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Credit Rating Agencies: How Watchful Are the Watchdogs?

Shweta Sharda
Assistant Professor, Department of Commerce, Indraprastha College for Women, University of Delhi, Delhi, India

Abstract:
Credit rating agencies have gained immense importance in the financial markets worldwide but the important role played by the credit rating agencies have come under appraisal due to their failure in providing accurate and timely ratings in some cases in the past. Credit rating agencies' activities in the recent times revealed their faulty assessment and lax monitoring of securities, thus the questions on the credit rating methodologies in assessing the default risk and their relationship with the issuer have been raised when Enron went bankrupt and in the subprime crisis. So it's appropriate to learn the lessons of Enron, and now with recent meltdown in financial markets, to check whether these agencies have some sense of accountability, to ensure they perform their function as expected properly. It becomes important to assess their role, which is considered indispensable part of the financial system after these market failures. The most important concern today is to understand the reasons behind it and to provide solutions to make sure that the credit rating agencies use their authority to protect capital markets.

Keywords: *Credit rating, Enron, Subprime crisis, Watchdogs*

1. Introduction

The credit rating agencies are playing crucial role as intermediaries between issuers and investors by assessing the risks associated with securities issued in the market. Regulators have made ratings as the judging criteria for the creditworthiness of issuer in the market that has increased their role in the system. The incorporation of credit ratings in various regulatory schemes gave strong position to agencies' such that Journalist Thomas Friedman once said- "There are two superpowers in the world today. There's the United States and there's Moody's Bond Rating Service. The US can destroy by dropping bombs and Moody's can destroy you by downgrading your bonds." In today's time the credit rating is strong enough to determine the future of any nation, security and company. Thus, it becomes imperative to justify the reliance of entire financial system on the rating agencies by evaluating their performance.

2. Relevance of the Study

Credit rating agencies have been criticised for being negligent in their assessment of risks associated and thus giving assessing issuers and giving deceptive ratings, as in the case of Enron, Parmalat etc., where they failed to raise the alarm timely. Also, the failure of large investment institutions worldwide (e.g. Bear Stearns, Lehman Brothers), happened due to the ratings assigned by rating agencies to subprime mortgages. The credit rating agencies are facing widespread criticism due to their non performance in recent times and thus the study is undertaken to discover possible reasons of their failure in the market and their effects on the financial system.

3. Objectives of the Study

The study on credit rating agencies has been conducted with the main objective to examine the effectiveness in the working of credit rating agencies and to reveal the factors influencing the accurate appraisal by credit rating agencies about the risks of issuers of securities.

4. Research Methodology

The research is based on the information gathered from various secondary sources. The articles published in leading journals, magazines, newspapers, books and websites are referred in conducting the study.

5. Discussion

5.1. Impact of Rating Agencies

Credit rating industry now plays central part of the financial system as the ratings are incorporated as assessment and quality standards through various regulations framed by regulatory bodies in all parts of the world. Their role is of utmost importance that they can control the minds of investors while making investment decisions. Though the rating agencies approach the credit risk in a disciplined and systematic manner that their ratings are accurate in majority of the cases, but they have made some poor judgment calls, for instance, earlier in 2001 the

agencies missed Enron's "house of cards" for an extended period of time.[i] On December 2, 2001 Enron Corp., the nation's 7th largest corporation rated high by all the credit rating agencies declared bankruptcy. The rating agencies have the authority to gaze into corporation's books but they never investigate the deteriorating financial condition of Enron and instead issued high ratings thereby failed to warn investors about Enron's true state of affairs. Same is the case with WorldCom, Parmalat and in the subprime crisis too where their role came under inspection for the accuracy of ratings provided on certain structured finance products, especially subprime residential mortgage-backed securities (RMBS). The major credit rating agencies have consistently failed to perform their basic mission of providing timely and accurate ratings of debt obligations.

