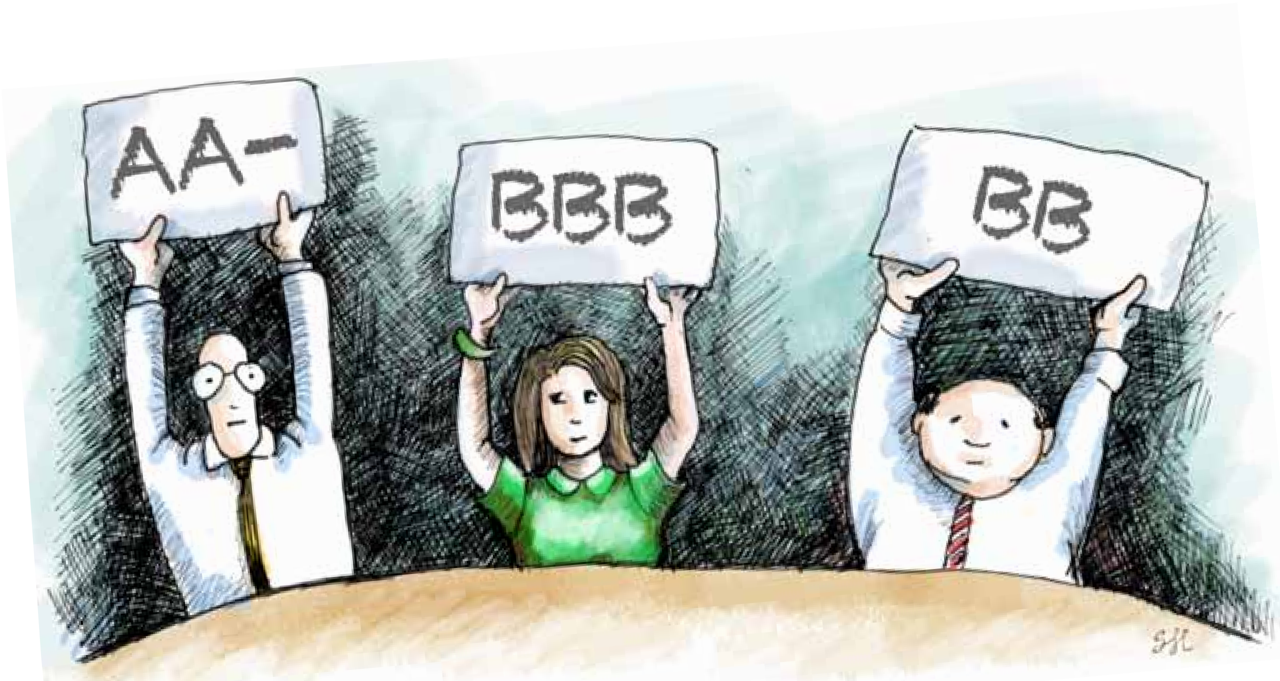


# RATINGS GAME

Panayotis Gavras

**Private credit rating agencies have been thrust into providing a public function because regulators have not come up with an alternative**

CREDIT rating agencies have become an essential part of the financial landscape. These private companies assess credit risk for companies and governments seeking to take out loans and issue fixed-income securities, such as bonds. Reliance on these agencies is so entrenched that prospective borrowers often must obtain a credit rating before they try to raise money in capital markets. The ratings provide prospective lenders with guidance on the borrower's creditworthiness, which contributes to the determination of the interest rate, or price, the borrower must pay for financing.

But these private rating agencies' assessments, which are designed for private financial markets, have been inserted into the public domain—regulators across the globe use them, for example, to assess the riskiness of bank portfolios and determine how much capital institutions must hold to guard against insolvency. With regulators' growing emphasis on risk as the basis of capital adequacy, the credit rating agencies' assessment of that risk has, in effect, been turned into a public good.

Putting credit rating agencies—mainly Standard & Poor's, Moody's, and Fitch (see Box 1)—into the public regulatory domain has had two consequences. First, it changed the nature of banking regulation from reliance on static, fixed percentages to use of dynamic scores that can change according to a rating agency's assessment of credit risk. This introduced greater sophistication, but also greater complexity and the possibility of incorrect, outdated, or otherwise misleading risk assessments. Second, it led to the entrenchment of private entities in regulation—a domain normally reserved for the public sector. Most discussion of rating agencies has focused on conflict of interest and other problems as they relate to assessment quality. Far less has been said about the potential for a serious conflict of interest between the objectives of privately owned credit rating agencies seeking to maximize shareholder value and the objectives of the regulatory role they play, even if they did not seek that role.

