ROUTLEDGE STUDIES IN CORPORATE GOVERNANCE

Credit Rating Governance

Global credit gatekeepers

Ahmed Naciri

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Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 2015
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

and by Routledge
711 Third Avenue, New York, NY 10017

Routledge is an imprint of the Taylor & Francis Group, an informa business

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging in Publication Data
Naciri, Ahmed
Credit rating governance: global credit gatekeepers / Ahmed Naciri. – 1 Edition.
pages cm. – (Routledge studies in corporate governance)
Includes bibliographical references and index.
1. Rating agencies (Finance) 2. Credit ratings. 3. Financial services industry. I. Title.
HG3751.5.N33 2015
332.1'78–dc23 2014029703

ISBN: 978-1-138-79654-6 (hbk)
ISBN: 978-1-315-75783-4 (ebk)

Typeset in Sabon
by Wearset Ltd, Boldon, Tyne and Wear

Almost unnoticed before the 2007 subprime crisis, credit rating agencies have since become the focus of much attention: who are they? How do they operate? Should we regulate them? ... and so on. Ahmed Naciri provides answers. His book explains their activities and how they discretely shape the world capital markets. This book is a must for anyone involved with finance.

Julien Bilodeau, *Professor, Université de Sherbrooke, Canada*

A solid and timely contribution to a fundamental issue within corporate and global finance. Features in depth analysis of the industry in terms of scope, structure, contribution, cross country performance, weaknesses and, finally, dark sides. It also provides viable future scenarios and possible approaches for reform. A must read for all involved in international business and finance.

M.S.S. el Namaki, *Dean, Victoria University, Switzerland*

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Global credit gatekeepers
Ahmed Naciri

This book is dedicated to all those who, because of others' greed, have lost life savings or retirement plans, in transactions in which they had no understanding or saying.

With business margins exceeding 40 per cent and secured by a quasi-legal oligopoly, credit rating agencies were granted so great power of wealth creation that had never been granted before and that only central banks can challenge.

Ahmed Naciri

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Preface

The 2007 financial and economic crisis has gripped the world financial system, and although many market participants have played an effective role in the development of the financial slump that wreaked havoc in communities and neighbourhoods across the world and had horrible social consequence, credit rating agencies (CRAs) appeared the most to be blamed. They were accused of mistakes, misjudgements and misdeeds. Although, incisive erosion of business standards of responsibility and ethics is to be underlined and had irreversibly damaged the trust in the whole financial system.

Financial system integrity and the public's trust in those markets are, however, essential to economic wellbeing. Indeed, the soundness and the sustainability of the prosperity of the financial system rely on notions like fair dealing, responsibility and transparency. Businesses and individuals are expected to pursue profits, conditional that they produce quality products and services and conduct themselves well (Financial Crisis Inquiry Commission Report, 2011). One reason credit rating agencies appeared to be most blamed, among the pillars of the business world for their rating role, despite that breaches to ethic and corporate governance in business activity seem to stretch from the ground level to the corporate suites, resides in the fact that major regulators have forced issuers and investors to blindly rely on credit ratings for their assessment of risk. This book endeavours to help gaining insight in credit rating activity and to unearth weakness that seemed to have ruined its governance.

Three main agencies control over 95 per cent of the world market and decades before the subprime crisis already witnessed excessive reliance on credit rating agencies for credit default assessment and for regulatory puposes. The aftermath of the subrime crisis has, however, ushered in a period of protest and questioning of the role of the major rating agencies culminating in new regulatory reforms requiring credit agencies to have more competition and tranparency and requiring national regulatory financial authorities to review their rules and guidelines for the sake of removing any reference to credit ratings in financial regulations.

Assessing creditworthiness of clients was always at the heart of business activities, even before the seventeenth century, but was essentially based on clients' wealth and morality and no reference was made to future economical prospects, turndowns or strategic development they may face or choose. Systematic classification of debtors by their level of default risk is, however, relatively new. Although, financial institutions of the seventeenth century had already clients' in-house classification systems allowing them to assess debtors' creditworthiness. What is new, however, is trusting third parties, neither debitors nor creditors, with the task. What is even more intriguing is to see governments going even further and trusting such third parties by a legislative power. Till recently, for instance, financial market authorities have been increasingly relying, for their regulatory activities, on private rating agencies, making nation states and their institutions dependent on them for their financing. Fitch Ratings, Moody's and Standard & Poor's, the Big 3 became therefore the real gate keepers of the world credit. These three biggest agencies have become, by the beginning of the twenty-first century, the most powerful and influential single private group ever on the global financial system. They were trusted with world capital allocation and wealth distribution. The Big 3's critical role and their powerful position, were unearthed by the 2007 global financial crisis that showed they had gained power over governments and investors, a power that far outranks any group that influential voters might have (Chakrabortty, 2012) and nowhere such power can be more obvious than in the case of the downgrade of countries, sending them to pasture for speculators and completely destabilizing to the breaking edge their economies. In 2009, for instance, Moody's issued a report entitled 'Investor fears over Greek government liquidity misplaced', and guess what happened? Within six months Greece was seeking a bailout (Kingsley, 2012). The Big 3 are able to make kneel governments: recall this sentence from a French Prime Minister following France's AAA downgrade: 'We will do everything to get [the triple A] back' (Chakrabortty, 2012). Recall also the S&P warning made in the middle of last turmoil in Tunisia to neighbouring governments that if they tried to calm social unrest with 'populist' tax cuts or spending increases, they may face a downgrade (Chakrabortty, 2012). Although a downgrade need not spell disaster, it still makes lenders likely to be more nervous about getting their money back and makes them inclined to charge issuers higher interest rates. It will also render government's debt repayments steeper, and more likely to default. Such an infernal cycle seemed to have given agencies contentious negotiating power they never dreamed of. It is indeed claimed that agencies do not deal robustly enough with the issuers who pay them, while on the other hand, they seem to be very aggressive with those who don't (Kingsley, 2012), up to practising arm twisting policy to get them asking for ratings and pay for. The case of the German insurer Hannover is often advanced; it seems that the insurer saw its debt downgraded to junk status, because of its refusal to pay for an unsolicited rating (Klein, 2004). Agencies are commonly blamed for the inaccuracy of their ratings (more than half of all corporate debt ever rated AAA by S&P has been downgraded within seven years, Engelen *et al.*, 2012); they are also blamed for their lack of tranparency and their feable integrity,

