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Credit rating agencies and moral values in the evaluation of credit risks

Abstract

The credit ratings awarded by the credit rating agencies enable participants in financial markets to make the most optimal choice in respect of where to invest free money assets. The agencies evaluate the risk of investing in securities offered by issuers by awarding them a specific credit rating, which influences the rate of interest, the value and the yield from the securities they offer. The credit rating agencies have had a crucial influence on events within the financial markets and it is considered that they have firstly caused and then fuelled the financial crash of 2008. Due to their influence on heating up the debt crisis in the Eurozone, the European Union has issued a regulation that limits and redefines their activities with the purpose of recovering trust in financial markets and increasing the protection for investors. In this article, the authors explain the background to this regulation and explore its aims which can be summarised in the context of improving transparency, independence and accountability. Indeed, accepting the latter is key to restoring credibility.

Keywords: *credit rating agencies, credit risks, credit rating, capital investments, financial institutions, financial markets, EU, regulation, transparency, conflicts of interest, accountability, disclosure, quality controls, sovereign debt*

Credit ratings and their influence on capital markets

The credit ratings awarded by the credit rating agencies enable participants in the financial markets to make the most optimal choice in respect of where to invest free money assets. The agencies analyse the capacity of the issuers (companies and states) and they evaluate the risk of investing in their securities by awarding them a specific credit rating which influences the rate of interest, the value and the yield from such securities. The credit ratings are used by companies, banks, insurance companies, pension funds, investors and other entities and financial institutions.

Actually, credit ratings started to become integrated in financial market regulations in the years following 1930, as a form of safety measurement that would force financial institutions not to undertake overly risky investments. When a credit agency awards a negative opinion, investors are obliged to follow because their role is determined precisely in several statutes and regulations stating that banks, insurance companies and pension funds can only invest in non-risk companies, financial institutions and state bonds. If the rating of the analysed entities is to fall, then investors are forced to sell financial instruments from an issuer whose credit rating has fallen.

The credit rating agencies are significant participants in financial markets, therefore their independence and integrity in conducting credit rating activities is particularly important in terms of guaranteeing the credibility of the ratings in the eyes of other market participants, especially investors. Therefore, the analyses for determining a rating should be based on objective facts and credible data in order to avoid any conflict of interests among financial market participants. However, in the last two decades, due to a lack of respect for moral norms and values, as well as due to a lack of transparency in their work, the credit rating agencies have jeopardised their own personal ratings in estimating credit risks. The agencies are neither above national nor are they less than independent institutions in the estimation of credit risk; they are financial associations that function according to the principles of the market. Today, 95 % of the market for such services is held by three private rating agencies working in the interests of Anglo-Saxon capital.

The credit rating agencies have had a crucial influence on events within financial markets and it is considered that they have both caused and also fuelled the financial crash of 2008 in that they seriously under-estimated the risk that the issuers of specific complex financial instruments would not be able to pay off their debts. They gave the highest possible ratings to many complex instruments and inexperienced investors, based on these high ratings, felt encouraged to buy as a result, failing to make a proper check-up on those ratings. Market conditions were worsening, but the credit rating activities failed to incorporate these indicators in their ratings.

These failures of the credit rating agencies were accompanied by unreasonable behaviour among investors. Consequently, the agencies, in July 2007, lowered the ratings of complex and obscure financial instruments to the level of 'junk'; at that point they had been awarded the highest (AAA3) rating but, actually, they were high-risk and worthless financial products. Among the most problematic and obscure financial instruments, we should mention 'Abacus 2007-AC1' a product which had been offered by Goldman Sachs. Abacus was composed of securities whose value was based on the value of real estate mortgages. The seller of this new financial product actually sold the illusion that the property market would grow indefinitely in the future, and thus guaranteed profits to investors if they were to buy it. However, in less than one year since the start of the sale of the product, during which time it had grown to a value of one billion US dollars, 99 % of the mortgages on which Abacus was based had lost their value. The truth was that the new financial product created by Goldman Sachs had been overloaded with risky bonds; investors just did not know it.

In purchasing this complex and obscure financial product, they were mainly driven by the high ratings given by the credit rating agencies. Thus, by a bursting of the mortgage bubble, all investors who had purchased securities based on the value of real estate mortgages suffered huge losses, contrary to the huge gains of the creators of these financial leasing products, among which are numbered analysts and credit rating agencies who have adopted an advisory role. Additional to this advisory role on the creation of such products, the credit rating agencies have also assisted in their sale on the financial markets, awarding such high-risk and obscure financial instruments with the highest credit rating, and thus misleading investors looking to place their free cash.

Additionally, however, the credit rating agencies also participated in the creation of other financial instruments belonging to other financial companies and institutions. The credit rating agencies allocated the highest ratings to Lehman Brothers, Merrill

Lynch and AIG, and just one day prior to their collapse. In fact, the credit ratings of the rating agencies have not only caused problems in the last financial crisis; the US company Enron had its highest credit rating just before bankruptcy in 2001.

