

Working Paper

Research Division EU Integration
Stiftung Wissenschaft und Politik
German Institute for International
and Security Affairs



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The Negative Impact of Credit Rating Agencies and proposals for better regulation

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**Working Paper FG 1, 2012/Nr. 01, January 2012
SWP Berlin**

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1. Introduction

This paper analyses the ongoing reputational crisis of Credit Rating Agencies (CRAs) and asks if the CRAs are playing a credible role in Eurozone financial markets. The current crisis in the Eurozone supports the proposition of skepticism on the credibility of CRAs which did not properly disclose risk and thus contributed to pushing the global financial system to the verge of collapse. Politicians across the European Union have called for restrictions on the role of CRAs in rating sovereign debt and for increased regulation of CRAs. In the U.S. the credit ratings agencies hide behind the First Amendment. Their legal argument is that they cannot be held accountable because they are merely issuing “opinions”. The European Commission released an impact assessment with proposals on 15 November 2011 that would give European supervisory authorities the power to temporarily prevent the issuing of ratings on countries in “a crisis situation”. Investors would also gain a framework to take legal action against agencies “if they infringe intentionally or with gross negligence” on their obligations. A rating agency would also have to disclose information about its rating methodologies.¹

CRAs under increasing scrutiny

The European Commission says it wants to cut reliance on credit rating agencies, encourage more competition so there is less reliance on three major agencies - Moody's, Standard & Poor's and Fitch - and reduce potential conflicts of interest. The European Commission proposes to give the European Securities and Markets Authority (ESMA) powers to vet agencies' methodology and insist, in exceptional circumstances, such as bail-out talks, sovereign debt ratings should be suspended. The reform package marks the most aggressive attempt yet by Brussels to bridle an unpopular industry that some European leaders have blamed for aggravating the sovereign debt crisis with erratic and “subjective” rating decisions. Michel Barnier, the commissioner responsible for the proposal, is mounting a last-ditch attempt to increase the clout of regulators so that they can suspend any sovereign rating within the EU – a broad scope that applies to countries such as France and Italy in prescribed circumstances. European Commission impact assessment report echoes some of its concerns, including rating agencies amplifying “contagious effects” though “subjective biases”, and “arbitrary” downgrades that are poorly explained, triggering “significant investor over-reactions”. While some radical ideas – such as an EU rating agency – have been dropped, Brussels will propose measures that attack the business model of the big agencies and increases regulatory scrutiny of their analysis methods.

Several policy reports published during and following the financial crisis – e.g. the Financial Stability Forum (2008)²; suggest that credit

¹ http://ec.europa.eu/internal_market/securities/agencies/index_en.htm

² Financial Stability Board, Principles for Reducing Reliance on CRA Ratings, October 2010

rating agencies should implement the revised IOSCO Code of Conduct Fundamentals for Credit Rating Agencies to manage conflicts of interest in rating structured products and improve the quality of the rating process and differentiate ratings on structured credit products from those on bonds and expand the information they provide. The Issing Committee (2009)³ recommended that credit rating agencies would be required to deposit their rating assessments with the entrusted institution that would produce an official performance measurement of all internationally active agencies, in order to facilitate an inter-agency comparison of their predictive performance. These assessments should be disclosed to markets and investors. The De Larosière report (2009)⁴ stated that credit rating agencies should register and be supervised by the new authority in charge of securities, a strengthened version of the then CESR (Committee of European Securities Regulators). In a similar vein, the Turner Review (2009)⁵ exposed the risk of ‘structuring to rating’: that is, issuers design structures so as to just meet the relevant criteria. Since ratings are not infinitely granular, issuers can earn a systematic profit by just clearing the hurdle. According to the Financial Crisis Inquiry Commission “The failures of credit rating agencies were essential cogs in the wheel of financial destruction... This crisis could not have happened without the rating agencies. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms”.⁶ All the reports suggest that the role played by rating agencies in the structured finance market may have exacerbated the crisis.

Michel Barnier, European Commissioner for Internal Market and Services sought – and mostly failed – to make the raters more “transparent”. He wanted a role for European authorities in the credit ratings and wanted to make it easier for investors to sue the agencies but faced stiff opposition from other commissioners.⁷

Even before the financial crisis, CRAs were already coming under close scrutiny. Public authorities were acutely aware of the pivotal – and deepening – role played by rating agencies in the financial system and had observed several apparent failings. In particular, rating agencies had been criticised for their slowness to respond to the strains that ultimately gave rise to the Asian crisis in 1997 and 1998⁸, and the high-profile corporate failures of Enron, WorldCom and Parmalat.