As authorities reexamine the regulatory and supervisory failures during the run-up to the global crisis, they must look at the reliance on credit rating agencies. Although any assessment must take into account the costs of making changes, there are a variety of potential paths—including reforming the rating agencies, bringing them under public control, or finding alternatives to them.

## Evolution of credit ratings

As financial markets grew increasingly complex, borrowing opportunities expanded dramatically and the ability of a lender to obtain full information about potential borrowers became ever more difficult. Through economies of scale, rating agencies are able to offer cost-effective information services that narrow the gap between what an investor knows about a borrower and what the borrower knows, assigning each borrower a grade, called a rating. By narrowing such information asymmetries between borrowers and lenders, agencies promote liquidity in markets, increasing financial activity and reducing costs. Borrowers with higher (that is, better) credit ratings typically enjoy greater and easier access to financing at lower cost, because they are deemed less risky and more likely to repay in full what they owe, including interest. Frequently, ratings represent the initial reference point in the due diligence process.

Although credit rating agencies are private firms, their role in financial regulatory frameworks has expanded since the 1970s—especially as a result of an international agreement to assess bank portfolios based on the risk of their assets and set capital requirements accordingly. This so-called Basel II Accord sought to add nuance to regulatory standards (see Box 2). A key justification for the incorporation of rating agencies' credit assessments was the belief that they offered a more sophisticated approach to measuring credit risk than did the simpler regulatory practice of basing capital requirements on a fixed percentage of total assets—the approach in the earlier Basel I Accord, which allowed for much less differentiation.

## Hardwired

The postcrisis debate over the role of credit rating agencies in financial regulation has focused primarily on issues such as conflict of interest and adequacy of performance. Among the questions are how the rating agencies assign ratings, what they rate, and whether ratings fueled the precrisis lending boom and resulting asset bubbles and provoked an opposite and pernicious effect after the crisis. These are valid concerns, but they also underscore how credit rating agencies have become an essential part of the financial system—"hardwired" if you will, in such a way that they take the place of due diligence rather than supplement informed decision making (BIS, 2009). This hardwiring results, in part, from the investment strategies of banks, investment funds, and other private entities. Primarily, though, it stems from credit rating agencies' institutionalized role in public policy activities—chiefly in banking regulation, but also in areas such as determination of the eligibility of collateral in central bank operations and investment decisions of publicly controlled or operated funds, such as pension funds.

The use of agency ratings in financial regulation amounts both to privatization of the regulatory process—inherently a government responsibility—and to abdication by government of one of its key duties in order to obtain purported benefits such as lower regulation costs and greater efficiency and nuance.

## A form of government failure

This surrender of regulatory responsibility to private agencies can be considered a form of government failure because the state in effect transfers regulatory authority to private firms but retains responsibility for the overall outcome. This approach is problematic for a number of reasons:

• Credit rating agencies aim to maximize profits and shareholder value. Although they have a powerful incentive to provide trustworthy information, they do not have the same mandate as a regulatory agency charged with providing information in the interest of the public. When the private motive and the public imperative are not fully compatible, there is potential for conflict and confusion. One or both may suffer. If the public imperative suffers, it undermines the credibility of the regulatory process.

• The licensing and regulation of credit rating agencies have been astonishingly limited (Katz, Salinas, and Stephanou, 2009). Agencies are selected mainly because of market recognition, rather than codified regulatory requirements or licensing. Systems of assessment and validation of methodologies used, processes for authorization of the rating agencies, and monitoring systems to ensure accountability have been weak—cursory at best.

• Even if a rating agency enjoys an excellent track record, the credibility of the regulatory process risks erosion because ratings are inherently fallible; they depend on judgments. In the marketplace, if a credit rating agency crosses a threshold of unreliability, it will lose customers and eventually fail. However, if it is part of the regulatory framework, its mistakes may have severe implications, and even if a poor performer can eventually be removed, how can a credit rating agency fail as long as it is part of the regulatory framework? Who will be liable if the agency's opinions result in distortions—especially if financial institutions end up holding too little capital? A faulty rating would mislead those dependent on it, with a potentially high price to pay. Rating agencies regularly caution that their ratings are only opinion and that they are not accountable for the outcome of ratings being incorporated into regulation. Perhaps they understand the nature of the problem better than government authorities do.