Each of the three major credit rating agencies – Standard & Poor's, Moody's and Fitch – have, in recent years, shown huge earnings on their balance sheets compared to the chaos they have prompted on the European financial markets. The lowering of the ratings of European countries by the three major rating agencies, based as they are in the US, has prompted the suspicion that the background of such agencies pits the interests of one region against those of another. The economic public may have, and reasonably so, supposed that Anglo-Saxon capital lays behind the speculative attacks on Europe and the Euro: all three credit rating agencies are based in New York, and Fitch has an additional headquarters in London. However, S&P and Moody's have American ownership (S&P is a branch of the publishing company, McGraw-Hill, while the largest shareholder in Moody's was the American industrialist, Warren Buffet), but Fitch is owned by the French company Fimalac.

At the beginning of the year, the American Department of Justice filed a civil lawsuit against Standard & Poor's, on the grounds that they had acted unlawfully in evaluating the mortgage bonds which were very closely linked to the development of the financial crisis. This represents a precedent since, for the first time in history, a state had sued a credit rating agency for unlawful conduct during the crisis and immediately prior to it.

Defects in the operation of the credit rating agencies

Initially, the credit rating agencies were very helpful to all financial markets participants in respect of where to focus and invest their cash, while the credit ratings awarded to companies, financial institutions and countries represented a kind of security in assisting direct investors to avoid overly risky ventures. However, in the last two decades, due to the violation of moral norms and values and as a result of the lack of transparency concerning their operations, the credit rating agencies have increasingly lost the confidence of investors while the reliability of their credit ratings has become questionable.

The main deficiencies in the operation of credit rating agencies are:

- excessive use of credit ratings by participants in financial markets, especially as a result of the excessive use of ratings for regulatory purposes
- non-transparent decision-making mechanisms in determining credit ratings
- conflicts of interest between those who are ordering credit ratings and the ownership structure of the rating agencies, implying that a shareholder in a rating agency may, from that same agency, obtain a rating of their own financial products
- inadequate and under-regulation of specific types of ratings, especially those associated with government debt instruments
- the issue of the accountability of credit rating agencies as regards the ethical nature of their conduct
- the limited number of agencies that offer these types of services.

Credit rating agencies are not only considered to be instigators of the problems that underlay the cause of the financial crash of the American capital market but, additionally, by lowering the ratings of certain EU countries that were under attack from financial speculators, they are considered to have caused a sharp increase in interest rates on the debt of such countries, thus making the repayment of debts both impossible and unsustainable for these countries.

The developments in the current debt crisis seems to make it necessary to modify the operations of the agencies, which will reduce their impact on the financial markets. The simplest solution as regards reducing the power of the agencies is to remove their ratings as a precondition for regulation. That will enable investors to seek alternative sources of information without being obliged to follow the opinion of the credit ratings agencies.

The non-transparent system of decision-making in determining a credit rating is also considered to be one of the shortcomings in the functioning of the credit rating agencies. The credit rating of countries is determined by a board consisting of twenty members, depending on the country whose credit rating is being determined. Each state has its own credit analyst who, in the process of the analysis and assessment of a country's risk, takes into account both official data sources, statistics, printed media, discussions with the originator of fiscal and monetary policy. The report which is subsequently prepared is presented to the Board for each individual state. States whose ratings are being determined have no say in the final decision; they may complain, although this rarely results in any change in the ratings decision.

As long as the clients of credit rating agencies were the only investors in credit ratings, they were unconditionally trusted by all participants in the financial markets. The aforementioned three major credit rating agencies were established in the late 19th and early 20th centuries and, at the outset of their work, their clients were investors who paid them to perform specialised and professional rankings of their potential investments, including in securities. In order to attract more customers and thus provide more income, however, they started during the 1980s to attract companies issuing securities as customers. This created the conditions for a lack of professionalism and abuse of position that led subsequently to conflicts of interest between financial market participants. Furthermore, issuers also gained the opportunity of making deals with the credit rating agencies in respect of earning better evaluations on their assets, and were willing to pay more to do so because, in such a manner, they could place their securities more easily and under better conditions. Moreover, issuers were able to choose which agency to determine their rating, meaning the one that offered the best assessment.

The consequence was that the credit rating agencies awarded evaluations to issuers and their securities that had less and less correlation with the actual situation. Thus was the highest grade (AAA) frequently awarded to the great mass of financial derivatives that were created and issued on the basis of high-risk home loans. However, the credit rating agencies went beyond that by giving high ratings to complex financial instruments. They began by offering advisory services for the modelling of financial derivatives. Therefore, it was often the case that the issuer, with an additional payment for the service, would ask the credit rating agency to model their assets which, later on, would receive the highest rating from the same agency.

In terms of addressing all the shortcomings in the functioning of the credit rating agencies, we can clearly conclude that it is necessary to reform their operations, from the point of view of the following considerations:

1. agencies should only bill investors for their ratings, not issuers
2. agencies should be prohibited from providing consulting services
3. abolishing the exclusive status of the existing ratings agencies in many regulations and official documents
4. breaking the existing monopoly
5. creating the conditions for competition through fewer requirements for the registration of new credit rating agencies.