Experience during the financial crisis has also heightened concerns that

³ New Financial Order / Recommendations by the Issing Committee / Preparing G-20 – London, April 2, 2009

⁴ De Larosière Report, High-Level Expert Group on EU Financial Supervision, European Commission, 25 February 2009

⁵ Financial Services Authority, The Turner Review, A regulatory response to the global banking crisis, March 2009

⁶ The Financial Crisis Inquiry Report”, Financial Crisis Inquiry Commission, January 2011

⁷ Christopher Caldwell, “An inconvenient truth: the power of moral suasion”, Financial Times, 10 December 2011

⁸ Ferri, G and Stiglitz, J (1999), ‘The procyclical role of rating agencies: evidence from the East Asian crisis’, Economic Notes, Vol. 29, Issue 3, November, pages 335–55

rating agencies' decisions may be subject to conflicts of interest. Since rating agency revenues are predominantly driven by rating fees earned from issuers, there is a concern that CRAs devote disproportionate resources to chasing new business and rating new products, rather than improving their analysis of existing instruments. Furthermore, the revenue incentives of a CRA are such that ratings may be biased upwards (inflated) so as to meet an issuer's expectations and thereby gain or keep its business.

CRAs are still trying to recover their reputations after their actions during the recent financial crisis; CRAs have also been the subject of controversy during the Eurozone sovereign debt crisis. They have been accused both of failing to predict the crisis, and then of precipitating it by downgrading the ratings of Eurozone sovereigns too far and too fast.

The agencies have faced severe criticism during the financial crisis, with Standard & Poor's erroneous downgrade of France recently causing the latest controversy. Standard & Poor's email went out on 10 November 2011 just before 4pm Paris time when the European markets were still open. Its "opinion" thrust a knife into "containment". The yield for France's 10-year bond jumped 25 basis points to 3.48% and the spread between 10-year French and German bonds hit 1.7%, a euro-era record. Standard & Poor's waited two hours to issue a correction, after the European markets had closed.

About \$6,000bn of debt issued in 2009 was given the top AAA rating; of that, about \$3,500bn was sovereign debt. That was a huge increase from a decade previously, when less than \$500bn of the \$2,000bn total of AAA was issued by governments. The ratings system provided a ready-made excuse for failure: as long as you were buying AAA-rated assets, you could say you're being responsible. After the subprime housing crash it was clear this was an illusion.

The growing importance of CRAs

CRAs as providers of opinions about the creditworthiness of companies and countries have become very important players in financial markets due to growth in Capital Markets, Credit Derivative Markets, Globalisation of Capital Markets; and an increase in Regulatory Use of Ratings. The call for 'risk management' eventually resulted in multi-level and multi-channel regulatory frameworks i.e. both 'legislation' and 'self-regulation'. CRAs actually impact both the 'supplier' and 'buyers' of credit. Any error in the credit rating process has an immediate and significant impact on buyers and sellers of credit. It also impacts the overall performance of the financial markets.

CRAs have been highly influential over the credit supply to firms and nations, yet are not held accountable for their actions. This has triggered the debate of the 'Accountability Gap' of CRAs which includes issues such as corporate failures, conflict of interest, lack of transparency and issuers' influence.

2. Background on Credit Rating Agencies

2.1. Definitions

Credit Rating Agencies (CRAs) may be simply defined as ‘specialists in providing information regarding bond creditworthiness’. Creditworthiness is ‘the likelihood that an issuer will default on the interest or principal due on its bonds’⁹. CRAs are thus commercial firms that assess the ability of companies, institutions and governments to service their debts. They do this by assigning credit ratings, typically in the form of a letter-grade scale, which symbolises the rating agency’s opinion, as of a specific date, of the creditworthiness of a particular company, security, or obligation. It is important to note that CRAs are not an absolute predictor of whether a particular debtor will default on a particular obligation, but is a subjective view regarding the creditworthiness of a company, security or obligation. The CRAs’ functions can be grouped under three general headings: (i) providing information and assessment for investors; (ii) enabling issuers to access capital markets; and (iii) helping regulators to regulate.

(i) Providing Information and Assessment for Investors

Credit rating agencies and the ratings that they supply are an invaluable information resource for investors. John Moody published the first publicly available bond ratings (mostly concerning railroad bonds) in 1909. Moody's firm¹⁰ was followed by Poor's Publishing Company in 1916, the Standard Statistics Company in 1922,¹¹ and the Fitch Publishing Company in 1924¹².

These firms sold their bond ratings to bond investors in thick rating manuals. In the language of modern corporate strategy, their "business model" was one of "investor pays." They play the critical role of determining the credit quality of debt securities which would otherwise need to be undertaken by prospective bond investors themselves. Credit quality is primarily determined by the expected loss of the security (the product of its expected default rate and expected loss severity), but can include many other dimensions such as financial strength and transition risk so that ‘bonds with the same credit rating may be comparable with respect to overall credit quality, but may differ with respect to specific credit quality characteristics’¹³.

⁹ The Economist, “Special Report: Who Rates the Raters?” London, March 26 2005, Vol. 374, Iss. 8419, p.91

¹⁰ Dun & Bradstreet bought Moody's firm in 1962; subsequently, in 2000, Dun & Bradstreet spun off Moody's as a free-standing corporation.

¹¹ Poor's and Standard merged in 1941 to form S&P; S&P was absorbed by McGraw-Hill in 1966.

¹² Fitch merged with IBCA (a British firm that was owned by French business services conglomerate FIMILAC) in 1997.

