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POLICY BRIEF

CREDIT RATING AGENCIES: JUNK STATUS?

Risk assessment is critical to well-functioning capital markets. Yet reliance on the "big three" credit rating agencies has increased with the rise of international capital flows. Their assessments have been strongly procyclical and have missed systemic risks. Insufficient competition, conflicts of interest and ideological bias are some of the reasons for this. The widespread use of their ratings has now come to be recognized as a potential threat to financial stability. Concerted reform of credit rating agencies is therefore urgently needed.*

Key points

- Risk assessment is critical to well-functioning capital markets
- The widespread use of the ratings of credit rating agencies has come to be recognized as a potential threat to financial stability
- Concerted reform of credit rating agencies is urgently needed

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Credit rating agencies are pivotal institutions in today's financial markets.[1] By rating large corporate borrowers, sovereign bonds, municipal bonds, collateralized debt obligations and other financial instruments, credit rating agencies provide prospective investors with guidance on a borrower's creditworthiness. Their activities, when conveyed as news about ratings, have an impact on asset allocation, as ratings contribute to the determination of the interest rate – or price – the borrower must pay for obtaining financing.

Reliance on these institutions, and in particular on the three big agencies (Fitch, Standard and Poor's and Moody's) that control most global business, has increased over time due to growth in international capital markets and to the increase in the regulatory use of ratings. This has given credit rating agencies a captive market. The importance of credit rating agencies is also evidenced by the heightened attention given by policymakers, particularly in developing countries, to ratings attached to sovereign bond issues.

This widespread use of credit rating agency ratings, however, has now come to be recognized as a potential threat to financial stability, both by amplifying cyclical flows of capital and adding to systemic risk.

Assessing risk or peddling prejudice

The 2008–2009 global financial once again exposed the serious conflicts of interest inherent in the business models of credit rating agencies: essentially, rating agencies are paid by the very issuers whose securities they are rating. Overrating debts and underestimating the default risk allows an issuer to attract investors. "Buy-side" investors may have incentives to accept inflated ratings, as this increases their flexibility in making investment decisions and reduces the amount of capital to be maintained against their investments. Such rating upgrades can contribute to mechanistic purchases of assets in "good times", fuelling financial bubbles and laying the ground for future crises.

Conversely, downgrades in ratings trigger large sell-offs of securities as a consequence of market participants adjusting to regulations and investment policies ("cliff effects"). The high volatility in the European sovereign debt market in 2011 after a number of rating downgrades is one example of the linkages between rating adjustments and the prices of debt instruments. A similar pattern though was seen in the emerging market crises of the 1990s and early 2000s. Recent downgrades (or just

* This policy brief is based on the *Trade and Development Report, 2015*, subtitled *Making the International Financial Architecture Work for Development*, published by UNCTAD.

the threat of this) in developing countries, after years of high ratings, are likely to exasperate the difficulties for policymakers in dealing with the current surge outwards of capital, and despite this surge being a product of what is happening in the source countries at least as much as in the receiving countries (UNCTAD, 2015).

An additional source of unease is the way credit rating agencies undertake their rating exercises. Ratings of sovereign debtors involve considerable judgement about country factors, including economic prospects, political risk and the structural features of an economy. Opinions on these matters could be expected to differ, with second or even third opinions of obvious value to any assessment exercise. However, sovereign ratings of the three major rating agencies are strongly correlated, possibly signalling a very low degree of competition in the credit rating agency market.** Credit rating agencies provide little guidance as to how they assign relative weights to each factor used in their risk assessments, though they do provide information on what variables they consider in determining sovereign ratings. Broadly speaking, the economic variables aim at measuring the creditworthiness of an economy by assessing a country's external position and its ability to service its external obligations, as well as the influence of external developments.

Credit rating agencies' assessments appear to be based on a bias against most kinds of government intervention. In addition, they often associate labour market "rigidities" with output underperformance, and a high degree of central bank independence as having a positive impact on debt sustainability (Krugman, 2013). At the same time, their ratings are significantly correlated with indicators that measure the extent to which the economic environment is "business-friendly", regardless of what impact this might have on debt dynamics.

An econometric exercise undertaken by UNCTAD researchers, based on a pooled sample of the average value of the "big three's" sovereign ratings of 51 developing countries for the period 2005–2015, indicates a significant linear fit (using a regression, R2 of 44 per cent) between those ratings and the following variables estimated by the Heritage Foundation: "labour freedom", "fiscal freedom", "business freedom" and "financial freedom" (see figure). These variables, however, appear to have barely any relation to the countries' fundamentals, which would determine their ability to service their sovereign debt.

For instance, "financial freedom" is considered a measure of independence from government control and "interference" in the financial sector. Consequently, an ideal banking and finance environment is believed to be one where there is a minimum level of government intervention, credit is allocated on market terms and the government does not own financial institutions. Also, in such an environment, banks are free to extend credit, accept deposits and conduct operations in foreign currencies, and foreign financial institutions can operate freely and are treated in the same way as domestic institutions. The "labour freedom" index is a quantitative measure that considers various aspects of the legal and regulatory framework of a country's labour market, including regulations concerning minimum wages and layoffs, severance requirements, measurable regulatory restraints on hiring and hours worked. "Fiscal freedom" is a measure of the tax burden imposed by the Government, based on a combination of the top marginal tax rates on individual and corporate incomes, and the total tax burden as a percentage of gross domestic product (GDP). Finally, "business freedom" refers to the ability to start, operate and close down a business (Heritage Foundation, 2015).

