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Regulation of Credit Rating Agencies

Evidence from Recent Crisis

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Abstract

The importance of ratings for investors' decisions and for the perceptions of the financial health of a nation pointed out the need that credit rating agencies should be regulated in some way. Regulators and market participants believed that the credit rating agencies need to abide by standards of corporate governance and supervision due to their pivotal role in the US subprime crisis. This belief was amplified recently because the rating agencies were deeply involved in the European debt crisis after various sovereign debt ratings were significantly downgraded. Therefore, the paper highlights the critique against the agencies' role in the two most recent crises and reviews the regulation proposals which subject the rating agencies to behavioral standards.

JEL classification

G15, G24, G38

Keywords

Credit rating agencies, subprime, Euro crisis

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1. Introduction

Since the 2007 financial crisis, the credibility of the three major rating agencies; including Moody's, Standard & Poor's and Fitch, had been adversely hit given that their rating practices proved to be at the heart of the crisis and that the rating agencies played a pivotal role in chasing a global financial meltdown. Accordingly, the rating agencies faced critiques against their stake in the crisis, and in response to their central role in bringing down global financial markets; regulatory proposals were put forward to address the major criticisms that the agencies faced.

Along with the discussions of regulatory reforms, the anger fumes against the credit rating agencies gradually faded away until the moment that the rating agencies announced sharp downgrades of European Sovereign debt, which started, with Greek debt in late 2009. After downgrading Greece, the role of rating agencies and their influence came under harsh spotlight again and once more anger fumes mounted against the agencies questioning the accuracy of the agencies' rating assessments that are the heart of the efficient performance of world economies.

As a follow up of the subprime crises, the credit rating agencies were criticized of creating boom-bust cycles because of issuing investment grade ratings on novel structured products backed by subprime credits (Verschoor 2007). Since the 2007 crisis, regulatory proposals were directed to the agencies due to their pivotal and critical role in the financial sphere (e.g. Sy 2009). However, although these proposals have been made, no action has been taken so far, so the rating agencies are again accused of triggering a European crisis and they have been under further blames and criticisms as a result of the sudden and continuous downgrades of highly-rated sovereign debts (Warner 2010, Reisen 2010). This paper points out the two critical incidents that crystallized the role of the rating agencies and that there were regulatory proposals being announced in response of the 2007 crisis, but in face of the current European crisis, it is evident that those proposed regulations were not applied as put forward.

Thus, the principle motivation of the paper is to identify that the major downgrades by the rating agencies of financial products either of structured finance products or of sovereign debt result in systemic panics and financial instability given that the rating agencies' announcements influence the investors' perceptions of a country's economic outlook and financial health. The paper highlights the critical role of the rating agencies in the two most recent crises starting with their role in amplifying the 2007 financial crisis, and their role in bringing down world economies by their sudden and major downgrades of European Sovereign debt including Greece and also of the subsequent downgrades of Spain and Portugal. Lastly, the paper reviews the regulatory proposals that were called for in the wake of the 2007 global crisis and questions whether such regulations were yet put into practice or not amid the influential effect of the rating downgrades of European debt.

2. The Role of Credit Rating Agencies in the Financial Crisis

In the financial sphere, the rating agencies play a vital role, but nevertheless they are among the least understood and one of the least regulated players. Since the beginning of the subprime meltdown, the market observers had criticized the role of the rating agencies as being critical players in the evolution and severity of the subprime crisis because the agencies helped in the massive growth and fast development of the structured finance market.

The credit rating agencies (CRAs) have been under the cloud of criticism following the collapse of the US subprime mortgage market for several reasons. One of the questions asked was tackling the accuracy of the structured finance rating methodologies. This question was raised as a follow up of the elevating delinquencies occurred on structured finance products; an effect which was responded by massive downgrades from the rating agencies. As it is well known, the results continued to spread beyond the mortgage market and beyond the borders of the United States to the extent that the subprime crisis is considered to be the first global financial crisis of the 21st century.

On one hand, the rating agencies were the primary raters of the structured finance Collateralized Debt Obligations (CDOs) backed by assets of dubious quality, such as the subprime credits, and on the other hand the rating agencies are blamed of publishing exaggerated ratings on over-sophisticated products that were backed by toxic assets. The problematic role of the rating agencies was when the highly rated CDO tranches, rated as high as AAA, started to default and to be significantly downgraded by the rating agencies. Since that the CDO tranches' performance depended on the performance of their underlying assets, thus, when the majority, if not all, of the subprime borrowers started to default and become unable to pay back their mortgage credits the rating agencies did not have any other option than to quickly downgrade the defaulting CDO tranches that created a systemic panic around the globe (BIS 2005, 22).

