Worldwide Recession and the Credit Rating Agencies: What Is Their Impact On The Global Economy?

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From the European Central Bank headquarters to the halls of the Senate floor in the United States, debt, deficits, and austerity measures are all on the minds of leaders all over the world due to the ongoing world-wide recession. Many facets of the economic crisis have been examined, however, the role of credit rating agencies has been largely ignored, with their being little to no in-depth analysis of the role of rating agencies in relation to the global economic downturn nor their influence on the global economy at large. It seems that while rating agencies can be used to rate the creditworthiness of a nation, they now have undue influence on countries and are able to hold them hostage, thus an examination needs to take place of how they wield such influence on the world at large.

Sovereign Credit Ratings

Credit rating agencies came into being due to the creation of railroad industry. In the 19th century "the growing investing class [wanted] to have more information about the many new securities – especially railroad bonds – that were being issued and traded" [1] and thus credit rating agencies filled that need. In the middle of the 19th century, railroads began to raise capital via the market for private corporate bonds as banks and direct investors were unable to raise the capital needed to construct railroads. This growth in the sale of the different private bonds led to a need for there to be "better, cheaper and more readily available information about these debtors and debt securities," thus Henry Varnum Poor responded by writing and publishing the Manual of the Railroads of the United States in 1868, containing the financial information of all major railroads companies and providing "an independent source of information on the business conditions of these corporate borrowers." [2]

With John Moody issuing the first credit ratings in the US in 1909, the credit rating agency had come into its own. Usually the entire process of "shaping investor perceptions of corporate borrowers" was dealt with by banks as they would be putting their reputations on the line by lending to corporations. Thus, if a venture succeeded, the bank's reputation would go up and if the venture proved a flop, the bank's reputation would be damaged, making it harder for them to attract new clients. Essentially the creditworthiness of a corporation was certified to the public via the reputation of the bank they had borrowed the money from. Due to this, "the bank as creditor would become more involved in the business of the corporation and become an insider," [3] yet bond investors would not have access to the same information that the banks did. Thus, rating agencies aided in a leveling of the playing field and improved the efficiency of capital markets.

However, in time rating agencies went from rating the bonds of railroads to rating the bonds of sovereign states. In the 1970s global bond markets were reviving, but the demand for bond ratings was slow to occur as most foreign governments didn't feel the need to have their credit rated since most already had good credit and for those that didn't, credit could be attained by other means. However, this changed in the '80s and '90s when countries with bad credit "found market conditions sufficiently favorable to issue debt in international credit markets." [4] These governments frequently tapped into the American bond market which required credit ratings, thus, "the growth in demand for rating services [coincided] with a trend toward assignment of lower quality sovereign credit ratings." [5] While this may have been good for investors as they would be able to now see if a nation was a financial risk, this ability to rate the credit of countries would give them the power to decide a countries economic fate.

Ratings and Economic Policies

Credit ratings, while they can be a potentially positive part of the financial industry, can also have a negative effect on the economic policy of countries. This is especially true for developing nations.

For countries that take out loans, "a rating downgrade has negative effects on their access to credit and the cost of their borrowing." [6] This could potentially force a government to have to borrow money at a higher interest rate and thus scale down its plans for economic development. The problem that this poses for developing nations is that the only way to increase their credit score is to follow the "orthodox policies [that focus] on the reduction of inflation and government budget deficits" [7] which is favored by such organizations as the IMF and the World Bank. The alternative, which would be to avoid a rating downgrade in the first place, is even worse as it could lead "borrowing countries [to] adopt policies that address the short-term concerns of portfolio investors, even when they are in conflict with long-term development needs." [8]

This entire state of affairs is rather unfair to the Developing World as they are forced to take on large amounts of debt as they try to industrialize and modernize. This is largely caused due to the fact that they are victims of neocolonialism and that the major means of production are owned mainly by foreigners who don't contribute much in terms of improving the long-term economic prospects of a country and getting them from under the weight of neocolonialism.

While rating agencies can have an effect on individual countries, they can also effect the global economic system at large as can be seen by their actions in the current global financial crisis.