The rating agencies claim that they analyze all the factors before rating a security that could affect borrower's creditworthiness, but in case of subprime mortgages, they never paid concern to the safety of products being rated, their underlying risks and the creditworthiness of borrowers who owns the property. Rating agencies have always stated in their methodologies about continuous monitoring of the ratings assigned in light of the recent developments so as to provide true picture, but in the case of subprime loans, they acted after defaults on these mortgages started and thus unable to protect the market tremors. Rating agencies are criticized that they should have taken performed their duty with due diligence before assigning 'AAA' rating and thus preventing losses. They were only interested in collecting substantial fees than to do the risk computations. Credit rating agencies were unable to deal with the complexity of new financial instruments with their staffs' inexperience in the concerned area but still went ahead to rate the securities for the lucrative business. The agencies made huge gains from the subprime crisis where it was stated in Congressional testimony that the total revenues for the three Credit rating agencies doubled from $3 bn in 2002 to over $6 bn in 2007.

Five big investment banks in the world : Lehman Brothers, Goldman Sachs , Merrill Lynch , Bear Sterns and Morgan Stanley, having large exposure to mortgage backed securities suffered huge losses and failed their existence. Now the question arises as to what made these investment banks so confident that they engaged themselves in such transactions? The answer to their dilemma was provided by the rating agencies' who assigned unduly high ratings to the risky products including bonds packaged as CDOs - causing harm to the investing community worldwide. The triple-A ratings assigned firms like Moody's, assured investors about the quality of these securities which were then bought considering them as safe as other triple A securities in the market.

Moody's and its two principal competitors, Standard & Poor's and Fitch are heavily blamed for the game played through investment-grade ratings to securitization transactions (CDOs and MBSs) based on subprime mortgage loans. The major credit rating agencies are facing the brunt of not only missing the Subprime Meltdown, instead actively contributing to it.

Even after being highly involved in crisis, rating agencies retort that they cannot be blamed for how ratings are used. The rating agencies maintained their position by saying that "Every time a rating is assigned, the agency's name, integrity and credibility are on the line and subject to inspection by the whole investment community"[ii]. Thus Credit rating agencies seek to screen behind the 'reputational capital' theory which pre-supposes that their reputation crucially depend upon the accuracy and veracity of their ratings and thus they are obliged to come out with their best performance each time they rate. They argue that they would never put their reputation at stake for short term monetary gains. The reputation of credit rating agencies provides an economic incentive to behave diligently and ethically, even in the absence of regulation. Rating agencies say that it is difficult to analyse risks involved in the world of uncertainty. Ratings cannot change as frequently as the market because their action can affect the system badly.

5.2. Factors Influencing the Credit Rating Agencies

The assessments made by the rating agencies get affected by factors such as low competition, conflicts of interest, lack of accountability, use of unfair means and anticompetitive practices, etc. in the business. The factors are discussed below:

5.2.1. Lack of Competition

The market share in the credit rating industry remains highly concentrated as Moody's, S&P and Fitch act as an oligopoly. The new market entrants are prevented from acting as raters due to the existing regulatory framework in the U.S. where vague process of NRSRO designation served as barrier to entry for new firms by assigning more than 80% of market share in the hands of top three agencies namely, Standard & Poor's, Moody's and Fitch.

5.2.2. Conflicts of Interest

Conflicts of interest were largely responsible for the disastrous performance of credit rating agencies in true assessment of the risks which arise due to the existence of 'issuer paid model' and due to the involvement of the rating agency in providing ancillary services.

5.2.3. Business Model

The rating agencies are dependent on companies for their revenues as the issuer pays to the rating agency for getting its issue rated. This could induce rating agencies to be liberal instead of probing for negative information before issuing rating.

