76 (1999). Manhattan’s real estate prices have defied the laws of gravity for quite some time. Christine Haughney, *Apartment Prices in Manhattan Defy National Real Estate Slide*, *N.Y. TIMES*, Jan. 3, 2008, at B1 (Manhattan saw a record high for real estate prices in the fourth quarter of 2007, while the rest of the country’s real estate markets were experiencing stagnation); Christine Haughney, *Manhattan Apartment Prices Hit Record High Despite Slump*, *N.Y. TIMES*, Apr. 2, 2008, at B1 (“While most of the nation plods through a housing slowdown, Manhattan is experiencing its highest prices in history.”); Edward L. Glaeser, Joseph Gyourko & Raven Saks, *Why is Manhattan So Expensive? Regulation and the Rise in Housing Prices*, 48 *J. LAW & ECON.* 331 (2005). Thus, perhaps one reason investment bankers, lawyers, and investors (and rating agency employees) could find an exponential increase in real estate prices plausible was that Manhattan’s real estate prices had seemed to be on such a trajectory for quite a while. I thank Matt Easterday for this suggestion.

64. See *supra* note 12.

65. Paul M. Healy & Krishna G. Palepu, *The Fall of Enron*, 17 *J. ECON. PERSP.* 3, 10–11 (2003).

66. See Hill, *Securitization*, *supra* note 61.

67. In Enron, the ratings that proved so embarrassing were those of Enron’s senior debt. Ratings of a company’s senior debt are colloquially referred to as those of the company. The assessment as to whether the company can pay its debt involves looking at the bundle of assets and liabilities that comprise the company, and includes, importantly, a determination of its residual risks. By contrast, for complex securities such as those involved in the present crisis, the inquiry involves some precisely segregated bundle that does not contain these sorts of residual risks.

68. See Hill, *Rating Agencies*, *supra* note 5, at 70 (“Indeed, after being criticized for downgrading too slowly in Enron and the other debacles, the rating agencies greatly accelerated their pace of downgrading; the agencies were then criticized for downgrading too quickly.”). The same reasoning was used in some accounts of how directors who had been on the WorldCom board might nevertheless still be deemed desirable as directors. See Andrew Countryman, *WorldCom Mess Hasn’t Disqualified Former Directors*, *CHI. TRIB.*, Mar. 7, 2004, at C1.

III. CONCLUSION

So what? Why does any of this matter? We now know that relying on the rating agencies was a big mistake; why anyone listened to the agencies after Enron matters for how we deal with investors and rating agencies—how we judge what they did, and how we go forward to minimize the chance of another crisis.

Whatever else is true, in the future, all market participants should be wary. Market participants are always looking for the next great thing—the higher yielding instrument that does not carry commensurate risk. ‘Rocket scientists’ can, apparently, convince themselves (as well as their employers, the investment banks, and the investment banks’ clients) that they have defied fundamental laws of finance and found that thing.⁶⁹ In a world where people can bet other peoples’ money, and many institutions are too big or too interconnected to fail, investment decisions potentially become everyone’s problem. We will dole out blame, and vilify some of the actors involved. But if we want to minimize the chance and severity of future crises, we can’t just deal with the bad guys. We’ll need to deal with normal market actors as well. Had such actors not concluded that subprime investments were a good deal, we almost certainly wouldn’t have had the crisis we now have. In retrospect, we can see how wrong they were. But it doesn’t do us much good to project what we know now into the past. To minimize the chance of future crises, we need to spend much more time understanding how normal market actors think.

69. See Steve Lohr, *In Modeling Risk, the Human Factor Was Left Out*, N.Y. TIMES, Nov. 5, 2008, at B1. “Innovation can be a dangerous game,” said Andrew W. Lo, an economist and professor of finance at the Sloan School of Management of MIT.” *Id.*