By contrast, the econometric estimates show a much weaker correlation (R2 of 16 per cent) when credit rating agencies' ratings are regressed on the four most relevant variables used in the standard macroeconomic literature to assess debt dynamics (see figure). Those variables are: the level of the primary budget surplus, the government-debt-to-GDP ratio, economic growth and the current account balance.

These estimates show that credit rating agencies' sovereign ratings are based much more on subjective assessments and prejudices (for instance, that government intervention reduces growth and efficiency) than on the "fundamental" variables related to debt sustainability.

There is a strong risk that alternative approaches to credit assessment might reproduce the same flaws of the underlying credit rating agency models. Indeed, other credit rating agencies, including the Chinese firm Dagong, have produced judgements similar to those of the "big three". This suggests either that other participants base their judgements on similar models, or that the "big three" are market makers in the ratings industry. As such, there is the added concern that internal credit risk

** The correlation in the movements of the ratings of those agencies surpasses 95 per cent in the case of sovereign bonds (UNCTAD, 2015).

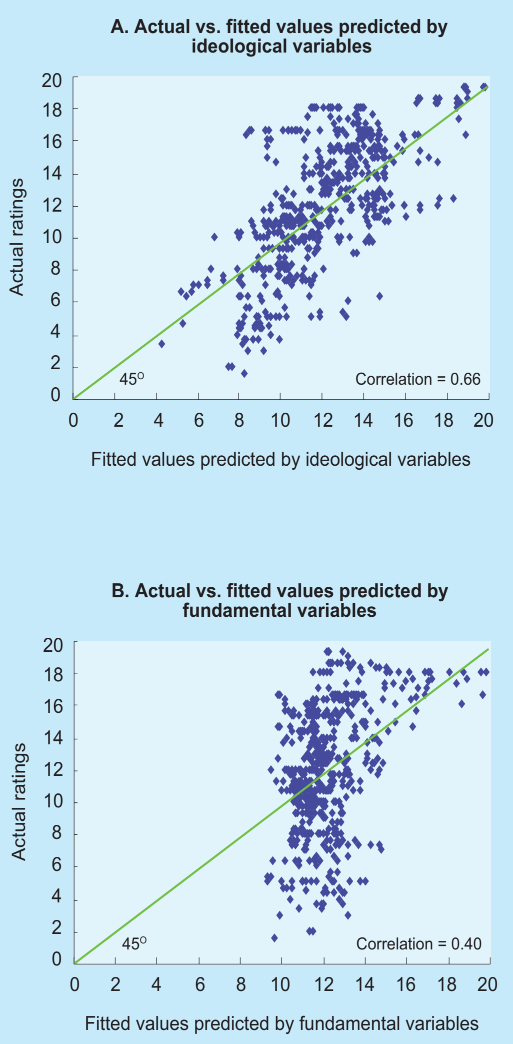
assessments made by risk departments of investors' institutions also deliver ratings with similar flaws.

Getting to grips with risk

Credit rating remains of relevance for the financial sector, despite the disastrously inaccurate assessments of the credit rating agencies prior to major crises, and the widespread recognition that the concentration of the sector in the three biggest international credit rating agencies has created an uncompetitive environment.

Sovereign ratings of developing countries, 2005–2015

(As an average of the ratings of the "big three")



Some initiatives have sought to reduce their power, both at the national and international levels. For example, in the United States of America, the Dodd-Frank Act has attempted to address problems relating to credit rating agency ratings by requiring that banks no longer use those ratings in their risk assessments for the purpose of determining capital requirements. Recent European Union regulations require greater disclosure of information on structured financial products and on the fees that credit rating agencies charge their clients.

After the crisis, the Financial Stability Board asked Group of 20 members to reduce mechanistic reliance on credit rating agencies ratings in standards, laws and regulations. However, progress toward the removal of references to credit rating agency ratings has been insufficient and uneven across jurisdictions (Financial Stability Board, 2014), in part because of organized resistance ("lobbying") from the financial services industry and in part because of the lack of an alternative approach to assess creditworthiness. As such, the Basel Accord guidelines keep open the use of the rating structure of the credit rating agencies for capital requirement purposes; central banks, in both advanced and developing countries, continue to rely on credit rating agencies for many of their operations.

More decisive action is necessary to reduce the power of credit rating agencies. In addition to the Group of 20 recommendation of tighter public oversight of credit rating to avoid bias and abuses, the Organization for Economic Cooperation and Development (OECD) has highlighted the need to move from an "issuer pays" to a "subscriber pays" business model to avoid conflict of interests and improve the quality of ratings (OECD, 2009).

A further step would be eliminating the use of regulation based on credit rating agency ratings (Portes, 2008), which would force financial institutions to revert to what has historically been one of their most important tasks, namely assessing the creditworthiness of the potential borrowers and the economic viability of the projects they intend to finance. Prudential regulation could be based on an unweighted leverage ratio for minimum capital requirements, such as the one prescribed in the Basel III package, but set at a much higher level so as to render the widely used capital to risk-weighted assets ratio irrelevant. Otherwise, commercial banks could be still be tempted to use credit rating agency ratings as benchmarks in their internal credit assessments to reduce costs.

More radical measures may be required, such as transforming the credit rating agencies into public institutions, since they provide a public good (Aglietta and Rigot, 2009). Banks should therefore pay fees to a public entity that will in turn provide a risk assessment based on a transparent methodology.

With the likelihood of increased debt distress across companies and countries, and at all levels of development, further reform of credit rating agencies should be an urgent priority of the international community, beginning with the next Group of 20 agenda under the leadership of China.

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