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Rating Agencies – General Issues and Potential Solutions

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Abstract

The paper highlights various issues related to rating agencies (ratings failure, revenue bias, increased use of ratings in the investment community to the extent of dependency on them, incompleteness of the analysis behind the rating process and the inability of ratings to predict financial crises) and provides a synthesis of the potential solutions advanced by the existing literature. Such solutions include: solving the rating agencies' conflicts of interest, reducing competition among rating agencies, switching to the "investor pays" model, and holding the agencies responsible for mistakes in the rating process.

Key words: *ratings failure, rating agencies' conflicts of interest, regulation of ratings agencies*

JEL Classifcation: *G01, G15, G24*

Introduction

Credit ratings are closely watched by the whole investment community for various reasons ranging from regulatory requirements to implications on the pricing of debt instruments. These ratings are issued by many agencies, but the most widely recognized ones are Moody's, Standard and Poor's (S&P) and Fitch. Following each financial crisis there has been a lot of talk on the failure of ratings issued by credit rating agencies to predict such crises.

However, the issues related to the rating agencies can be much more general and different from the obvious ones such as ratings failure. For example, one such issue is the fact that the ratings have become increasingly important for the financial markets to the extent that it is often difficult to ignore them during the investment process. Consequently, there have been numerous proposals of solutions for the issues previously mentioned, but the degree to which they can be turned into reality is debatable.

The current paper is organized as follows: the first part will give an overview of the various meanings of ratings failure and it will highlight several other issues related to the rating agencies, and the second part will synthesize the potential solutions advanced by the existing literature on the topic of rating agencies.

What Are the Problems Related to the Credit Rating Agencies?

There are several types of problems related to rating agencies, the most obvious one being the ratings failure. According to Minescu & Stancu (2010), ratings failure can have multiple meanings, such as: (i) the failure of a rating to predict default (examples: Enron, WorldCom, various Asian countries during the 1998 Asian crisis); (ii) the failure of ratings to be stable, meaning the occurrence of large upgrades or downgrades of a rating (one such example would be S&P's foreign currency ratings on Korea , which was downgraded by 10 notches within 2 months in 1997 and upgraded by 4 notches within 11 months in 1998); (iii) the failure of an agency to issue a rating in the correct category of ratings (i.e. investment grade or junk); and (iv) the failure of two or more agencies to issue similar levels of credit rating for the same country at the same time (for example Argentina in 2001, 2005 and 2006). In this previous article, ratings failure were defined mainly in the context of sovereign credit ratings. However, the same definitions (except the last one) would apply to the extended universe of credit ratings which also includes financial instruments such as corporate bonds, CDOs, structured products and others.

According to Bhatia (2002), there could be 4 causes of ratings failure, namely: information risk (i.e. the data provided by the institutions whose products are being rate are inaccurate), analytical constraints (meaning that rating agencies may rely on already issued rating reports in order to overcome the lack of human resources working for the rating process), revenue bias (i.e. the issuer of the product being rated may be inclined to pay additional fees to the rating agency in order to receive a more favorable rating) and other incentive problems.

The revenue bias could also be seen in a more general context together with the issue of conflicts of interest at the level of rating agencies. More precisely, there are 3 parties that contribute to the potential agency problems in the credit rating industry: rating agencies, firms and investors. The rating agencies assign credit ratings to the financial instruments issued by firms. Investors are interested in investing in those financial instruments and they may be constrained by regulation to pay special attention to the ratings assigned to them. Firms must decide which rating agency to choose based on whether investors will assign value to the ratings received. In this context, firms must choose a rating agency with a good and well established reputation. However, investors' decision among various financial instruments in the same category depends to a large extent on their ratings, their returns and their price, and there is a general preference for financial instruments with higher ratings, all other things being equal. In this context, firms would tend to choose rating agencies which would assign a higher rating to the financial instruments they issue, in order to make them more appealing to investors, which describes the conflict at the level of the firm. At the level of the rating agency, the conflict arises due to the fact that on the one hand, the rating agency wants to issue ratings as accurate as possible in order to maintain its reputation in the market in the long term, but on the other hand it may want to issue as favorable ratings as possible in order not to lose its client (the firm) to its competitors and consequently lose the fee that it would otherwise earn for issuing the rating. A similar (but less detailed) description of these conflicts was also provided by Becker & Milbourn (2009). In addition to my description, they also noticed that it is cheaper to produce low quality ratings than high quality ratings; this fact has implications for all three parties involved in this agency problem.

On a different note, with regard to revenue bias, it is worth mentioning that there are two main elements in compensation of employees: fixed pay, which is the annual base salary, and variable pay, which is a component dependent on the employee's and company's performance (Andrei (2009)). In this context, one could identify a new dimension to the revenue bias, in the sense that the analyst is biased to perform a "favorable" analysis for the client (i.e. the issuer) in order to receive positive feedback from them and thus indirectly influence the variable component of their compensation (Minescu, Stancu (2010)).

