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CREDIT RATING AGENCIES: A CASE OF POWER WITHOUT RESPONSIBILITY?

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ABSTRACT

This article critically analyses the moral hazard issue that exists due to the compensation model of Credit Rating agencies. Our focus is on the role played by Credit rating Agencies in the US Subprime Crisis and recommendations to resolve the prevailing issues in the industry.
KEYWORDS: *Credit Rating, bond credit, US Subprime Crisis, bankruptcy*

INTRODUCTION

Credit Rating Agencies are the specialist in providing information regarding the "bond credit worthiness" i.e. likelihood that an issuer will default on interest and principal payments.

From global perspective the most dominating credit rating agencies are Moody's Investment Service, Standard & Poor and Fitch. These three credit rating agencies have oligopoly in rating the debt instruments accounting for approximately 95% of the market (According to Annual Report on Nationally Recognized Statistical Rating Organizations December2013) created by the reputation and regulations. Ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs) are widely used in rules issued by Financial and other regulators, regulatory schemes in many countries around the world. For instance mutual funds and government run pension funds are often restricted to investing in only certain grades of bonds, typically excluded those rated as "Junk" (below BBB).

Ratings given by these agencies have wide implications because these ratings affect both buyers and suppliers of credit. If there is any error in credit rating process it impacts the overall performance of the financial market and has repercussion on other sectors of economy also as has been witnessed around the world during East Asia Crisis, US Sub Prime Crisis and Euro Crisis.

ISSUES

"There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe sme; it's not clear sometimes who's more powerful."-Thomas Friedman, New York Times Columnist

The relevance of the above line in the current times is paramount. The Credit rating agencies have enormous quasi – governmental power. They are embedded in the system as part of regulatory requirements. Whereas CRAs give opinions but recent past has proven that their lack of accountability and independence have perpetuated if not caused failures such as Enron, WorldCom and US Subprime Crisis.

Perusal of the existing oligopoly market in the Credit Rating agencies brings into focus the following problems:

- **Lack of Competition**: Until late 1990s there were only 3 firms considered under NRSROs which are agencies permitted by SEC to issue credit ratings for regulatory purposes it was raised to 10 by 2011.It is surprising to know that this is in direct conflict with FED Reserve which requires ratings from major players i.e. the big 3 for lending programmes, this rule hasn't changed yet even in the light of recent events.
- **Lack of accountability**: The ratings are opinions and cannot be verified by court.
- **Lack of independence**: Objectivity is hampered due to payment model where Issuers pay Credit Rating Agencies for ratings.
- **Lack of timeliness**: There is a lack of predictability. Carmen M. Reinhart (2002) analyzed the ability of sovereign ratings to predict crises. Her empirical findings suggest that behaviour of sovereign credit ratings have practically no predictive power vis-à-vis crises, and this result has remained valid for crisis after 2002.
- **Rating triggers**: Major downgrades leads to liquidity problem for obligors and loss of investors' confidence. It causes LT bonds to become due immediately and low solvency firms are forced towards bankruptcy. It worsens an already bad situation.

The various criticisms mentioned above echo one major issue: Moral Hazard problem

The Compensation model of the Credit rating agencies provides disincentive to accurately rate Issuers.

CRAs provide unsolicited and solicited ratings. Lower unsolicited rating by CRAs can work as implicit blackmail against the issuers to get solicited rating from CRAs.

The only deterrent from gaining short term profits through repeated business by giving favourable ratings is the loss of reputation. It therefore becomes a balancing act between the two forces acting against each other.

Another important aspect of the problem is shopping for rating since it is not necessary to publish all ratings. Issuers would prefer to go to CRAs who give better rating thus hampering the process of objectively issuing ratings.

Issuers and CRAs also collaborate while designing securities (special reference to Mortgage Backed Securities). They also offer consulting and advisory services to issuers. This leads to a situation where CRAs are rating products they helped design and improve.

Arthur Levitt, a former chairman of the Securities and Exchange Commission put it very nicely:

"[Credit rating agencies] are playing both coach and referee in the debt game."