Since summer 2007, problems with the ratings were revealed and the rating agencies have been blamed of signaling a false sense of security about the credit-worthiness of the complex and novel structured finance products. Furthermore, a chain of adverse events occurred, leading to a systemic crisis when the CRAs started to significantly downgrade the exaggerated initial ratings of structured finance products, leading to a crisis of confidence in the global financial system. The tragic story continued when the equity or the unrated CDO tranches did not act as safety cushions to protect the highly-rated CDOs from default; simply because the losses were significant enough to the extent that the initial rating of highly rated CDOs had to be downgraded from AAA to junk status.

Therefore, the rating agencies are blamed of publishing ratings that did not reflect the true risk of the CDO deals. Three major points of criticism have been raised, namely model risk, conflict of interest and lack of transparency.

Since the rating agencies played a significant role in rating the novel structured finance CDOs by issuing investment grade ratings that were later sharply downgraded, the market participants have been pointing out the problem of model risk that exists in the applied rating models. Hence, the first criticism the rating agencies received identified technical problems in the rating methodologies used for the rating of structured finance CDOs. As the name suggests, model risk relates to potential errors in the quantitative models and in the accuracy of the assumptions fed into their specific rating methodologies (BIS 2005, 49; Fender and Mitchell 2005, 9-13). The sharp downgrades of the initial AAA-ratings manifest an underestimation of the default risk and correlation among the underlying assets and that the rating agencies were over-optimistic regarding the housing bubble and that they expected that the real estate prices would continue to increase (Fender and Mitchell 2005, 9-13), thus, pointing out that model risk is an important concern arising from the complexity of the structured finance CDOs that questioned the reliability and credibility of the quantitative rating methodologies.

A second major criticism arises from the business model itself. Since the inception of the structured finance market, the issuers of the structured finance products were keen to obtain ratings from the prominent CRAs in order to use those ratings as sell triggers to attract global investors.

Due to the market participants' over-reliance on such ratings, the structured finance market became a promising and growing business segment for the rating agencies to the extent that it turned out to be one of the biggest markets for the agencies, regardless of the novelty and complexity of the structured finance products (Fender and Mitchell 2005, 72-73; Kiff 2010, 2). The problem arising here is conflict of interest; it has three angles from which the rating agencies are blamed.

The first issue is related to the current business model, the CRAs are paid solely by the issuers, and not by the market investors that use the ratings to make informed investment decisions. The problem does not only lie on who pays the agencies, but also in the fact that such issuer-fees constitute a significant percentage of the agencies' revenues, especially as the structured finance ratings proved to be the most profitable segment for the agencies. The issuer-paying model had created biased incentives for the rating agencies when the agency has the interest to be selected by the issuer by giving a better rating to the structured finance deals than any competitor in order to keep the business going with this issuers (Hunt No Year, 32-35). Therefore, the issuer-paying model creates the incentive for the issuer to shop-rate the agency that publishes the most favorable and highest-possible ratings for their deals. A higher rating enables the issuer to better place the structured finance products in the financial markets by citing the high ratings published by the so-called chosen rating agencies. Consequently, the apparent deficiencies in the rating process and the major downgrades in the structured finance initial ratings question the inherit conflicts of interest under the issuer-paying model of CRAs (SEC 2008, 25-26).

The second angle of conflict of interest is based on the unsolicited credit ratings that the agencies would publish for a non-client issuer of structured finance deals. This had created pressure and motivation for the issuers to pay the agencies as high fees as possible in order to receive high ratings for their structured finance CDOs; therefore avoiding the (lower) ratings they would receive if they do not do business with any of the three prominent rating agencies. Therefore, the issuers of such complex deals were keen to obtain ratings by the CRAs to make the marketability of their novel products easier. The issuers believed that purchasing ratings and paying the agencies high fees would improve the ratings they receive for their products.

The last but critical angle of conflict of interest is that the rating agencies did not stop at only quantitatively rating the structured finance deals, but they went beyond that to the extent that the agencies had an active and integral role in the structuring of specific CDO deals. The agencies had provided the issuers with advisory and consultancy services that they were paid for in order to help the issuers to create and manufacture CDO tranches that meet the desired ratings. The trouble is that the rating agencies ended up rating products that they actually designed which created biasness and conflict that inappropriately influenced the ratings published by the agencies to the public.