Other problems related to rating agencies are: (i) the increased importance of the use of credit ratings in the financial markets due to existing financial regulation, despite the impossibility of holding them responsible in front of the law for the ratings they issue (World Bank (2009)); (ii) the agencies' inability to take into account during the rating process the fact that the liquidity of the financial instruments being rated can change over time and even disappear, which would have a strong influence on the market for those financial instruments (Portes (2008)); (iii) the agencies' inability to react on time and anticipate the financial crises (Portes (2008)).

Potential Solutions

According to the existing literature, various solutions have been proposed in order to address the problems described above. Some of these proposed solutions include: solving the rating agencies' conflicts of interest; switching from the "issuer-pays" model to the "investor-pays" model; increasing competition among rating agencies (however, this is a largely debated solution, as there are certain authors who suggest that reducing competition among rating agencies would in fact be more beneficial to the final user of the ratings and this way would contribute more to solving some of the problems related to the rating agencies); creating a legal framework in which rating agencies could be held responsible for the failed ratings they issued. The paragraphs below will detail all these proposed solutions and will also mention few others which have received less attention in the existing literature on this topic.

Solving the rating agencies' conflicts of interest has been widely recommended by a large number of authors. For example, Sy (2009) mentions the recommendations made by the Joint Forum (2008) to all the stakeholders, one of them being that the credit rating agencies should address the potential conflicts of interest, including concerns about the remuneration models. With regard to the use of material non-public information, the Joint Forum (2008) recommends that market participants should implement strict compliance rules to address the potential conflicts of interest and to prevent inappropriate use of such information. Moreover, the investors themselves are also recommended to check for potential conflicts of interest. Sy (2009) also mentions the recommendation made by SEC (2003) that more developments would be needed with regard to procedures to manage potential conflicts of interest that arise when issuers pay for ratings and restriction of direct contacts between rating analysts and subscribers.

Switching from the "issuer-pays" model to the "investor-pays" model has also been a widely recommended solution, but there have been also authors which disagreed with it and considered that it would have an effect opposite to the one desired. The difference between the "investor-pays" and the "issuer-pays" is obviously who pays the fees to the rating agency to assign a rating to a financial product. Since the early 1970s, rating agencies have been paid by issuers and the "investor-pays" model has been abandoned because of free riding problems – as Freixas & Shapiro (2009) notice, this time of the switch to the "issuer-pays" model coincided with the introduction of affordable photocopying. According to Sy (2009), the current "issuer-pays" model is not very suitable because it can generate conflicts of interest, cases of "shopping" for a better rating and issues related to the quality of disclosed information. In fact, there are plenty of other authors who agree with this opinion: World Bank (2009), Freixas & Shapiro (2009), Becker & Milbourn (2009). All these authors strongly believe that a return to the "investor-pays" model would partly solve these problems. Freixas & Shapiro (2009) and Mathis et al (2008) suggest that one potential method of adopting again the "investor-pays" model would be to let exchanges pay for the ratings and collect further payments from the issuers or investors. However, this may generate a new conflict on the level of the exchange, as the exchange would also have an interest in having high ratings assigned to the financial products in order to benefit from a larger and larger number of products traded on its platform.

In their defense, the rating agencies argue that the model used is not a big issue because what is most important to them is to safeguard their reputation for issuing objective and credible ratings, which as a general principle should definitely reduce the potential influence from the issuer's side (Sy (2009)). In addition to this argument, they also claim that the amount of fees collected from a single issuer is a very small percentage of the total amount of fees collected; therefore, it would not be worth to compromise the rating for such a small additional gain.

At the other extreme is Calomiris's (2009) study, arguing that a switch to the "investor-pays" model would not make the ratings more reliable, because the ones really inflating the ratings are the regulated buy-side investors (such as hedge funds and pension funds) who would be favored by higher ratings because the financial products with such ratings would have a better chance to qualify for investment of their portfolios.

Increasing competition among rating agencies has probably been the most widely debated solution in the existing literature, and there have been numerous recommendations both for the increase of competition among rating agencies and for the decrease of competition among rating agencies.

One study which should be mentioned for the arguments described in favor of an increased competition among rating agencies is World Bank (2009). The study mentions that several other studies have advised that an increase in competition would result in a better quality of ratings, but it also admits that such a step would be very difficult to take due to the huge size of the market, the high barriers to entry and the oligopolistic structure of the ratings market.

Among the authors who considered that decreasing competition among rating agencies would be the best thing to do were: Becker & Milbourn (2009), Skreta & Veldkamp (2008), Bolton et al (2009) and Freixa & Shapiro (2009). Their main line of argument is that increasing the number of rating agencies also increases the ratings shopping problem, which is not beneficial for the final investor. Skreta & Veldkamp (2008) also add that the more complex the products being rated, the more variable the ratings are and the higher the incentive to shop for better ratings. Moreover, Becker & Milbourn (2009) perform a study and bring evidence that the large increase in the market share of Fitch was accompanied by a reduction in the quality of credit ratings. They showed that competition was associated with "friendlier" ratings and that the correlation between the bond yields and the credit ratings decreased with competition. Therefore, their final recommendation was that the system is likely to work better when the competition is not too tight.