¹³ Richard Cantor (2001), ‘Moody’s investors service response to the consultative paper issued by the Basel Committee on Bank Supervision “A New Capital Adequacy Framework”, Journal of Banking and Finance, vol. 25, p.175

(ii) Enabling Issuers to Access the Capital Markets

Whilst the origins of the credit rating agencies industry were such that investors paid for the ratings assigned by agencies, it is now the case that the leading credit rating agencies all receive their revenues from the issuers of securities. Issuers paid credit rating agencies to evaluate their creditworthiness and assign them ratings because this effectively certifies the financial products of the issuer, giving them access to a ready market of investors.

Each rating mandate lasts for several years while the credit rating agency monitors the issuer. In this way, rating agencies can provide issuers with access to more financial market segments and cheaper costs of borrowing than permitted by traditional bank lending. This allows issuers to structure their financing in a more efficient manner across a range of loans, bonds, commercial papers, bank deposits and insurance claims, allowing the issuer to minimise its cost of capital. In theory, credit rating agencies also attempt to minimise abrupt changes in rating levels and ensure that rating decisions are ‘time-invariant’, incorporating the vulnerabilities of issuers to cyclical economic conditions. This minimises the negative impact on an issuer’s cost of borrowing which accompanies rating downgrades. The rating decision is only adjusted in the event of significant changes in the client’s financial situation which mean that the rating action is unlikely to be reviewed within a relatively short period of time.

(iii) Helping Regulators to Regulate

Rating agencies are also important from a regulatory perspective. Over recent decades, regulators have increasingly used credit ratings to help monitor the risk of investments held by regulated entities, and to provide a suitable disclosure framework for securities of differing risks. Since 1975, the US Securities and Exchanges Commission (SEC) have relied upon ratings by market recognised credit rating agencies to distinguish between grades of creditworthiness in various regulations under US federal securities laws. These were labelled, ‘nationally recognised statistical rating organisations’ (NRSROs).

Ratings by NRSROs are now widely used in rules issued by financial and other regulators, regulatory schemes in many countries around the world, and private financial contracts. For instance, mutual funds and government-run pension funds are often restricted to investing in only certain grades of bonds, typically excluding those rated as ‘junk’ (below BBB). Others have internal rules that prevent them from buying more than five to ten percent of unrated debt. Credit rating agencies’ judgements define a globally uniform benchmark for credit risk and this also makes them an attractive reference for international regulatory standards, a reason that the Bank for International Settlements (BIS) decided to use them in Basel 2 to calculate banks’ regulatory risk capital.

The UK’s Financial Services Authority’s (FSA) Chief Executive, Hector Sants commented that credit ratings “have become very deeply embedded

in the regulatory architecture, so when they change they have knock-on effects across the board in terms of the way companies can fund themselves"¹⁴. In the Turner Report, the FSA made clear its conviction that regulatory change was required in order to improve the "governance and conduct of rating agencies and the management of conflict of interest"¹⁵. Similar actions were taken forward in the wider international community. The Financial Stability Board, founded by the G20 in 2009 to promote financial stability, produced a report calling on governments to act to reduce the markets' reliance on ratings in standards, laws and regulations.¹⁶

2.2. Criticisms of CRAs

Notwithstanding the useful functions that CRAs provide, a number of criticisms have been made of them.

(i) Lack of Competition

The financial ratings industry is dominated by Standard and Poor's and Moody's, both in the US and worldwide. It constitutes a duopoly, or at best, an oligopoly if Fitch is included, with the leading agencies able to charge issuers substantial fees. Since two ratings are normally needed to issue rated debt the two major firms do not compete with each other.

High ratings given to low-quality assets, particularly those based on risky mortgages, have been criticised by authorities around the world for contributing to the credit market bubbles that have collapsed in the crisis.¹⁷ Henry Waxman, chairman of the US House of Representatives oversight committee cited internal documents obtained from Moody's and Standard & Poor's which, he said, showed they were clearly aware of the problem of conflict of interest.¹⁸

"If the industry adopted an alternative business model in which investors rather than issuers pay for ratings, this would not relieve the perceived conflict - it would only shift it," said Mr McDaniel of Moody's. An "investor-pays" model would give preferential information for bigger and wealthier investors. Ratings agencies have been blamed for contributing to financial turbulence by underestimating the risks attached to the mainly mortgage-related bonds at the heart of the credit crisis.¹⁹

Henry Waxman said the agencies were wrong to insist that the massive downgrades of mortgage-based and other assets during the financial crisis

¹⁴House of Commons, Treasury Select Committee, Banking Crisis: reforming corporate governance and pay in the City, 12 May 2009

¹⁵ Financial Services Authority, The Turner Review, A regulatory response to the global banking crisis, March 2009, p78

¹⁶ Financial Stability Board, Principles for Reducing Reliance on CRA Ratings, October 2010

¹⁷ Financial Times, "Rating bodies broke bond of trust", October 23 2008

¹⁸House of Commons, Treasury Committee, Banking Crisis: reforming corporate governance and pay in the City, 12 May 2009

¹⁹ibid

were unforeseeable. Questioning executives from the three leading ratings agencies, Moody's, Standard & Poor's and Fitch, Mr Waxman said: "The credit rating agencies occupy a special place in our financial markets. The ratings agencies broke this bond of trust".²⁰