Therefore, putting the three angles together it can be concluded that conflict of interest is most apparent in structured finance deals that question the accuracy of the ratings published by the rating agencies (SEC 2008, 25-26; Verschoor 2007, 11).

The third main criticism is the lack of transparency. Since the subprime meltdown, it became obvious that the rating agencies did not sufficiently disclose information allowing investors to understand how they derived the ratings and to correctly understand their assumptions. This made it more difficult for market participants to adequately make informed investment decisions. Thus, lack of transparency was a further criticism against the rating agencies, especially since the ratings of CDOs did not fully and clearly reflect the true quality of the underlying assets and therefore giving a false impression about the true risk embedded in the different tranches. Also, the investors had little understanding about the inner structuring of the CDO tranches and also they lacked critical information about how the rating agencies had reached the published ratings of such products because the rating agencies failed to disclose adequate information regarding their rating techniques for such sophisticated and novel products (Frost 2006, 10-11).

With the same token, the rating agencies are blamed of applying the same rating schemes of traditional financial products like bonds to rate the complex structured CDOs. Despite the fact that structured finance instruments posses different risk characteristics and the failure of the agencies to clearly communicate that, the use of the same rating schemes for two different financial products led to misinterpretations in the global financial markets and to risk miscalculation by the market participants (Rudolph and Scholz 2008, 1-5).

To conclude, the three major criticisms that the rating agencies had faced since the fall of the US subprime mortgage market resulted in a loss of confidence in the ratings that the CRAs published to the extent that the liquidity of the structured finance market had turned from highly-active market to a very dry and illiquid market in a very short time period.

3. Regulation and Supervision proposals

The failures by the CRAs with rating structured finance products and due to their central role in the financial markets, the international regulatory bodies in the US and EU were provoked and proposed a regulatory reform. These proposals addressed issues like

- subjecting the CRAs to behavioral standards to manage conflict of interests,
- improve transparency,
- and, most importantly, to set a registering regime to subject the CRAs to increased supervision.

Hence, the prime objective of the regulation is to stabilize the financial system, and to prevent the reoccurrence of similar chain events that adversely affected the wellbeing of world economies.

It is proposed that the Securities Exchange Commission (SEC) in the US must have clearer authorities and to subject the CRAs to explicit legislation. This is mainly due to the fact that the conflict of interest became critical because of the agencies' active involvement with their clients who explicitly pay the rating agencies fees. The focus now is that such relationships with the rating committee and their clients must be closely monitored by the regulators, and the regulation states that the rating committee that approves the ratings should not make proposals and recommendations, either formally or informally, concerning the rating deals in order to manage any potential conflict of interest. For example, the CRAs shall be prohibited to offer advice regarding the design of structured finance products for the issuers to meet their desired ratings (SLC 2010, 886).

Thus, the consulting and advisory services on credit enhancements to qualify the issuer for higher-ratings which led to conflict of interest shall be managed under the regulatory proposal because the agencies are not allowed to rate the securities if they had an active part in the securitization process and/or the design of structured finance deals (Dam 2010, 51). Additionally, to avoid biased incentives, there shall be a separation of ratings from sales and marketing activities by the rating committees in order to avoid influence by the clients and to mitigate conflict of interest. Moreover, it is asked to provide alternative paying and compensation schemes rather than the issuer-paying model in order to motivate the rating agencies to issue more accurate ratings and to avoid any conflict of interest that may arise (SLC 2010, 886; Kiff 2010, 10).

Therefore, the most radical measure to reduce conflict of interest is to move to a ‘performance-based’ model than ‘issuer-paying’ model. In this model the issuers pay a minimum start-up fee at the beginning of the rating deal, and the remaining amount of the rating fee has to be paid over an agreed time frame based on the ultimate accuracy of the published ratings (Kiff 2010, 10). Also, it is proposed to increase the accountability and litigation of the CRAs since the reform calls for effective internal control structure that shall control and govern the implementation of and the observance to the policies, and techniques for determining the ratings published to the financial markets (SLC 2010, 850; Kiff 2010, 2). The aim of having an internal governance and independent compliance departments is to ensure that the CRAs are managing any inherit conflict of interests and to review the rating methodologies on a regular basis (Utzig 2010, 16).

Allowing the CRAs to set their own internal code of conduct requires regulatory supervision to ensure that there are no deviations from the regulations by the agencies; therefore the rating agencies shall be subject to registration in order to better regulate and supervise them according to one international umbrella and a common regulatory approach. When a rating agency is registered, then the regulatory bodies can exert supervisory and investigatory powers, and thus the CRAs shall be dealt with as any gatekeeper such as investment firms that are subject to regulation and legal liability (Financial Institutions Advisory 2009, 3; Lannoo 2008, 3). Registering the rating agencies provides a better mechanism and increased supervisory powers to ensure effective enforcement of the regulation (Commission of the European Community 2008, 9-10).