THE SUB PRIME CRISIS: A CASE IN POINT

The Economic Boom due to technology boom, Economic rise of developing countries who lent money to overseas banks causedbanks to have more money to lend leading to fall in price of lending which is interest rate.Sales pressure lowered lending standards. Investors looked for safer investments than the share market and turned to property.

Sub-prime mortgages are home loans given by banks to people who are high-risk having poor credit history and can't reasonably afford them.

Parties involved are not just the Borrowers and Banks but further these loans were sold to large banks,

pension funds etc. to invest. These investments are backed by assets such as houses are called CDO (collateralized debt obligation). The interest paid on the home loans is the income for the investor. Credit rating agencies were paid to make the security 'appear' less risky.

NOW WANT WENT WRONG

The entire system was based on the fact that Property prices will go on rising but the Property boom turned to bubble

Borrowers could not sell the property or rent out at high price .Banks due to default by borrowers had property of far lower value with investors unwilling to invest. Investors were not receiving their return as they were holding assets of far lower value.

The purpose of credit rating agency is to avoid such crisis. They continued to give top ratings months after the housing market started to collapse.

Further beginning July 2007 unprecedented downgrading of 1000s of CDOs and RMBs began.This made their market illiquid leading to the collapse of the market.Due to conflict of interest, they did not issue conservative ratings which the RMBs and CDOs deserved.

RECOMMENDATIONS

"Never allow a crisis to go to waste; they are opportunities to do big things." - Rahm Emanuel, Mayor of Chicago and former White House Chief of Staff to President Barack Obama

- **Mandatory rotation**: As per this recommendation issuer who pays CRA for rating instrument must switch to another agency after every 4 years. The outgoing CRAs are not allowed to rate the security of issuer for the period not exceeding 4 years.
- **Ensure accountability**: Regulatory authority should facilitate the investors to hold CRAs accountable when CRAs knowingly fails to conduct a reasonable investigation of a related security and give them inflated ratings. They have been excused from underwriters liability under the garb of issuing only opinions.
- **New model of payment**: There must be a search for new models which are transparent enough to tell how these agencies are paid. Instead of "issuer payment model", there is a proposal to shift to"government payment model" through collecting taxes from market participants. In 1970, Investor payment model was changed to issuer payment model for the benefit of CRA then why not change the issuer payment model now for the benefit of investors. The new model should reduce the moral hazard problem and eliminate the risk of inflated rating.
- **Difference in rating firm and consulting firm**:"Chinese walls"are said to exist between the consulting division and rating division of a CRA. However, the current scenario calls for stricter norms.
- **Ease of entry barrier and promote competition**: There should be more players for rating debt instruments because it will force CRAsto improve their efficiency in order to get business and stay in the market.
- **Publication of ratings**: It will improve comparability and visibility of all ratings for an instrument awarded by different CRAs .
- **Proper disclosure of assumptions and transparency**: CRA's generally don't provide the assumptions underlying the model used to arrive at particular rating. This is especially relevant in case of CDOs (Collateralized Debt Obligation) and RMBs (Residential Mortgage-Backed Securities). They were blamed for giving AAA rating equivalent to Treasury bonds. The excuse given was that they are highly complex products hence difficult to rate. This leads to the question whether the ratings given irresponsibly?In such cases, disclosure becomes imperative. There has been a proposal of having separate rating system for complex products.
- **Ranking of performance**: There should be ranking of performance of credit rating agencies in terms of their accuracy in rating various debt instruments.

Job not well done!

- *Enron was kept at investment grade until just 4 days before bankruptcy*
- *In 2011, S&P alerted its subscribers about downgrade of France from AAA without taking such action. The alert came 2 hours before market close and the mistake could not be corrected till market close.*
- *During East Asia crisis South Korea was downgraded by three notches by S&P in a single day*

CONCLUSION

While giving the above recommendations, we are fully aware that they are not without flaws; the challenge here is to overcome the flaws and reform the industry which plays a very important role in the financial system. Various acts such as Dodd-Frank Act have tried to regulate Credit Rating Agencies but in our opinion the only way where the conflict of interest can be resolved is through changing the "Issuer payment model".

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