The committee released a copy of an internal presentation from Raymond McDaniel, chief executive at Moody's, to directors at the company in October 2007. Under part of the presentation entitled "conflict of interest", a section marked "Market Share" says the entry of the Fitch agency into an industry previously dominated by Moody's and Standard & Poor's had created competition that put downward pressure on ratings quality. Stephen Joynt, President and Chief Executive Officer of Fitch Ratings, accepted that some "investors may have relied on ratings to be all-encompassing, not reflecting as carefully on the risks that they did not cover".²¹

The rating agencies Standard & Poor's, Moody's and Fitch played starring roles in the failure of finance. The further entrenchment of their dominance comes thanks to the Federal Reserve. The Fed's lending programmes, such as its commercial-paper facility and the Term Asset-Backed Securities Loan Facility (TALF), accept only collateral that has been appraised by a "major" rating agency, i.e., one of the big three. This marks a setback for the rating firms that have been recognised by the Securities and Exchange Commission (SEC) such as Egan-Jones. It also sets the Federal Reserve in conflict with the SEC, which introduced reforms in 2006 to promote competition by speeding up the approval process for rating agencies.²²

The Federal Reserve has promised to consider expanding the list of eligible raters, but Ben Bernanke, its chairman, recently said he was "comfortable" with the big three's revamped ratings models. Their rewards could be handsome: up to \$400m in TALF-related fees alone, reckons Richard Blumenthal, Connecticut's attorney-general. He has launched an antitrust probe and accuses the Fed of "rewarding the same companies that helped burn down the house". Keen to restore securitisation's credibility, Wall Street's main trade groups, too, want the TALF opened up to smaller rating agencies.²³

(ii) Lack of Accountability

It has been shown that CRAs wield enormous power as gatekeepers to financial markets for companies and as a primary assessment tool for investors. However, while rating decisions are ostensibly based on fixed, documented standards, agencies themselves admit that their evaluations are essentially opinions and cannot be verified in courts. The assignment of a certain issuer to a rating category is consequently based on non-

²⁰ Financial Times, "Rating bodies broke bond of trust", October 23 2008

²¹ House of Commons, Treasury Committee, Banking Crisis: reforming corporate governance and pay in the City, 12 May 2009

²² The Economist, "The wages of sin" 23 April 2009

²³ *ibid*

verifiable, non-auditable information with the issuer allowed no legal recourse.

The CRAs have been severely criticised for their lack of diligence and for their bad decisions during the last few years. The collapse of corporate giants triggered a series of examinations on the role and credibility of the CRAs²⁴.

No one has been more wrong than CRAs. They put the insurance giant American International Group (A.I.G.) in the AA category. They rated Lehman Brothers an A just a month before it collapsed. The CRAs maintained AAA ratings on thousands of nearly worthless subprime-related securities. The reason for this continued reliance on ratings is simple: bad regulation.²⁵

As more regulators and institutions rely on ratings, the CRAs have become increasingly reluctant to downgrade. Even a one-notch downgrade of A.I.G. before it hit the crisis would have saddled it with an extra \$8 billion of obligations. It is no coincidence that when US government officials were debating the fourth round of A.I.G. bailouts in 2009, they quietly called on the rating agencies to ensure that they would not downgrade the insurer. In a crisis, downgrading debt can be like firing a bullet into a company's heart.²⁶

It is of course argued that this was an unfortunate aberration, and that the ability of the agencies to rate conventional bonds is unaffected. But corporate defaults are only getting started this time round, so we shall see about that. The answer to all this is for the regulatory tie to be severed, and for investors to pay for ratings as they please and from whoever they please, rather than from a sanctioned handful. It is doubtful that will happen. But these are difficult times. If the authorities want to sort the whole sorry mess out, they will never have a better opportunity²⁷.

"Potential conflicts exist regardless of who pays. The key is how well the rating agencies manage the potential conflicts." Mr. McDaniel and the other executives present - Deven Sharma, of Standard and Poor's, and Stephen Joynt, of Fitch Ratings - said their companies were co-operating with reviews of the agencies' performance by the Securities and Exchange Commission and other authorities. But they stressed that many parts of the financial system had underperformed, and said it was disproportionate to blame the ratings agencies for their role.²⁸

(iii) Lack of Independent CRAs

CRAs assert that their independence is crucial to their role. The main CRAs do not meet this criterion for independence and have consequently received criticism that they have an entrenched conflict of interest, the

²⁴ Why Ratings Are Failing Us, By Sean Egan, Newsweek, May 25, 2009

²⁵ Jerome Fons & Frank Partnoy "Rated F for Failure", New York Times, 16 March 2009

²⁶ *ibid*

²⁷ Financial Times, "Is writing on the wall for agencies' regulatory ties?" 2 March 2009

²⁸ House of Commons, Treasury Committee, Banking Crisis: reforming corporate governance and pay in the City, 12 May 2009

issuer pays conflict. There is a difference between solicited and unsolicited ratings, arguing that agencies that provide solicited ratings may have an incentive to give a higher rating. This is because an issuer who is pleased with a high rating might be more likely to become a subscriber and pay for future (solicited) ratings. Policies such as advising clients on the impact of different management strategies on the firm's rating assignment further weaken the independence of the main CRAs.