> since they can't rest on their records, the discredit agencies prefer to drape themselves in the cloak of science, claiming the work they do is highly technical and independent and were declining any voluntary reporting regarding their approaches and methodologies of rating assessment.
>
> (Chakrabortty, 2012)

Agencies are also blamed for their astronomically high fees they bill issuers with, which have nothing to do with 'their oracular genius' (Chakrabortty, 2012).

Nation states are today the first to challenge the superpower status that they have granted, in a very short period of time, to the Big 3 and are angrily reprimanding them for all the sins that have happened to the ill financial system. Especially that it is believed what gives agencies such immense power is not so much their 'brilliant analysis', but simply the function they perform (Chakrabortty, 2012). Regulatory power has proven to be a poisoned chalice for agencies, although many jurisdictions may have continued to trust them if it was not for America's AAA downgrade and the threat to downgrade the 15 EU countries. 'S&P has shown really terrible judgment and they've handled themselves very poorly.... They've shown a stunning lack of knowledge about basic US fiscal maths', argued the US treasury secretary Timothy Geithner commenting on America's downgrading (BBC News Business, 2011) and this will cost S&P a landmark suit of $5 billion by the US government. Agencies still wield tremendous power that many believe needs more regulation, and ambitious steps were taken by the international financial community to curb agencies' hegemony and to bring them under stricter monitoring and control. Consequently, agencies are now submitted to tough regulations aiming to enhance their transparency and to prohibit the use of ratings for regulatory purposes.

Given such an important role that credit agencies play in the financial system, it is paramount to understand their structure and their interaction with their environment. This book highlights the driving reasons behind the global rating oligopoly, built under the consenting eye and the complicity of the financial standard setter. Since the subprime financial crisis, however, there have been considerable efforts on behalf of the world financial community, not only in developed countries but also in a number of other jurisdictions, to find a way out of credit agencies' grip. For this reason the book also focuses on the regulatory reversal constituted by recent supervision measures of CRAs undertaken by the international financial community aiming to curb agencies' opacity and appetite and assesses their chance of success. The book suggests methods of measuring governance improvement for CRAs that can help users to gain insight in credit rating activity and into the regulatory process at work and assessing the progress made in CRAs' governance. The book reaches the conclusion that the Big 3 have in a clever way built up their system in such a way that it seems difficult, if not impossible, to do anything against it, applauds the extent and the courage of new regulations for CRAs, but remains pessimistic about their realistic effect, despite the earliness of regulations. The book draws attention to a more fundamental question regarding the accuracy of the risk-modelling techniques used by CRAs that may lead to some lack of foresight and keep them from having all the needed insurance for timely reacting and making them appear shy in some rating circumstances and overreacting in others. Indeed, the problem posed by credit ratings agencies seems to lie not solely in their alleged malpractice or negligence, but also in the inability of the methodologies they use to assess default which do not allow 'ordinality' in risk of default classification.

Despite the expressed view that the rating crisis could not have been foreseen or avoided, this book argues that there were warning signs, well rooted in the rating system, but were ignored or discounted, and focuses on ways of correcting them. The book, therefore, suggests alternatives and comes at a very sensitive moment and provides an assessment of the progress made by agencies on the road of transparency and more competition and of the chance of small agencies of benefiting from whatever is left over in the market share. It therefore contributes to a better understanding of the changing rating environment.

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Abbreviations

ABS	asset-backed securities
AC	audit committee of the board
AFS	Australian financial services
A.M. Best	Alfred M. Best Ratings
APEC	Asia-Pacific Economic Cooperation
AR	accuracy ratio
ASIC	Australian Securities and Investments Commission
BCBS	Basel Committee on Banking Supervision
Big 3	Fitch Rating, Moody's and Standard & Poor's
BIS	Bank of International Settlement
CAP	cumulative accuracy profile
CAPM	Capital Assets Pricing Model
CDO	collateralized debt obligation
CEO	chief executive of operations
CEREP	central repository (of the European Securities and Markets Authority, ESMA)
CFR	Council of Foreign Relations
CGFS	Committee on the Global Financial System
CMBS	commercial mortgage-backed security
CPG	Credit Policy Group
CPSS	Committee on Payment and Settlement Systems
CR	credit rating
CRA	credit rating agency
CRP	credit rating provider
Dagong	Chinese rating agency
DBRS	Dominion Bond Rating Service.
DFATA	Department of Foreign Affairs and Trade, Australia, 2009
EC	European Commission
ECB	European Central Bank
EDF	expected default frequency
EJR	Elgon-Jones Ratings Company
ESMA	European Securities and Markets Authority
EU	European Union