Box 1

### The big three

Credit rating agencies, some of which trace their origins to the 19th century, assess the credit risk of debt issued by companies and governments and assess investment products such as collateralized debt obligations. The agencies generally assign a grade, called a rating, that ranges from highest quality with little risk to lowest quality with little or no likelihood of repayment.

The rating business is dominated by three firms—Moody's, Standard & Poor's, and Fitch. Moody's and Standard & Poor's, headquartered in New York City, each have about 40 percent of the global business, and Fitch, with headquarters in New York and London, has about 10 percent. Smaller rating agencies are scattered across the globe, mostly in country- and product-specific niches.

• Rating changes move markets, affecting the value of assets and thus capital requirements. They also affect whether those assets can be used as collateral. This is not inherently bad (indeed such changes are intended to affect assessments of riskiness and asset prices), but a change may cause sudden destabilization, unnecessarily raise volatility, and/or lead to overshooting of the asset's value, particularly in the event of a downgrade. Ratings changes, then, can cause regulation-induced crises. Moreover, the due diligence of investors whose decisions are tied to ratings (for example, certain pension funds) is diminished or even overridden because of the overwhelming importance of credit ratings.

• Credit rating agencies have long enjoyed considerable influence over market movements because of the faith placed in them by those who demand their services. The enshrinement of their role in regulation multiplies their potential power. It further distorts competition in an industry that has oligopolistic tendencies, because consumers benefit not only by being able to compare different asset classes under one rating system but also by not having to decipher the methodologies of numerous credit rating agencies. For users, fewer agencies are easier and better.

Moreover, even if eligible private credit rating agencies do their job admirably, there is always the potential for the appearance of impropriety—including whether ratings judgments are consciously or unconsciously affected by the fact that rating agencies are paid by the potential borrowers rather than potential lenders. The possibility of impropriety can as easily undermine the credibility of the process as any actual wrongdoing.

### The way forward

Because capital requirements are an important facet of the overall regulatory framework and credit ratings are key to the determination of those requirements, the role of credit rating agencies must be considered in any postcrisis regulatory reform. There are at least four possible directions reform could take.

Box 2

**The Basel Accords**

The first Basel Accord, dubbed Basel I, agreed to in 1988 by a forum of central bank governors of the world's 10 largest economies, was meant as guidance for regulators of internationally active banks.

The group—now called the Basel Committee on Banking Supervision, with 27 members—is hosted in Basel, Switzerland, by the Bank for International Settlements, an independent organization of central banks.

There have been three formal accords—which look at such issues as how to determine the amount of capital banks should be required to maintain. Basel II was agreed to in 2004, while agreement on Basel III, a comprehensive set of reforms, was reached in September 2010. Implementation of its recommendations is still under discussion.

***Regulatory enhancement:*** This would involve modifying existing rules, but keeping credit rating agencies in essentially the same regulatory role. Regulations could be tighter. For example, authorities might require rating agencies to be more open about how they operate. The way they are remunerated might also be changed to resolve conflicts of interest. Fees might be regulated. Governments could establish more effective evaluation and accreditation processes for rating agencies and their methodologies and enhance quality control. Investor boards could be established to request credit ratings, which would keep clients and rating agencies separate. Regulators could acknowledge fallibility and establish acceptable levels of accuracy, although this would raise questions about recourse or compensation when inaccuracy occurs. Some or all of these approaches could mitigate certain problems, improve accuracy and responsiveness, and reduce the conflict of interest when the entity seeking a favorable rating is also paying for it. However, such reforms cannot resolve

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the fundamental conflict between private incentives and regulation's public imperative for ratings accuracy.

An alternative might be to regulate private credit rating agencies so extensively that they would become essentially public utilities. This approach would substantially reduce conflict of interest and would cost much less than establishing a new public credit rating agency. It would also raise important questions about how to select a rating agency. Would prospective borrowers be compelled to use a particular agency? Would agencies be asked to volunteer? Would there be a competitive selection process?

***The public solution:*** One or more of the private credit rating agencies could be brought under public control, or all private agencies could be excluded from regulatory activity and replaced by a new public agency. The new agency would follow a transparent and approved rating methodology. It would be paid to cover its operating costs, but instead of profit maximization, provision of accurate information to optimize the regulatory process would be its main objective. Setting up such an agency may be beyond the ability of individual countries and could lead to other problems, such as regulatory protectionism. At the same time launching such an agency at the supranational level would be complicated, requiring international cooperation and considerable good faith.