(iv) Lack of Timeliness and Procyclical Behaviour

CRAs have been criticised for not providing credit ratings on a timely basis. During the East Asia Crisis in 1997 CRAs were criticised for not providing any early warning signals, but simply following the majority opinion of market participants and responding to the crisis by revising ratings too far too quickly (e.g. South Korea was downgraded by three notches by S&P in a single day).²⁹ This has led to criticisms of CRAs behaving procyclically, causing credit crunches in times of crisis.

The failure of the credit rating agencies to challenge the fundamental assumptions on which their assessment of the sustainability of sovereign debt in the Eurozone was based meant there was inadequate differentiation between the sovereign debts of individual countries. Credit rating agencies were not alone in failing to fully understand the extent of the problems developing in certain member states, but this does not absolve their failure to assess properly the financial health of certain Eurozone member states in the run-up to the sovereign debt crisis.³⁰

(v) Rating Triggers

CRAs have created a vicious cycle for obligors and for the whole industry. By virtue of 'rating triggers' they can, at any time, downgrade a company's or country's rating thus causing an increase in financial cost and demotion in creditworthiness. The rating triggers cause an acute liquidity problem for the obligor and a quick downfall in investor's confidence. In case of any major downgrade, the long term bonds become due immediately and low solvency firms fall trap to forced bankruptcy. The collapse of Enron, for example, was a direct result of 'Rating Triggers'. Though it is claimed by CRAs that such rating triggers keep the obligors on track and committed to their obligation, they have been criticised for abusing these powers. This issue has created demand for greater disclosures on accuracy and validity of "Rating Triggers" and their potential impact on companies and countries as observed in the Eurozone recently.

Critics have also suggested that the CRAs have released ratings at inappropriate times without considering the potential impact of their decisions, or waiting for key policy decisions to be taken. In April 2010, for example, S&P decided to downgrade Greece's credit rating to BB+, below

²⁹ Financial Times, "South Korea: Credit rating agencies under fire" 12 December 1997

³⁰ House of Lords European Union Committee, "Sovereign Credit Ratings: Shooting the Messenger?", July 2011

investment grade, shortly before a financial assistance package was due to be agreed with Eurozone member states and the IMF. Dr Wolf Klinz MEP explained his reservations about the CRAs' behaviour: "the rating agencies on the one hand smooth their ratings over a long period of time and they hold on to a specific rating far longer than really justified ... and then all of a sudden, and particularly a few days before very decisive meetings, they start downgrading. ... Of course this is worsening the situation".³¹

Rather than properly assessing the risk of sovereign default and taking a longer-term view, CRAs are simply reflecting the views of the markets at a time when turbulence is making the financial markets' judgement unreliable. Lorenzo Bini Smaghi, then member of the ECB Executive Board, suggested in a speech that some of the downward revisions of sovereign ratings "were not based on macroeconomic data or new budgets, but on the assessments given by the market for sovereign bonds and the possibility of contagion". He was echoed by Dominique Strauss-Kahn, then Managing Director of the IMF, who noted that rating agencies "are reflecting what they are collecting in the market. One should not believe too much what they say, even if they are useful"³².

Investors and politicians agree on one thing: the agencies' business model, where the rated entity – including countries – pays the agency for an opinion, bears heavy conflicts of interest. The Financial Stability Board has published a thoughtful report, which noted that there are significant dangers in the current system.³³ In particular, the way that ratings are "hardwired" into numerous regulatory and investment judgments, means that changes in ratings tend to cause a "herding" effect, because small shifts in a rating can prompt an avalanche of sales, worsening a bad situation.

2.3 Did Credit Rating Agencies trigger the Financial Crisis?

The recent US Congressional Report found Moody's and Standard and Poor's triggered the worst financial crisis in decades when they were forced to downgrade the inflated ratings they slapped on complex mortgage-backed securities.³⁴ In one of the starkest condemnations of the credit rating agencies³⁵, a Senate investigations panel said the agencies continued to give top ratings to mortgage-backed securities months after the housing market started to collapse.³⁶

³¹ House of Lords European Union Committee, "Sovereign Credit Ratings: Shooting the Messenger?", July 2011

³² *ibid*

³³ Financial Stability Board, Principles for Reducing Reliance on CRA Ratings, October 2010

³⁴ "The Financial Crisis Inquiry Report 2011" The Financial Crisis Inquiry Commission

³⁵ Frank Partnoy, "Overdependence on Credit Ratings was a Primary Cause of the Crisis", University of San Diego School of Law Legal Studies Research Paper Series No. 09-015 July 2009

³⁶ Huffington Post, Credit Rating Agencies Triggered Financial Crisis, U.S. Congressional Report Finds April 13, 2011

The findings come after the Senate's Permanent Subcommittee on Investigations members reviewed countless documents and held hearings on the causes of the crisis. The probe only focused on the two largest rating agencies; it did not study Fitch Ratings. The report called for radical reforms to the industry that are authorized in the Dodd-Frank financial reform law, but may not be realized. The US regulatory environment has not changed the inherent conflict of interest in credit raters' business model, in which the raters are paid by the companies whose products they rate. The panel's suggested reforms include having the US Securities and Exchange Commission rank the credit raters, based on the accuracy of their ratings.³⁷