EU legislation to redefine the activities of credit rating agencies

Due to the impact of the credit rating agencies in reheating the debt crisis in the Eurozone, the European Union passed legislation through which their activities have been restricted and redefined such that ratings awarded in the future would not have such a major impact on the financial leasing market. Even in October 2007, the finance ministers of EU member states had agreed to adopt conclusions on the crisis, including the drafting of a proposal to evaluate the role of credit rating activities in order to overcome the above-mentioned drawbacks.

Legislation concerning the operation of the credit rating agencies aim to restore market confidence and increase investor protection. So, according to the regulation, all credit rating agencies that would like their ratings to be used in the EU will have to apply for registration to the Committee of European Securities Regulators (CESR).

Registered credit rating agencies will have to harmonise their activities with stringent rules to ensure that:

a) the assigned ratings are not affected by conflicts of interest
b) the agencies observe a quality methodology in determining a rating
c) the agencies act in a transparent way.

The legislation also sets down an effective surveillance regime under which the regulators will supervise the credit rating agencies. The new rules include the following:

- credit rating agencies cannot perform advisory services
- the agencies will not be allowed to perform a ranking of financial instruments that do not contain sufficient quality information on which to determine the ratings
- they must disclose the models, methodologies and key assumptions on which they base their ratings
- they have to conduct different ratings of complex financial products with the addition of specific symbols
- they will be required to publish an annual report on transparency
- they will have to create an internal mechanism for checking the quality of their ratings
- they should have at least two independent directors on their boards whose remuneration cannot depend on the business performance of the rating agencies. Each will be appointed for a term which shall be no longer than five years. Their appointments can only be cancelled in the case of professional crime and at least one of them must be an expert in securities and structured finance.

The new rules are largely based on standards set by the International Organisation of Securities Commissions. The legislation imposes rules that have legally binding character.

The European Union is aiming to reduce the impact of the credit rating agencies on European financial markets as well as to reduce the level of reliance on their ratings. These will no longer be taken automatically, but all participants in the financial leasing market will have to make their own assessments of risk when investing in financial instruments.

The adopted rules of operation for the credit rating agencies stipulate when and how sovereign debt can be assessed. Therefore, the credit rating agencies can publish unfavourable credit ratings for sovereign debt only to a specific date, out of working hours and before the opening of stock markets in Europe. The new rules prescribe that the agencies must inform countries 24 hours in advance before they change their rating (not just 12 hours, as before); thus, the agencies will be required to publish the information on the basis of which they have decided to change the credit rating of a particular country.

In addition, the regulations project that the agencies should rotate their customers every three years to prevent possible corruption and conflicts of interest; additionally, in the evaluation of complex financial derivatives, the agencies should rotate so as to prevent the possibility that the profit-orientation will lead them to rate issuers in order to win customers. And, unlike now, when the credit agencies have not accepted responsibility for what may happen after lowering the credit rating of a country, the new European rules increase the accountability of agencies for all cases of intent and abuse, which also gives the possibility of their ratings being challenged before the civil courts. Also, with the aim of avoiding conflicts of interest, the role of the credit rating agencies in assessing companies who are shareholders in the agency will be limited.

Furthermore, it is prescribed that the credit ratings themselves should be clearly defined, while the agencies will have to clarify the key components and the methodology by which they have calculated and determined their ratings. Assessments will not be allowed to affect politicians and agencies will not be allowed advocacy or to provide support in the political domain.

Despite the existence of several smaller European credit rating agencies, the EU is increasingly talking about the formation of a large European credit agency, which would be equal to the US credit rating agencies. It would be financed by private investors – banks, insurance and financial companies – to prevent individual states affecting its judgments and thereby compromising its integrity. Unlike the three largest credit rating agencies, the European credit rating agency is planned to be a non-profit institution. Investors would be the ones paying for its services – i.e. determining credit ratings – and not the companies and financial institutions subject to the evaluation. The European credit rating agency is intended to operate transparently and professionally, and credit ratings will show the real value to issuers (companies and countries) in terms of their creditworthiness, with the sole purpose of restoring market confidence and increasing the protection of investors.

Conclusion

The credit ratings awarded by the credit rating agencies were intended to enable participants in the financial markets make the most optimal investment choices. The analysis determining the rating objective and credible but, over the last two decades, the agencies have put a shadow over their own personal ratings in the process of evaluating credit riskiness.

In particular, the agencies had a crucial influence on events within the financial markets in the run-up to the financial crash of 2008 and in its aftermath. This has led the European Union to issue a regulation seeking to limit and re-define their activities with the purpose of recovering trust and increasing protection for investors. It is too early to assess the success of these measures, but the intention – reducing reliance on the agencies, increasing transparency, greater independence and the elimination of conflicts of interest, and improving accountability – is laudable in itself. The prevailing regulatory framework was clearly too weak; toughening that and removing other areas of weakness is clearly a major priority in applying the lessons associated with the huge damage that the crash has caused European economies and the social infrastructure.

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