The regulatory reform addresses the need to increase the legal liability of the CRAs by giving the SEC the authority to revoke the Nationally Recognized Statistical Rating Organization (NRSRO) designation if it is found that any rating agency published credit ratings based on inadequate financial and managerial resources to issue ratings with integrity. Also, the regulation requires that the rating agencies should not publish any structured finance ratings unless reliable data is available and that the quality of information about the new deal is satisfactory enough to issue credible ratings. Additionally, the proposal is aiming at requiring the CRAs to publish an additional symbol in order to distinguish the structured finance ratings from any traditional ratings for the sake of capturing the difference between the structured finance products such as the CDOs that behave differently than any other rated instrument (SEC, 27-28, Utzig, 2010, 16).

Furthermore, the European Commission (EC) is introducing a centralized EU oversight of CRAs in which the CRAs that are operating in the EU should be registered. The registration is mandating them to follow a code of conduct that reduces conflict of interest and increases transparency. Gradually, the regulatory reliance on the CRAs by policymakers is expected to be reduced in laws and bank regulations at the same time of enhancing the CRAs regulatory oversight that shall in return reduce shop-rating by issuers and enhance competition in the rating industry since that the CRAs shall not be captive players in the financial markets (Kiff 2010, 12, 14, 28).

In addition, the regulation is addressing another critical aspect which is improving transparency for the sake of investor-protection: the CRAs are asked to provide and publish annual reports, financial and inspection reports and a publication of each rating that discloses the methodologies and procedures used in the rating process of a specific deal (SLC 2010, 859, 864) as well as the quality of underlying collateral assets in any structured finance deal. Moreover, the rating agencies are asked to keep free and public the historic records of the rated instruments and to disclose performance information about initial ratings in a timely manner and any relevant changes in order to enable the investors to compare rating instruments and rating agencies (Herring and Kane 2010, 18-20). Not only that, the CRAs shall be required to disclose information about their own due-diligence, their assumptions and any stress scenarios performed in order to help market participants with their investment decisions. Also, it is being suggested that the CRAs should be transparent about the quantitative rating models applied by publishing a description of their rating processes including methodologies and procedures, and also to be transparent about how they internally validate their ratings (Kiff 2010, 11, 28)

Lastly, the federal regulators are proposing to find a replacement for the credit rating agencies after the rating disaster that contributed to the US housing bust and to the global recession. The regulators are targeting to eliminate the extreme reliance on the rating agencies in rules for bank capital and in assessing the risk of investments (Gordon 2010). Regulators claim that mitigating the critical role of and reliance on CRAs became vital after they led the world economies down when the agencies published high ratings on toxic securities based on untested models and optimistic assumptions (Adler 2010).

In the wake of the subprime crisis, the paramount role of the rating agencies was criticized and regulatory measures were put forward in order to enhance financial stability and to subject the rating agencies to increased supervision and regulation. But history repeats itself and nowadays the rating agencies are once again put under fire and their role is amplified regarding country-ratings and they are highly criticized because of their sharp and sudden downgrades of European Sovereign debt.

4. The Role of CRAs in the European Debt Crisis

Despite being discredited by their role in the financial crisis, the important role of the rating agencies for the financial markets could again be recognized when they severely downgraded European sovereign debt, including Greek, Spanish and Portuguese. This again was an incident that confirmed how the credit rating agencies had failed the market; showing how weak they are in trailing events in the financial world and also that their pricing of risk and their credit analyses sometimes lag behind market realities (Warner 2010).

History shows that the credit rating agencies have been critical players in the most systemic crises by creating bubbles through assigning top notch ratings to debt instruments that did not deserve such high ratings leading to the misallocation of capital in the global financial markets and to weak investment strategies. Not only that, the rating agencies make the situation even worse when they rush to significantly downgrade the initial ratings to junk status; contributing to a crisis of confidence and financial instability (Warner 2010). This could be seen when the rating agencies reacted by heavily downgrading sovereign debt in the Eurozone; leaving financial markets volatile and triggering a European-wide crisis (Reisen 2010).