Although ratings downgrades for investment grade securities are supposed to be relatively infrequent, in 2007, they took place on a massive scale that was unprecedented in US financial markets. Beginning in July 2007, Moody's and S&P downgraded hundreds and then thousands of Residential mortgage-backed securities (RMBS) and Collateralized debt obligations (CDO) ratings, causing the rated securities to lose value and become much more difficult to sell, and leading to the subsequent collapse of the RMBS and CDO secondary markets. The massive downgrades made it clear that the original ratings were not only deeply flawed, but the US mortgage market was much riskier than previously portrayed.³⁸

Housing prices peaked in 2006. In late 2006, as the increase in housing prices slowed or leveled out, refinancing became more difficult, and delinquencies in subprime residential mortgages began to multiply. By January 2007, nearly 10% of all subprime loans were delinquent, a 68% increase from January 2006. Housing prices then began to decline, exposing more borrowers who had purchased homes that they could not afford and could no longer refinance. Subprime lenders also began to close their doors, which the US Department of Housing and Urban Development marked as the beginning of economic trouble.

The timing of this surge of new ratings on the eve of the mass downgrades is troubling, and raises serious questions about whether S&P and Moody's quickly pushed these ratings through to avoid losing revenues before the mass downgrades began. This volume of rating downgrades was unprecedented in US financial markets.³⁹ The downgrades created significant turmoil in the securitization markets, as investors were required to sell off RMBS and CDO securities that had lost their investment grade status. RMBS and CDO securities in the investment portfolios of financial firms lost much of their value, and new securitizations were unable to find investors. The subprime RMBS secondary market initially

³⁷ United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs' "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse" April 13, 2011

³⁸ *ibid*

³⁹ United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs' "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse" April 13, 2011

froze and then collapsed, leaving financial firms around the world holding suddenly unmarketable subprime RMBS securities that were plummeting in value.⁴⁰

Neither Moody's nor S&P produced any meaningful documentation explaining their decisions to issue mass downgrades in July 2007, disclosing how the mass downgrades by the two companies happened to occur two days apart, or analyzing the possible impact of their actions on the financial markets. When Moody's CEO, Raymond McDaniel, was asked about the July downgrades, he indicated that he could not recall any aspect of the decision-making process. He told the Subcommittee that he was merely informed that the downgrades would occur, but was not personally involved in the decision.⁴¹

The US Senate panel released internal documents showing how Moody's and S&P failed to heed their own internal warnings about the deteriorating mortgage market. Emails in 2006 and early 2007 show employees were aware of housing market troubles, well before the massive downgrades in July 2007.

"This is like watching a hurricane from Florida moving up the coast slowly towards us. Not sure if we will get hit in full or get trounced a bit or escape without severe damage ..." one S&P employee wrote in response to an article on the mortgage mess. Senate investigators concluded that had Moody's and S&P heeded their own warnings; they might have issued more conservative ratings for the securities linked to shoddy mortgages. The problem, however, was that neither company had a financial incentive to assign tougher credit ratings to the very securities that for a short while increased their revenues, boosted their stock prices, and expanded their executive compensation," the report said.⁴²

3. The Credit Rating Oligopoly

In the US, the Securities and Exchange Commission (SEC), an organization that regulates which companies are "nationally recognized securities rating organizations" (NRSRO), has never allowed more than five companies to be recognized at one time since the industry began in the 1920s⁴³. Moody's Investors Service and the Standard & Poor's Division of the McGraw-Hill Companies, Inc. and Fitch Ratings, Inc. are three major players.

⁴⁰ *ibid*

⁴¹ *ibid*

⁴² United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs' "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse" April 13, 2011

⁴³ Lawrence J. White, "Good Intentions Gone Awry: A Policy Analysis of the Sec's Regulation of the Bond Rating Industry", NYU Working Paper No. EC-05-16, 2005

3.1 How does the Oligopoly Continue to Exist?

The rating industry is known as an oligopoly, because there are only three significant credit rating agencies. According to Lawrence White of New York University, the cause of this oligopoly can be attributed to two reasons. First, it is quite clear that “regulation...is currently limiting entry”⁴⁴ derived from the fact that the SEC admitted no company into the NRSRO between 1991 and 2003⁴⁵. Also limiting entry is the need for a strong reputation in credit rating agencies: the three incumbent companies have existed longest, making it difficult for new companies (with less experience) to enter the field. In an industry run by an oligopoly, perfect competition does not exist. Because each company has a large share of the market, it is assumed that they have market power, a situation “[where] one or more of the participants has the ability to influence the price or other outcomes in some general or specialized market”.⁴⁶ Because the industry is characterized by imperfect competition due to oligopoly, the oligopolists have the ability to take advantage of the market.