The public solution would resolve certain conflict of interest problems, but arguably would generate new ones with respect to the rating of sovereigns, which would be rating themselves or being rated by an entity they own (wholly or partially). Moreover, a public agency would have to establish

Box 3

### Postcrisis reforms

Following the 2008 crisis, reforms have focused on rating agencies, particularly in the United States and the European Union. In the United States, the Dodd-Frank Act increased oversight of rating agencies, to enhance information disclosure requirements and address conflict of interest related to the "user pays" model. The legislation also requires regulators to explore approaches that reduce reliance on rating agencies and to prepare regular reviews.

The European Union does not plan to reduce reliance on agencies; instead it is expanding regulation and changing the agency business model. It has proposed much tighter rules affecting accreditation, disclosure requirements, and conflict of interest, including a proposal to require issuers of debt to rotate rating agencies every three years, or annually if an agency rates more than 10 consecutive debt instruments of the issuer.

Other proposals include permitting an EU regulator to bar publication of sovereign credit ratings in "exceptional circumstances" and establishment of a public EU rating agency.

credibility and independence from political influence and prove itself a reliable source. It would be costly because it would involve establishment of one or more new institutions. It would also not be immune to problems such as regulatory capture, fallibility of ratings, failures of timeliness, moral hazard, and political repercussions emanating from its decisions. Existing rating agencies would likely suffer a drop in business.

***Return to simpler capital rules:*** The role of rating agencies could also be eliminated and regulators could return to a few simple and predetermined capital requirements for borrowers. What is lost in nuance and sophistication would be offset by greater simplicity, and therefore transparency. It would also be more predictable and easier for regulators to apply and monitor. A return to static ratios would eliminate errors in judgment arising from ratings changes, although determination of the ratios would be a significant point of contention. Without private rating agencies' conflicts of interest, transparency and predictability would improve. Greater simplicity would also likely reduce the potential for market participants to evade regulations. However, the simplified capital rules could increase the cost of raising funds and make it harder for some entities to do so, which would curtail financial activity and could impair economic growth. Moreover, because the simpler rules would not differentiate among risks, they could create a perverse incentive for banks to lend more to riskier entities, thus increasing the likelihood of future financial crises. So a simple-rules approach would have to be monitored carefully and implemented in conjunction with other regulatory tools and indicators. Its relative simplicity and lack of institutions render it the cheapest proposal for governments to implement. From a political point of view, any return to simple rules could suggest the failure of the Basel II approach, which supported risk-based capital charges.

***Market-linked capital charges:*** This approach would turn to the market to determine the level of capital an institution must hold to support an asset (Rosenkranz, 2009). Instead of a credit rating, the market price would be used to gauge the asset's risk profile. In essence, the amount of capital required to hold a fixed-income security would be related to its yield. The capital required for a security would rise in proportion to its spread over a designated benchmark: the market would determine the risk.

Such an approach would remove credit rating agencies from regulation while retaining a sophisticated, transparent, and market-friendly process. Indeed, because market determinations change frequently, capital adjustments could be made more often—in a more gradual and nuanced fashion than the credit rating agencies' grade changes, which often lead to sudden, destabilizing movements. But this approach requires deep and liquid markets and might have to be supplemented with minimum and maximum capital charges—turning it into a variant of the simple capital rules option. Additional safeguards during periods of market crisis would require regulators to intervene when prices cross certain thresholds and diverge significantly from underlying values. The market could serve as a guide to regulators, without removing them from the regulatory process—as happens when they rely on credit rating agencies. But there is the potential for manipulation, especially when liquidity is constrained or an asset is traded infrequently and therefore susceptible to volatile movements.

The drawbacks and costs of each option must be weighed against expected benefits—which must be identified and, where possible, quantified. In some ways, it is a case of pick your poison because there will always be risks associated with regulation, and those who are regulated will always find creative ways to evade or subvert rules not to their liking. Any reform of credit rating agencies must be part of a broader revamping of regulation, because many regulatory failings were identified in the aftermath of the 2008 global financial crisis (see Box 3). Moreover, the transition costs of moving to a new system must be examined carefully, because they will surely be considerable. Cost, however, should not become an excuse for inaction—which would perpetuate government failure and erode the credibility of financial regulation. That could jeopardize the health of the financial sector and the economy—both nationally and globally. ■

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