Even though Greece has a history of weak economic outlook and budgetary problems such as large deficits and concerns for growth prospects, still the prominent rating agencies believed that the Greek government debt is a safe investment and it took the agencies long time to issue warnings on the riskiness of the debt default level (Jinwei 2010). In late April, the rating agencies had started their continuous downgrades by firstly rushing to cut down Greek debt to the lowest level of junk status, and also spreading their downgrades to other countries such as Spain and Portugal which in return had resulted in busting national economies through the sharp and sudden downgrades of the agencies' inaccurate ratings of sovereign debt (Jinwei 2010, Warner 2010).

The tragedy continues when the sudden and severe cutting down of sovereign debt by the rating agencies did not stop at Greece, nevertheless the agencies have been red-flagging Spanish sovereign debt and announcing downgrades of Spain's debt ratings as their economy still suffers from its real estate crisis. Moody's had downgraded Spanish debt because of shrinking economic growth, budget deficits, and increasing borrowing costs leading to the fact that the Euro-Zone debt crisis is spreading to other countries after the agencies started to downgrade Greece along with Spain (Brown and Ross-Thomson 2010, Mallet 2010).

Amid those downgrades of Greek and Spanish debt, fears and panics were provoked concerning European sovereign debt problems and about the weakening of the Euro-currency when the three prominent rating agencies further downgraded its rating on Portugal as well as on Ireland because of the negative financial outlook of such attacked countries (GuardianBlog 2010). Adding up to Greece and Spain, the agencies are blowing the Eurozone market stability by their continuous downgrading of Portugal and Ireland simply because the agencies have changed their positive outlook on the countries' economic performance. Not only that, the agencies are expecting to further downgrade Irish debt within a 12-24 time frame since their latest cutting down of Ireland's rating in October because of Ireland's weak and slow growth of its economy (Brown 2010).

Given their continuous chain of downgrades of European sovereign debt, the rating agencies are further criticized about their rating performances and how they create boom-bust cycles. Also, the agencies are being accused of reflecting the true default risk of the sovereign debt too late and in a rush leading to severe market fears and a spill-over effect across global markets because simply a downgrade by one agency is always followed by another creating the fear of contagion in the area (Jinwei 2010). Thus, the EU criticized the approach to the Greek crisis when the CRAs severely downgraded the country's rating to junk status implying that the risk of Greece defaulting increased and the chance of meeting their debt obligations decreased sparking a crisis of confidence throughout Europe (Wachman 2010).

Accordingly, attacks have been redirected to the agencies in response to their reaction to the Greek debt crisis and how they chased the economy to another downturn when the Eurozone ratings proved to be failing which was another wake-up call for European leaders to ask for stricter standards under the European Law to regulate the rating agencies (Reisen 2010).

To conclude, it is being questionable once more that the rating agencies triggered the European debt crisis, and severe discussions are ongoing regarding the relationship between the rating agencies with their clients highlighting that the rating agencies are more likely to issue high ratings to the debt they are asked to rate by the debt issuers. Thus, it is important for the financial regulators to take a closer look at the rating agencies and ways to better regulate the agencies with regard to the inherit conflict of interest arising from the fact that the agencies are paid by their clients and not the investors highlighting that their business model is semi-corrupt and also ignoring the fact that the agencies base their sovereign ratings only on publicly-available data (Jinwei 2010, Reisen 2010, Warner 2010).

5. Conclusion

The two most recent crises are wakeup calls for a development in the regulation of CRAs as being proposed in the US and in the EU. The agencies' critical position in the markets to the extent that a downgrade by any agency would result in dramatic and immediate adverse outcome, leading to a spillover effect and therefore destabilizing global financial markets. Major downgrades do not only impact the financial markets of a specific country but also the negative outlook reach to other countries since the financial markets are globally interrelated.

After the major discussions of CRAs' regulation and increased supervision, we can see that to date there is no evidence that put the proposals to any realized application. Even though the newest Basel III lost focus on the failing role of the CRAs, so the question remains when the regulators are going to subject the rating agencies to increased regulation and supervision amid their failures in rating toxic structured finance instruments and of country debts.

It is of paramount importance to highlight that the subprime crisis was not the first and will most probably not the last that showed how critical are the rating agencies and how significant it is to better regulate such agencies and enhance their supervision, yet there is no concrete application of any of the proposed measures still leaving the gap of credit rating agencies' regulation empty.

In conclusion, since the regulatory rules and proposed measures have not been realized, the agencies still don't have to disclose information about their rating methodologies to enhance transparency, and they are also not subject to new corporate governance standards to manage any inherit conflict of interest. The credit rating agency issue is important and needs urgent attention by the policy makers.

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