Credit rating agencies: Role and regulation

Credit rating agencies (CRAs) are often blamed for contributing to the current financial and economic crisis.

CRAs have existed for over a century, giving opinions on the creditworthiness of public and private bond issues. A few agencies dominate the global market today. Their role is to inform investors about credit quality. Since the 1970s, ratings have become more influential as many financial institutions are obliged to take them into account.

At the same time, the agencies switched from collecting subscription fees from investors to charging issuers for rating their securities. Critics accuse CRAs of a conflict of interest as the agencies are paid by those they evaluate. They also give financial advice before issuing a rating, allowing for "shopping for ratings".

Many claim that CRAs provoked the outbreak of the subprime mortgage crisis in 2007 by issuing overly positive ratings and hiding risk information. The transparency of CRAs' methodology, especially in relation to complex financial instruments is an issue regulators need to tackle.

While financial legislation in most developed economies refers to CRAs, the regulation of the agencies themselves has only started. The EU introduced rules on transparency, personnel and conflicts of interest. According to experts, more regulation may still be needed as certain issues have not been solved.

	Moody's	S&P/Fitch
Prime quality	Aaa	AAA
High grade	Aa	AA
Upper medium	A	A
Lower medium	Baa	BBB
Speculative	Ba	BB
Highly speculative	B, Caa	B, CCC
Extremely speculative	Ca	CC

Main steps in the rating systems of the major CRAs
Data source: The Guardian

In this briefing:

Issue definition

Credit rating agencies have been giving professional opinions on investment options for over a century. CRAs have come under criticism in recent years, although the current rating system emerged in the 1970s.

Their role in the subprime mortgage crisis exploding in 2007 is considered substantial. They have been blamed for inflating ratings and not providing sufficient background information on complex securitised debt products, especially in the period between 2005 and 2007. Since 2010, their severe downgrades of sovereign debt instruments have been criticised for aggravating the economic crisis in the euro area.

Critics emphasise the CRAs' excessive role in determining the value of financial instruments. The conflict of interest present in the rating process and lack of transparency are the main problems.

Credit rating agencies

Major agencies
A few credit rating agencies dominate the global financial market. The Poor company (became **Standard & Poor's** in 1941) started publishing bond ratings in 1916. It is also known for its S&P 500 stock market index. **Moody's** published its first statistics on stocks and bonds in 1909. Their "Investors Service" for government bond markets was

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created in 1914 and expanded to commercial paper in the 1970s. In 1924, **Fitch Ratings** introduced the rating system (AAA to D) still in use. As of August 2011, nine CRAs were registered in the EU and ten in the US (one company is registered in both jurisdictions). Nevertheless, these three are the best known, and their ratings are considered as points of reference.

Credit ratings are opinions, based on the models of the CRA, on the ability and willingness of the issuer of a specific security to meet its financial obligation in full and on time.

History of rating

The first CRAs (Moody's and Poor's) started as specialist financial publishers (focusing on railroad bonds). They made their living from the subscription fees of investors. This changed in the 1970s when CRAs started to charge the issuers of securities for rating services. Another major change came in 1975 when the system of nationally recognised statistical rating organisations (NRSRO) was created as a response to the new capital and liquidity requirements of the Securities and Exchange Commission (SEC) in the US. So ratings became officially recognised by the financial regulator. Since then, most countries have made reference to CRAs in their financial legislation. In the EU, the Capital Requirements Directives (2006/48/EC and 2006/49/EC) use ratings for regulatory purposes. The US Credit Rating Agency Reform Act of 2006 granted SEC broad authority to scrutinise the CRAs' compliance with NRSRO rules (but not the right to interfere with the substance of rating, methodology or procedures).

The role of CRAs

Originally the role of the CRAs was to help investors overcome the problem of insufficient information. CRAs gave information on the creditworthiness of corporations, public authorities (such as municipalities or states) and sovereigns, so that investors could decide whether to buy the bonds of these issuers or not. As a result of financial regulation first in 1936-1938 and then since 1975, some investors (e.g. pension funds, insurance firms, etc.) are obliged to buy bonds above a certain minimum rating to avoid taking inappropriately high risks. Sovereign credit ratings evaluate the general economic and political situation, and especially national debt, fiscal balance, foreign investment currency reserves and capital market transparency. Corporate ratings are based on analysis of the issuer's ability to meet its obligations, as well as the market conditions for the specific security.

CRAs stress that their ratings do not evaluate the instrument itself and do not recommend buying or selling. They only deal with one aspect of the security: credit quality, or the probability of default. They also underline that their ratings are opinions and not absolute measures.

Criticism of credit rating agencies

General criticisms

Conflict of interests

The first aspect of conflict of interest in the rating business is that CRAs are paid by the issuers whose securities they rate. Issuers can choose to use the services of the agency which offers them the highest rating based on the results of pre-ratings. This is called "**shopping for ratings**". Another aspect is that CRAs also provide analytical services and can advise issuers how to change the composition of a financial instrument in order to get a better rating. This leads to "**ratings inflation**", meaning that more and more securities receive good ratings.