Although poor policies and procedures are an appealing political target, requiring the agencies to file forms with even lower-paid regulators would not have prevented the crisis. Indeed, increased scrutiny would reinforce the oligopoly dominated by Moody’s and Standard & Poor’s. By making compliance more costly, regulators would increase the barriers to operating a rating agency and deter new competitors.⁴⁷

3.2 Market Power in the Hands of the Incumbent Agencies and Collusion

S&P and Moody’s have an enormous share of the market and both companies together could easily control the market. Curiously, the companies have not, so far as we know, engaged in collusion. This could be due to a kinked demand curve “at the point where the price paid just offsets the reduction in issuance costs. But this kink would have to be uniform for all issuers and to be present just above 3.25 basis points for the current schedule to be a maximizing one. This is possible, but seems unlikely”⁴⁸. Another possibility involves tacit collusion. One company may fear that if it “raises [its] price, [its] rivals will refuse to reciprocate and will steal a substantial number of [its] customers, leading to a large fall in sales.” In other words, “Its perceived demand (given it fears that the other will not “cooperate” in a price increase) may be quite elastic”.⁴⁹

"The best balance-sheet snoops are often way ahead of the pack in find-

⁴⁴ Lawrence J. White, “The Credit Rating Industry: An Industrial Organization Analysis”, NYU Center for Law and Business Research Paper No 01-001, February 2001

⁴⁵ Note that after the industry was under suspicion for moral hazard behavior, the SEC began admitting more NRSROs: one in 2003 and one in 2005

⁴⁶ “Market Power”, Investor Dictionary

⁴⁷ Frank Partnoy, “Do away with rating-based rules”, 9 July 2008

⁴⁸ Lawrence J. White, “Markets -The Credit Rating Agencies”, *Journal of Economic Perspectives*—Volume 24, Number 2, spring 2010, Pages 211–226

⁴⁹ *ibid*

ing signs of trouble. Sometimes, however, the big credit-rating firms, Standard & Poor's and Moody's, which get paid by the companies they rate, are slow off the mark slower, as a rule, than independent bond-rating services like Egan-Jones.

Egan-Jones was the first US rating agency to downgrade the country's sovereign credit rating from AAA to AA+ as it focused on the rapid rise in outstanding debt over the past five years. Egan-Jones was officially recognised in 2008 by the Securities and Exchange Commission and, unlike its larger rivals, generates revenue from institutional investors and not from issuers of debt. During the past decade it downgraded US carmakers and structured credit products before similar decisions by the big rating agencies.⁵⁰

3.3 Moral Hazard Behaviour in the Credit Rating Industry

European Union leaders have expressed concern about the oligopolistic nature of the credit rating market, and suggested that greater competition is needed in the industry.⁵¹ The German Finance Minister, Wolfgang Schäuble, stated in July 2011 for example that he wanted “to break the oligopoly of the rating agencies”.⁵² There is also due suspicion of moral hazard in this oligopoly in terms of high profits. Credit rating agencies receive their money from issuers of securities. They say that they will make all ratings public, whether or not the issuer wants a rating. “If the issuer does not request a rating, then the rating firm will simply do the rating on the basis of publicly available information”.⁵³ This is a small threat to force bond issuers to pay a one-time fee in order to have the “privilege” of giving the rating company all the information it needs to make a well-balanced decision. In terms of moral hazard behaviour, “a rating firm might offer to improve an issuer's rating in return for a higher fee. Or it might threaten that an unsolicited rating would be substantially lower than a requested (fee-based) rating”.⁵⁴ Whether or not these companies are engaging in moral hazard behaviour is unknown, but activities in the past have aroused much suspicion. A prime example of this is the failure of the three major ratings agencies to flag up problems at Enron, WorldCom and Parmalat in 2001.

3.4 The EU and China: New Market Entrants?

The EU, trying to calm the turbulence that is threatening the stability of

⁵⁰ Andrew Ackerman and Mark Taylor, "Rater Egan-Jones Cuts U.S. Debt," Wall Street Journal, 18 July 2011.

⁵¹ House of Lords European Union Committee, "Sovereign Credit Ratings: Shooting the Messenger?", July 2011

⁵² Financial Times, "Finance: Arbiters under fire", 25 July 2011

⁵³ Lawrence J. White, "Markets -The Credit Rating Agencies", Journal of Economic Perspectives—Volume 24, Number 2, spring 2010, Pages 211–226

⁵⁴ *ibid*

the Euro, has introduced legislation to curb what it sees as the excessive powers of the agencies to influence the markets.⁵⁵ It wants to encourage more competition for the big three agencies, increase transparency over how ratings are assessed and examine new models as to how agencies can be paid. There has been some support for the EU to fund, or encourage, some type of European credit rating agency, both to increase competition in the sector and to combat the perceived US bias of the 'big three' rating agencies. A number of ideas have been suggested. One idea is the establishment of a European Credit Rating Agency, whose start-up costs could be "wholly or partially covered by the public sector" although over time "public investment could be phased out".⁵⁶ One way of doing this would be to create a part publicly-funded pan-European independent agency. The European Commission did not include the European Parliament's request to conduct a detailed impact assessment on the establishment of an independent and autonomous European Credit Rating Foundation to foster competition.⁵⁷

The thinking goes that if there were more than the existing three dominant global players of Moody's, Fitch and Standard & Poor's, one single rating would hold less significance. It is fair to ask how independent of Wall Street or the US governments are the Big Three. There is a need for independence to ensure credibility of ratings.

