Credit rating agencies  
and the faulty marketing authorisation of toxic products

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If one thing differentiates the current financial crisis from previous ones, it is the fact that it has its roots in financial innovation. The nature of financial innovation is now well understood. A financial engineer would assemble thousands of residential mortgages and bundle them into new securities, some called collateralized debt obligations (CDOs) that would include both good and bad credit-risk mortgages from several parts of the country. This aimed to spread the risk of default across a range of investors.

Given that crisis commentators drew analogies between financial products and health products, CDOs soon became ‘toxic’, supporting demands for finance to be regulated just as much as food, pharmaceutical or consumer products. Pascal Lamy, the Director-General of WTO, illustrated this by declaring, ‘Finance is one of the last “black holes” of globalisation. … A sick bovine or an unknown unknowns into known unknowns’. How appropriate is this comparison to identifying the cause of the crisis and possible reform?

In this crisis, the world of finance is experiencing what the pharmaceutical world has known for a while, that products can cause ‘serious and rare’ adverse events that are hard to detect. Crises are occasions that have the power to force us to recognize the existence of events to which we were culturally and epistemically blind. They turn ‘unknown unknowns’ into ‘known unknowns’.

The seminal discovery that medicines can cause adverse reactions was made with a substance called thalidomide. Until the 1960s it was not conceivable that molecules that could cure also kill. The term ‘adverse drug effect’ did not even exist. So the prescription of thalidomide to pregnant mothers, causing several thousands of fetal deformations around the world in the early 1960s, produced the undeniable and tragic lesson that products that cure might also seriously damage health. Now the sub-prime crisis is set to be the closest thing to that in the financial markets. The management of such systemic risks requires the sharing of information.

Such a process can fail because it might well be that pharmaceutical companies withhold information or make it difficult to interpret. Scientific experts and regulators may be ‘captured’ or doctors fail to notify observed adverse events. However, sociological research shows that cadres of medical scientists do foster common knowledge. Individually, they may not be independent from manufacturers, and some indeed work for them, but as medical professionals, they are linked to the various interested parties in the regulatory domain, ranging from regulatory agencies to professional bodies, clinical research organizations, patients and international standard-setting arenas.

Such experts are driven by a public willingness to improve collective knowledge of products rather than by a private or commercial will to distribute them. They are instrumental in making common knowledge circulate. They organize to study large populations, centralize dispersed signals and undertake to evaluate knowledge for others, which is important since information about risks is always sparse, incomplete and ambiguous. These collectives maintain the knowledge of safety issues by collecting, storing, comparing and classifying adverse events and such information serves to test new ways to detect risks before they materialize in patients. By reviewing past failures such as non-detected serious adverse drug reactions, they try to create new protocols to improve detection in the future, so they function much like academic colleagues, exchanging news, deliberating and cross-examining their work in conferences, publications and informal communications.

It is quite obvious that the world of finance does not generate such common knowledge. Rating agencies’ triple-AAA gradings concealed rather than conveyed risks. By advising banks on how to securitize assets, the agencies co-manufactured ‘toxic’ products and were not in a position to independently assess them for safety. They employed a small knowledge base, not taking into account historical trends of default on mortgage payments.

As this crisis demonstrates, the most dramatic risks are systemic ones. The management of such systemic risk requires the sharing of information. Neither the rating agencies, regulators, and even the academic and professional corps of financial economists have provided the collectives that would be needed to make this happen, nor did they demonstrate the sense of public service that would inspire the creation of a common knowledge.

The analogy that depicts financial products as toxic undoubtedly encourages reform. But the most needed changes that this comparison would suggest might also be the most ambitious and unrealistic of all.

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