Some theorists claim that the inclusion of ratings in regulation, together with charging issuers for ratings, marked a shift in the CRAs' business. They changed from rating to issuing licences, as certain investors could only be sold the issuers' bonds with the approval of a CRA. Pension and investment funds and insurance companies are obliged to buy highly rated securities. Therefore they are also involved in ratings inflation.

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The agencies dismiss such accusations, arguing that their long-term profitability depends on their reputation. They would risk this by giving weak firms good ratings.

Lack of transparency
Despite the powers given to CRAs by the regulators, in some respects they were until recently treated simply as publishers. Ratings were considered to be opinions and therefore CRAs were not required to meet transparency rules nor face criminal liability similar to other financial service providers. The lack of transparency was manifold.

In the process of securitisation of structured investment products detailed information on the underlying assets was lost. The growing complexity of the financial instruments and the high cost and complexity of additional information made it possible to hide risks.

Ratings are expressed by letters and numbers, which cannot convey all information needed. First they are not a continuum, which means that, after consulting the CRA, issuers can create structured products just good enough to fit a certain rating category. The meaning of ratings differs: S&P and Fitch estimates default probabilities, while Moody's assesses expected default loss.

Oligopoly
The existence of only three internationally renowned CRAs suggests an oligopolistic market. Limited competition may have provided insufficient incentives to offer the best quality services possible. On the other hand, the fear of losing market share may have led CRAs to perpetuate ratings inflation despite its consequences, as it was in their customers' interest.

Role in the crises
CRAs have been criticised for rating mortgage-backed securities too optimistically in the period before 2008. More recently, they have been accused of aggravating the sovereign debt crisis by cutting Greek, Irish and Portuguese ratings too radically and slowing down global recovery by downgrading the USA in 2011.

Subprime mortgage crisis
Several analysts agree that CRAs have some responsibility for the outbreak or the escalation of the crisis. The excessively favourable ratings of structured investment products (60% of them received AAA rating) based on subprime mortgages were unfounded and could potentially have misled investors. It was unclear to them that ratings of such products differed in substance from traditional bond and sovereign ratings. And in retrospect, they performed much worse. Some say CRAs played an active role in hiding the risk by making ratings opaque, counting on the "naivety" of some investors.

Even the agencies themselves admit that their methodology did not cope well with mortgage-backed structured products.

Sovereign debt crisis
Critics claim that CRAs' downgrades worsened the financial situation of some countries thus turning into self-fulfilling prophecies. Some analysts say that CRAs cannot be blamed as they followed rather than led the markets in their ratings. However, their methodology is still criticised for lack of transparency. The CRAs' analyses of national economic situations differ from those of international financial institutions.

Regulatory framework in the EU

Regulating CRAs
In 2005, the Commission, taking the advice of the Committee of European Securities Regulators (CESR, now ESMA), decided not to act on Parliament's resolution to regulate CRAs. They were already subject to the Market Abuse and Capital Requirement Directives, as well as some self regulation and regular assessment by CESR.

As the crisis hit, preparations for new legislation started with consultations in 2008. This resulted in a Regulation in 2009, introducing conditions for issuing ratings, a

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registration procedure and external surveillance of CRAs. Agencies are prohibited from providing consultancy or advisory services to their clients to prevent "shopping for ratings". Strict rules on conflict of interest for analysts were introduced. A recurring internal review of methodologies is required, as well as greater visibility of all ratings (and pre-ratings) performed, methodologies used and performance of ratings. The regulation was amended in 2011 to give ESMA oversight of CRAs operating in the EU.

Credit ratings in regulations

According to a survey of the Basel Committee of Banking Supervision, most EU Member States, as well as some EU legislation, refer to CRAs in their financial regulatory framework. They are generally used to determine capital or disclosure requirements, classify assets, evaluate risk, and determine prospectus eligibility. Some say this implies endorsement of CRAs and so enhances the reliance of investors on ratings, lessening the quality of their due diligence. The European Commission, the SEC and also the Bank of Japan tried to identify the potential problems of referring to CRAs after the crisis.

Further regulatory options

Commissioner Barnier has mentioned the possibility of temporary suspension of sovereign ratings for countries participating in international assistance programmes, e.g. European Financial Stability Facility (EFSF). The House of Lords' EU Committee, on the other hand, regards this as censorship.

The idea of a European credit rating agency run by the EU has been brought up. An EP Resolution requested the Commission to investigate the possibilities. It found support in the German government but not in the UK. Such a CRA would face challenges regarding its independence and impartiality if its ratings differ significantly from those of the big three. The credibility issues of China's Dagong agency may be instructive.

According to some economists, the optimal solution would be to make investors pay for ratings, reduce regulators' reliance on CRAs and disclose all underlying assets. Others suggest that it would be sufficient to make issuers pay up-front, regardless of rating result (to stop shopping for ratings) and make all ratings and pre-ratings public. They also suggest closer oversight of rating methodology and greater transparency in the functioning of CRAs.

Credit rating agencies also see the need for registration and oversight and have their own suggestions. They agree on the need for transparency and suggest performance measurement, disclosure of methodologies and non-public information. They propose better explanation of ratings and distinction between traditional and new/complex ratings. CRAs suggest eliminating conflicts of interest and reinforcing independence. Agencies also propose that, when ratings are used in regulation, other benchmarks should also be included. They stress that the rules should be global and consistent.

Main references

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