China's leading credit rating agency Dagong used its first foray into sovereign debt to give much greater weight to "wealth creating capacity" and foreign reserves than Fitch, Standard & Poor's, or Moody's. In their ratings report the US dropped to AA, while Britain and France dropped down to AA-. Belgium, Spain, Italy were ranked at A- along with Malaysia. Meanwhile, China rise to AA+ with Germany, the Netherlands and Canada. Dagong rates Norway, Denmark, Switzerland, and Singapore at AAA, along with the commodity twins Australia and New Zealand. Dagong said it wanted to break the big three Western rating agency monopoly and "win the right for financial pricing in the process of Renminbi internationalization".⁵⁸ Dagong also condemned its Western rivals as "politicised and highly ideological" and called for China to have more influence in the worldwide ratings ascribed to various countries' sovereign debts. "The rating agencies didn't properly disclose risk and this brought the entire US financial system to the verge of collapse".⁵⁹

⁵⁵ A general introduction and the regulation and directive proposed by the European Commission can be accessed through http://ec.europa.eu/internal_market/securities/agencies/index_en.htm

⁵⁶ Wolf Klinz, a member of the European Parliament for the FDP, believes he has found the solution. He proposes that the new European rating agency be set up as a foundation, which would grant it financial and political independence. Klinz presented the idea late last year on behalf of the European Parliament's Economic and Monetary Affairs Committee.

⁵⁷ "Credit rating agencies: Future perspectives", European Parliament Committee on Economic and Monetary Affairs report, 23 March 2011

⁵⁸ <http://www.dagongcredit.com>

⁵⁹ Financial Times, "China rating agency condemns rivals", 22 July 2010

The failure of the credit rating agencies to challenge the fundamental assumptions on which their assessment of the sustainability of sovereign debt in the Eurozone was based meant there was inadequate differentiation between the sovereign debts of individual countries. The CRAs were not alone in failing to fully understand the extent of the problems developing in certain member states, but this does not absolve their failure to assess properly the financial health of certain Eurozone member states in the run-up to the sovereign debt crisis.

Rating agencies with a background in developing economies may develop a different approach towards ratings. They have opted for a very different approach, which is to emphasise future growth as opposed to existing wealth and existing ability to pay debt". Dagong's approach to sovereign debt ratings showed "that different judgments can be made" and may also suggest "that others from different power blocs may produce new ratings.

4. Conclusion

The financial and the sovereign debt crisis have drawn considerable attention to the role of CRAs in the financial system. The rating agencies were criticised after the banking collapse in 2008 for the failure of rating correctly certain financial products, contributing to the severity of the collapse. With their reputations yet to recover, they have now been accused of precipitating and exacerbating the Eurozone crisis by downgrading the sovereign ratings of Greece, Ireland and Portugal too far and too fast. This debate accelerated with Standard and Poor's downgrade of France, Austria and other Eurozone member states as well as of the EFSF in January 2012. Politicians across the EU have called for increased regulation and suggested that the oligopoly of the three major rating agencies should be challenged by the promotion or creation of a European credit rating agency.

The valid charge against the rating agencies is that they failed to challenge the assumptions upon which their assessment of the sustainability of sovereign debt was based in the years running up to the crisis. They thus failed to identify risks in some Eurozone states which began building long before the crisis hit.

On 5 December 2011 Standard & Poor's put 15 Eurozone member states onto negative credit watch, a move which normally means that there is a 50% chance of a credit rating downgrade within 90 days. S&P suggested that all non-AAA rated countries together with France could be subject to a two notch downgrade. S&P said the move was "prompted by [the] belief that systemic stresses in the Eurozone have risen in recent weeks to the extent that they now put downward pressure on the credit standing of the Euro zone as a whole".⁶⁰ On 6 December 2011 Standard & Poor's then put the Eurozone's rescue fund, the European Financial Stability Facility, on

⁶⁰ "Brussels plans radical sanctions for euro sinners", The Guardian, 6 December 2011

watch. Those placed on “negative credit watch” include all of the currency union’s remaining triple-A rated sovereigns: Germany, France, Austria, Finland, the Netherlands and Luxembourg. S&P cited rising “systemic stress” due to an “approaching recession”, a dysfunctional political process and a bank credit crunch, with the agency estimating that Eurozone banks will see €205bn (£131bn) of their debt mature in the first quarter of next year.

There is a need to strengthen the accuracy of credit ratings and reduce systemic risk. First, there is a need for a regulatory authority to rank them in terms of performance, in particular the accuracy of their ratings. Second, regulatory authorities need to facilitate the ability of investors to hold credit rating agencies accountable in civil lawsuits for inflated credit ratings, when a credit rating agency knowingly or recklessly fails to conduct a reasonable investigation of the rated security. Third, regulatory authorities need to ensure credit rating agencies institute internal controls, credit rating methodologies, and employee conflict of interest safeguards that advance rating accuracy. Fourth, the regulators should use their inspection, examination, and regulatory authority to ensure credit rating agencies assign higher risk to financial instruments whose performance cannot be reliably predicted due to their novelty or complexity, or that rely on assets from parties with a record for issuing poor quality assets. Finally, regulators should reduce a government’s reliance on privately issued credit ratings.