Ratings agencies: front, centre and still flawed

Stephen Grenville

The Australian Financial Review

1 August 2011

P. 23

Just about everyone is critical of the credit ratings agencies' performance during the past decade. Nobel prize-winner Joe Stiglitz described them as the "key culprits" in the global financial crisis because they bestowed AAA ratings on shonky assets. More recently, they identified the problems in Greece, Ireland and Portugal only after the crisis arrived.

Despite these failings, the agencies' role in resolving the euro mess is even more central than before. The European Central Bank relies on their assessment when it decides whether to give Greece further liquidity credits. The agencies are arbiters of whether a debt default occurs (a concept full of ambiguity, when default might take the form of "reprofiling" debt, which involves changing the interest payments and maturity without changing the face value).

There is little doubt that if the agencies declared Greece to be in default, this would have a profound contagion on euro debt, not only for Portugal and Ireland, but Italy and Spain as well. It is not too much to say that the future of the euro is in the hands of the ratings agencies.

The agencies would be the arbiters, too, of whether the insurance offered through credit default swaps (CDS) would be triggered. This, in turn, would determine where the losses lie, with great implications for the health of the banking system.

Beyond the situation in Europe, their well established reputation for tardy recognition of deteriorating risks has often exacerbated downswings. They didn't anticipate the 1997 Asian crisis and their sudden reassessments worsened the devastating capital reversals.

It's not just that the agencies draw attention to previously dormant problems, but many investors are constrained by mandates which require them to hold only investment-grade paper. Thus investors are forced to sell when the ratings are downgraded, even when the portfolio managers think the downgrade is unjustified.

If they are often slow to recognise deteriorating risk, they are just as tardy recognising improvements. It is absurd that one agency had Greece in investment grade until early this year, while at the same time none of the agencies have so far raised Indonesia (with an outstanding macro-performance) to investment grade.

Of course their job is not easy: bearers of unpalatable news have to be thick-skinned. The Portuguese resident of the European Commission, Jose Manuel Barroso, complained when his country was downgraded; European parliamentarians have called for ratings downgrades to be suppressed and American congressmen have seen the ratings as an infringement of sovereignty.

While there is wide agreement that the past performance has been deficient, it's not clear how to fix this. The ratings agencies' job is intrinsically subjective, conflicted and constrained.

One early idea was to reduce the key role of the agencies, removing their part in regulatory requirements so that ratings were no longer the criterion for mandates or for the acceptability of collateral. The role of the agencies' ratings in determining bank capital requirements (a central element of Basel II) could be altered.

In the United States, the Dodd-Frank legislation has gone down this path, eliminating the rating requirement for some regulatory purposes. But some kind of impartial risk assessment is needed. If this is not provided by the ratings agencies, who will do the job?

One suggestion is to give greater weight to market-based measures of risk (for example, CDS pricing). But their pricing is no more prescient and is more volatile to boot.

Conflicts of interest arise from the methodology, in which the issuer of the investment instrument pays ratings agencies for the assessment. Why not get investors to pay for the ratings, rather than the issuers? But individual investors have little incentive to pay for a detailed assessment. The rating is a public good and once it is made, everyone can benefit without paying.

The agencies have an unusual advantage, whereby they cannot be held legally responsible for ratings that turn out to be misleading: these are only "opinions". It would seem to be an obvious improvement to change this situation, making them subject to the usual discipline imposed by aggrieved investors seeking redress. But the agencies say they won't work in such a legally fraught environment: they would refuse to allow their ratings to be used in prospectuses and other legal documents. All care but no responsibility.

Some argue that the answer is to let the risk assessment lie solely with investors. Diversity of opinion may provide some advantage, but the history of lemming-like investor behaviour gives little comfort that this would foster a less cyclical environment.

One of the lessons of the GFC was that risk of loss of reputation was not sufficient discipline to ensure responsible behaviour by financial firms. The ratings agencies seem especially Teflon-coated, coming through the GFC with reputations unscathed.

Greater official oversight would put a spotlight on their value to society.

The US Dodd-Frank legislation envisages the creation of an Office of Credit Ratings, which could set down operating standards. Such an office could compile a public record of the performance of each ratings agency, with analytical annotations for good and bad performance and comparative statistics, in the same way that other financial institutions are subject to external scrutiny by domestic and international regulators.

If agencies can't be subjected to tight legal discipline, the court of public opinion should be given a stronger role. Ratings agencies should compete on the basis of the track record of their assessments, not by promising a rosy scenario for the highest bidder. Investors, more aware of the strengths and weaknesses of individual agencies, would know when to supplement or override these ratings with their own judgment.

Stephen Grenville is a visiting fellow at the Lowy Institute for International Policy.