5.2.4. Ancillary Services

The rating agency offered services such as consultancy and financial advice, and where the service is provided to the same clients they rate, the agencies tend to please its client by giving good rating for developing market for its allied services. Sometimes even the issuers feel that getting service might help them in receiving high ratings. In case of structured finance, the process of assigning rating differs from the process for traditional instruments. The structured finance market has been a "rating by request" market where the debt issuers invite some or all of the major rating agencies to preview the collateral pools so the rating agencies can provide preliminary rating indications. Credit raters participate in every level of packaging a CDO, said Calomiris, who has worked as a consultant for Bank of America, Citigroup, UBS and other major banks. "The rating companies tell CDO assemblers how to squeeze the most profit out of the CDO by maximizing the size of the tranches with the highest ratings", he said.[iii] Rating agencies help issuers in deciding the size of the bond classes and structure the bond

transactions in order to achieve the desired rating. Thus the rating of a structured securitized instruments is intentional, and not provided as result of the rating process. Thus the agencies turn out to be in the business of facilitating the issuance of securities for the benefit of issuers.

5.2.5. Transparency

The credit rating agencies are not considered as transparent for the methods and processes used by them in assigning ratings. The rating agencies do not perform an audit but solely rely on information provided by the issuer. And if the information provided is inaccurate and incomplete, the rating process will surely tend to give misleading results. There is doubt on whether Credit rating agencies sufficiently monitor and review issuers' financials, seek answers themselves through further probing or just take the word of issuers' officials.

5.2.6. Accountability

Credit rating agencies are not responsible to anyone for their ratings. They are unaccountable because they are protected by the First Amendment, i.e. their ratings are deemed to be mere opinions protected as free speech. They do not face any civil liability and regulatory system doesn't scrutinize and penalize them in case of bad performance.

5.2.7. Anticompetitive and Unfair Practices

There are various means used by Credit rating agencies to eliminate or minimise competition in the market by resorting to unfair means such as:

- The Practice of "Notching" - Notching is exercised by the rating agencies to maximize rating fee gains where a rating agency assign ratings according to the ratings already assigned by other agencies. Credit rating agencies often resort to notching when rating, collateral debt obligations ("CDO") by assessing and downgrading the underlying securities that they themselves did not rate.
- Unsolicited Ratings**-** The rating assigned without the request made by the issuer is unsolicited rating, they are assigned to induce issuers to pay for getting a more favourable rating which help Credit rating agencies in increasing their market share.
- Shopping for Ratings- The corporate are also allowed to 'shop for rating' i.e. if a company is not satisfied with the rating given by one rating agency it can approach another agency for superior rating.

5.2.8. Lack of Timeliness in Ratings

The rating agencies are criticized that they are too slow in lowering down their ratings, they have failed to continually monitor ratings and update them. In subprime crisis, they were aware of the deteriorating quality of the underlying assets but still did not act for a year. Later they revised their ratings from one extreme to another without any sufficient warnings to the investors. This only reveals the defect in the original ratings and the manner in which these agencies give ratings. Rating agencies are accused of being overly cautious, reactive rather than proactive and aching to catch up with the market, rather than leading the market.[iv]

5.3. Reliance on Credit Ratings: Case of Reliance without Reliability

Credit rating agencies are heavily relied upon by issuers and other market participants. Due to their incorporation into a variety of regulations, market has no option but to rely on them. It was established that investors, banks and regulators rely on credit ratings for an increasing variety of purposes. There is demand for credit ratings despite proven shortcomings in their informational input and predictive capability by regulatory bodies. Recently, the role of rating agencies has been enhanced through inclusion of rating in Basel II. The ratings by ECAI (external credit assessment institutions, the credit rating agencies) will be used to calculate capital requirements for banks providing them incentive to select highly rated borrowers only because it mechanically lowers their capital requirements. Also the revision of ratings in the case of economic downturn can prove to be detrimental to the entire system.