Creating a legal framework in which rating agencies could be held responsible for the failed ratings they issued is another idea brought forward by researchers in the field of rating agencies' performance (Sy (2009)). However, Portes (2008) argues that such a measure could take the rating agencies out of business because of too much suing.

There have been some regulatory responses in this direction both in the USA and in Europe. In USA, the Credit Rating Agency Reform Act of 2006 has brought important changes: it provided the SEC authority for the first time in this area; credit rating agencies in the USA have to make certain disclosures; the SEC is authorized to prohibit conflicts of interest, especially related to compensation for the service of providing ratings. Europe also came forward with new legislation, including the following 3 Directives: the Market Abuse Directive, the Capital Requirements Directive and the Markets in Financial Instruments Directive (MiFID). In addition to these, the European Commission also recommended that the 2004 IOSCO Code should be included in the codes of conduct of the rating agencies. This Code is concerned with issues such as the quality and the integrity of the rating process, the avoidance of conflicts of interest, the independence of rating agencies and their responsibilities towards the investors and the issuers.

Other solutions proposed (but analyzed to a lesser extent in the literature) are: assigning rating intervals to the financial instruments instead of punctual ratings (Portes (2008)); separating the rating and advisory businesses within the rating agencies (Portes (2008)); and last but not least withdrawing financial regulation that imposes the use of ratings (Sy (2009)). Such regulation refers to situations when: certain contractual provisions that change credit availability and pricing relate to specified rating actions; determining capital requirement is a calculation which is not independent from the ratings assigned to the financial products on the balance sheet; establishing the eligibility of a product for investing is often also related to ratings etc. This increased role of ratings in the financial markets and the increased dependence of investors on ratings have been at the origin of the new line of argument which suggests that the reliance of investors on rating agencies should be greatly reduced if not eliminated altogether.

On a more general note, it is worth mentioning Lo (2009)'s findings with regard to a general regulatory reform. According to Lo (2009), "financial manias and panics cannot be legislated away" (page 5), but the 2007 – 2008 financial crisis provided us with the opportunity to promote major changes in the existing regulatory framework which would have been almost impossible otherwise. Lo (2009) highlights a multitude of implications for a regulatory reform in the context in which he believes that the main purposes of regulation are to facilitate access to information and education, and to address market failures and human behaviors. These implications range from general ones, such as the need to be able to define and measure explicitly the risks of financial crises, to more specific ones, such as the need to break up into smaller entities and financial companies that are "too big to fail" or the need to revise existing corporate governance structures in order to allow more independence for the risk management function. There are also several more unusual implications added to the list, such as the suggestion for requirement of periodic certification of the senior managers and directors of institutions involved in complex financial instruments. Last but not least, Lo (2009) also suggests that a dedicated inter-agency team of public relations professionals should be formed in times of crisis in order to establish clear and regular lines of communication with the public on topics related to the financial crisis, since most of the terminology used in the media is not enough accessible to the general audience.

Conclusions

Rating agencies face various issues, such as: ratings failure, which can be understood in multiple ways (the failure of a rating to predict default, the failure of ratings to be stable, meaning the occurrence of large upgrades or downgrades of a rating within a short period of time, the failure of an agency to issue a rating in the correct category of ratings (i.e. investment grade or junk), and the failure of two or more agencies to issue similar levels of credit rating for the same financial product at the same time – applicable usually to sovereign debt), revenue bias, increased use of ratings in the investment community to the extent of dependency on them, incompleteness of the analysis behind the rating process and the inability of ratings to predict financial crises.

The second part of the paper synthesized the solutions proposed by existing literature to deal with these issues. These solutions include: solving the rating agencies' conflicts of interest, switching from the "issuer-pays" to the "investor-pays" model, decreasing competition among credit agencies, creating a legal framework in which rating agencies could be held responsible for the failed ratings they issued, assigning rating intervals to the financial instruments instead of punctual ratings, and even withdrawing financial regulation that imposes the use of ratings. However, some of these measures proposed have been widely debated. For example there are also many authors who suggest that increasing the competition among rating agencies is one measure which would help rating agencies to provide a higher quality service and more reliable ratings.

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Agențiile de rating – probleme generale şi soluții potențiale

Rezumat

Articolul evidențiază diferite probleme referitoare la agențiile de rating (eşecuri ale ratingurilor, instabilitatea ratingurilor, utilizarea sporită a ratingurilor în comunitatea de investiții - ajungându-se aproape la dependență de ele, caracterul incomplet al analizei aflate la baza procesului de rating şi incapacitatea ratingului de a prezice crizele financiare) şi oferă o sinteză a soluțiilor potențiale avansate din literatura de specialitate. Astfel de soluții includ: rezolvarea conflictelor de interese ale agențiilor de rating, reducerea concurenței în rândul agențiilor de rating, trecerea la modelul „investitorul plăteşte" şi responsabilizarea agențiilor pentru erorile din procesul de rating.