5.3.1. Rating Agencies are Pro-Cyclical

Banks that use external ratings for allocating capital will always have the least amount of capital put aside at the point when they need it most, when the business cycle is about to turn and non-performing assets are set to rise. A downturn in the business cycle will cause the ratings on firms to deteriorate, forcing banks to put aside greater capital at the worst possible time, when the economy is heading into recession. Should ratings decline unexpectedly; banks will not have the capital in place in advance of the event. Thus, the risk of financial crisis and contagion as banks will be undercapitalized when market conditions are most difficult.[v]

Rating agencies claim that they rely on the information obtained by the issuing authority in case of securities or the company being rated, denying any obligation to verify the information and statistics provided to them or undertaking any sort of enquiry for the purpose of taking action against the concerned party. This clearly shows the lapse in their assessment methods and if still the regulators want market participants to rely on them blindly, then it is truly a case of reliance without reliability. Market has shown a great deal of concern over the ambiguous ratings issued by rating agencies that creates the need for reviewing the reliance placed on them. The rating agencies are now under scanner as investors have started asking questions as how reliable is their methodology of evaluating risks. The surge of failures in the market due to heavy reliance placed on the ratings justifies the intervention of regulatory authorities worldwide governing the activities of credit rating agencies. A rating can be considered as reliable only if it estimates the credit risk precisely without being influenced by interested parties. Rating agencies have authority, but lack political accountability. They have acquired authority due to their professional expertise, their specialist knowledge and acceptance by regulators, but there is lack of public oversight of the rating agencies.

5.4. Gaps in Regulatory Framework Governing Rating Agencies

The role of ratings assigned by credit rating agencies in the collapse of Enron in 2001 drew attention of regulators worldwide. They framed various rules to govern them in the future, but the role played by them in inflating the mortgage bubble that lead to fall of worlds' major financial institutions has proved them worthless.

SEC set up the NRSRO criteria for rating agencies on the basis of their wide acceptance in the market by the issuers for obtaining ratings. It created artificial barrier to entry with only three agencies serving the market as NRSRO but never provided a statement of the qualifications for being designated as an NRSRO. The SEC's NRSRO designation "system" received attention with respect to the potential for conflicts of interest in the issuer-pay model, this gives way to the enactment of The Rating Agency Act 2006 to lay down stringent disclosure requirements and to improve competition in the rating industry. The IOSCO came up with its code of conduct for rating agencies but it was voluntary and never enforced. The factors influencing rating agencies still remain unsolved in the market.

5.4.1. Authority without Responsibility

The role of Credit rating agencies in capital markets have given them loads of power over issuers and investors. The incorporation of use of ratings by all institutions in the regulations has given strong position to the rating agencies. But there appears to be an accountability gap, which constitutes an imbalance between the vast power of Credit rating agencies and the mechanism to hold them responsible for their use of this power. Given the role that Credit rating agencies play in capital markets it is of particular concern for market participants because investors and markets get hurt if the ratings given by Credit rating agencies are not accurate and are volatile. With the strong position of Credit rating agencies, concern over the "accountability gap" arises as: (i) this accountability gap is worrisome for Credit rating agencies as well as market participants; (ii) for the former, the accountability gap may affect their credibility in the marketplace; and (iii) for the latter, it is of particular concern given the role that Credit rating agencies play in capital markets. There is a need for a mechanism to take over if reputation fails.[vi]

The agencies are paying inadequate and in- sufficient attention to the external and long-term effects of their actions. They should realise that their lack of attention and inflated ratings facilitate unsustainable growth. The time has come for the rating agencies to initiate action and incorporate standards of diligence in performing their duty to provide ratings by means of fair and responsible means. With one crisis after another, it can be said that agencies suffer from lack of self-discipline because they are well aware of the fact that whatever may be the case, there won't be any penalty imposed on them. To make them disciplined is the need of the hour, thus, the system should be designed where they could be punished for their faulty assessments.

5.4.2. Need for Tighter Regulation

The market participants and even regulators do not learn in spite of shortcomings in ratings given by Credit rating agencies and still make market participants to rely on the ratings. They show concern when the system fails but lacks determination to make the system foolproof for future assessments. Regulators should frame methods to reduce this accountability gap and remind rating agencies about the purpose they have been established i.e. to provide credible information in the interest of market.

The regulatory bodies have initiated various rules to govern them by amending regulations from time to time keeping pace with the time. IOSCO and securities regulators are concerned with a wider range of issues, such as credit ratings' impact on the market and with their disclosures. The business rules (based on transparency and independence) recommended by CESR and by the SEC, are mostly identical and are based on the IOSCO Code of Conduct. But they have failed to make the system transparent and independent from inherent conflicts:

- Credit rating agencies work under "business model"
- The reliance on rating agencies is maintained by the regulators without any legal liability of their actions.

Rating agencies are criticized for favouring business volume instead of acting rigorously and independently affecting the investors and market. In spite of serious limitations in the rating agency industry regulators are extending their role in the market e.g. through rating requirements in Basel II which will make these agencies even more powerful. Instead they should first take steps to restore investor confidence by making them accountable towards the market for the indiscriminate use of their authority. Only the passage of time will tell the effect of these rules on the market. Real assessment will have to wait a few years of experience after enforcement of these rules, on the efficiency of markets. The securities regulators are being undertaking initiatives to assess how they could prevent the market from falling victim to the assessments given by rating agencies.

6. Suggestions

The credit rating agencies' performance is affected by number of factors; the industry has some inbuilt issues that need to be addressed by the regulators before assigning them the position of well built market intermediaries. The financial markets' dependence on the ratings made them vulnerable to bad assessments and thus for market's efficient operations the rating agencies should be made to realize the consequences of not exercising due diligence in their area. The main argument relates to the requirement of making the Credit rating agencies accountable for their actions in long term interests of the financial system by framing appropriate guidelines on regular basis and make improvements therein to ensure efficiency. In this regard various suggestions are made to enable credit rating industry operate efficiently:

6.1. Compliance and Enforcement of IOSCO Code

Regulators should set standards for the enforcement of best practices strictly in accordance with The IOSCO Code of Conduct to improve accountability and transparency in the rating industry. There can be liability or other forms of enforcement mechanisms such as penalize them or even de-recognize them, in the case of non-compliance.

The credit rating agencies should be continually monitored to avoid lapses and tighter regulation is the answer in this direction. The efforts should be taken to implement the IOSCO Code in its stringent form and also the threat of losing the credit rating agency license can be incorporated in case of non-compliance with the code.

6.2. Issue of Compensation

The system of rating agencies being dependent on issuers for their revenue should be done away with to avoid possible conflicts. Instead a system can be considered whereby the regulatory body is authorised to assign a Credit rating agency to the company which will then pay to

the agency the amount prescribed by the regulatory body itself which will solve the problem of conflict of interest and avoid the negotiation on fees also.

6.3. Enforce Financial Liability

The conflict of interest faced by Credit rating agencies is prevalent in the audit profession also. But the auditors can be held financially liable for their wrong reporting. The same case should be made for rating agencies. They need to be held legally liable to pay damages for their wrong assessments, this can reduce their mistakes.

6.4. Eliminate Rating Shopping

As a measure to eliminate rating shopping, companies should be asked to show all the ratings they have obtained from different rating agencies. Also the rating agencies should show ratings given by them to all the companies who have approached them for assessment.

6.5. Active Monitoring and Due Diligence

The performance of rating agencies can be improved if through dedicated teams who will monitor the ratings assigned on regular intervals. Credit rating agencies should give much more attention to analysis of accounting policies and practices in the assessment. As they rely on information given by issuer, they should perform analysis on the statements provided before giving ratings. It will also encourage companies to improve the quality of their reporting.

6.6. Reduce Reliance on Ratings

Credit rating is not revised simultaneously with market changes because they adjust to new information slower than the market. Then why should market rely on them? Instead, market participants can use them as reference and undertake their own research for their investment decisions. Ratings should be used as one element of and not the sole basis for investment decisions.

6.7. Ancillary Services and Rating should not be given to the Same Client

The provision of allied services to those clients whose securities are being rated by the agencies affect the decision making process leading to loss of independence.

6.8. Development of Human Resources

With the growing importance of complex quantitative models in the credit assessment of exotic products, there is need for recruiting educated and professional staff. They can design new methods of rating and improve the quality of rating process. Regulators can also keep a check on the level of staff, their experience and turnover as only the person with best knowledge can ascertain the risk involved in instruments.

6.9. Full Disclosure

Credit rating agencies should highlight clearly to the investors, which particular methodology is used for rating a particular instrument by clearly labelling of ratings to indicate against which version of a methodology they were based upon, including a link on their website to the specific model.

7. Conclusion

Credit rating agencies play an important role as information provider and facilitator for the efficient allocation of resources in the financial market, but they can best serve the world markets only if they function independently, success of the rating agencies depends solely on the preservation of its credibility and integrity.

The regulatory authorities enacted various regulatory provisions that helped in increasing the role of rating agencies in the market. The issuers are forced to obtain a rating because an institution may not otherwise invest in their securities, thus they obtain the rating only as a license from regulators. Thus issuers just purchase ratings for sale of their securities and not according to the quality. The rating-dependent regulation clearly serve the laudable purpose of creating a market with consistent failures and even after series of faults, regulators never enforced any legal liability on them. Recent turn of events in the financial industry has shaken the confidence levels of investors, bringing credit rating agencies under the scanner. Though the bad lending policies of banks are to be blamed, but the role played by rating agencies is no less in making the entire process of securitization successful by giving golden ratings to highly risky mortgages. The current market turmoil led to screening of the credit rating agencies which reveals following areas of concern:

7.1. Transparency of Credit Rating Agencies' Rating Methodologies

Transparency concern stems from the fact that Credit rating agencies only rely on the information provided by issuers and they do not properly disclose the assumptions underlying the rating assigned. The types of information relied upon by the rating agencies are not understood by the market.

7.2. Potential Conflicts of Interest

Their role has been highly criticised that due the existence of business model and their involvement in structuring the deals, they did not consider the market risk factors present in home loan mortgages. This issuer pay model is itself defective and they changed their model as they realize that issuers needed ratings to get their bonds into the portfolio of investors and other regulated entities as pension funds, insurance companies because various regulations were initiated. Before assigning ratings, they should have performed 'what if' analysis, such that what will happen if property prices fall? Will these deals be able to sustain that fall? What if these individuals won't be able to pay back

the loan? The credit rating assigned to an issuer or security is affected by the existence of business relationship because agencies want to maintain flow of business with them.

7.3. Concentration in Industry

Issuers desire ratings from those Credit rating agencies that have a long performance record. And since reputation takes time to achieve, this further increases the dominant position of the established Credit rating agencies and thus potentially diminishes credit rating quality. Issuers are relatively weak compared to the Credit rating agencies because of their dependence on the ratings, which become severe due to imperfect competition in the credit rating industry. Due to lack of competition, they are not working under any reputational pressures.

7.4. Periodic Monitoring of the Ratings and Timeliness of Rating Actions

The rating agencies failed to provide timely actions to the investors, which could help them, but they took action when the market has already reacted. The monitoring of the ratings assigned by them is questioned. The delay in the downgrading process is the cause of their insufficient rating surveillance procedures. Even after the defaults in mortgage started, rating agencies did not start downgrading the securities. They started lowering ratings when most of the financial institutions started encountering problems. Thus, the rating agencies are criticized for initially assigned very high ratings to the securities, then not adjusting them timely and are influenced by issuers. Moreover, all the agencies have given the same ratings which give the picture of some sort of cartel operating in the rating industry.

7.5. Lack of Accountability

One of the major issues we are grappling with is the relatively low level of regulation over the rating industry and process. There is no mechanism to protect market from mistakes made by Credit rating agencies or any abuse of power on their part. Even if reputable interests and competition provide incentives for generating quality financial information, the need for more formal regulation to address market failures remains there.

The assessment of working of Credit rating agencies as how far they have proven themselves in their job, has proved that there are failures in their performance because of lack of oversight and absence of legal liability. The factors influencing the rating agencies in their due diligence while evaluating issuers are seriously severe and the attempts made by regulators to make credit rating agencies effective in their role also could not achieve results, thus they have to be looked into for increasing the efficiency of rating agencies for long term sustainable growth of financial markets.

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