Global Recession

As we all now know, the major reason for the near global economic collapse was due to a subprime mortgage lending bubble that occurred between the late '90s and 2007. The deep financial risk occurred due to the fact that financial corporations sold mortgages to families who could not pay them and used them to create collateralized debt obligations. This "encouraged subprime lending and led to the development of other financing structures, such as "structured investment vehicles" (SIVs), whereby a financial institution might sponsor the creation of an entity that bought tranches of the CDOs and financed its purchase by issuing short-term “asset-backed” commercial paper.” (ABCP) [9] Credit rating agencies came into play due to the fact that favorable ratings that the agencies gave allowed for high ABCP ratings. It is quite crucial to note that the ratings agencies gave were extremely important as they “had the force of law with respect to regulated financial institutions’ abilities and incentives (via capital requirements) to invest in bonds” and due to their friendly relationship with corporate and government bond ratings, many rating agencies were able to influence “many bond purchasers— both regulated and non-regulated—[to] trust the agencies’ ratings on the mortgage-related securities, even (or, perhaps, especially) if the market yields on those securities were higher than on comparably rated corporate bonds.” [10] Thus, the rating agencies were crucial in the economic calamity due to the fact that they were able to influence bond purchasers to bank on, what were in essence, junk investments.

Corporations may have had an effect on the ratings they were given due to the fact that the higher the ratings were, the larger the profits would be. Thus, corporations “would be prepared to pressure the rating agencies, including threats to choose a different agency, to deliver those favorable ratings.” [11]

Eventually, when the house of cards that was precariously built upon high risk mortgage loans came tumbling down, the rating agencies were swift to pass judgement in the form of massive downgrades. These downgrades caused the rated securities to lose value in both the primary and secondary markets, quickening the pace of the economic downturn. However the downgrades revealed that the ratings system itself was quite flawed, being influenced by such things as “the drive for market share, pressure from investment banks to inflate ratings, inaccurate rating models, and inadequate rating and surveillance resources.” [12]

Evidence reveals that in the years leading up to the economic meltdown both Moody’s and S&P were quite aware of the increasing credit risks due to factors such as “higher risk mortgage products, increasingly lax lending standards, poor quality loans, unsustainable housing prices, and increasing mortgage fraud” [13], yet the agencies continued to ignore any and everyone’s- even their own- assessment on the risks and refused to adjust the credit ratings to accurately reflect the risk of the investments. Interestingly enough, “Moody’s and S&P began issuing public warnings about problems in the mortgage market as early as 2003, yet continued to issue inflated ratings for [mortgage] and CDO securities before abruptly reversing course in July 2007.” [14] This leads one to wonder why they would continue to give good ratings to mortgages that they knew were junk. The reason this occurred was due to the issuer-pays model under which the firm interested in profiting from a security is required to pay for the credit rating needed to sell the security. In addition to this, “it requires the credit rating agencies to obtain business from the very companies paying for their rating judgment” which results in “a system that creates strong incentives for the rating agencies to inflate their ratings to attract business, and for the issuers and arrangers of the securities to engage in ‘ratings shopping’ to obtain the highest ratings for their financial products.” [15] Thus, the rating agency is forced to give inflated ratings if they want to stay in business. The ratings agencies are partially to blame for the financial crisis, but it is also the very system at large that needs to be uprooted and replaced. This entire fiasco brings up the question: Can the rating agencies be regulated?

Regulation and the Revolving Door

There has been some arguments for reform for CRAs, among these are switching to an investor pays model and promoting competition among rating agencies, however, each of these proposed solutions have their own problems.

Some argue for moving from the issuer-pays model to "an 'investor pays' model in which rating agencies would earn fees from users of the rating information." [16] While this may sound like a good solution, there are still problems as " it would not eliminate conflicts of interest but instead shift them from issuers to investors" [17] as it would now be in the interest of rating agencies to attract business from the very investors who are paying for their rating judgement, resulting, once again, in inflated ratings.

The proposal to promote competition among rating agencies is quite problematic due to the fact that "size and market recognition may be higher barriers to entry than regulatory status, turning the credit rating industry into an oligopoly." [18] In addition to this, promoting competition could potentially lower the quality of the ratings due to the fact that new entrants would most likely offer higher ratings or lower prices as to compete with the three large rating firms, thus reducing both the level of effort in ratings and their reliability.

While these proposals may seem good, one must keep in mind that they are only reforms, which only make certain amendments to the overall system rather than creating an entirely new one. None of these reforms deal with the revolving door that exists between the Securities and Exchange Commission (SEC), the government institution that is supposed to regulate the ratings agencies among other financial markets, and the rating agencies themselves.

In May of 2011, the Project On Government Oversight announced that after completing a study from 2006 to 2010, found some rather interesting facts concerning the revolving door, such as that the SEC Office of Inspector General had "identified cases in which the revolving door appeared to be a factor in staving off SEC enforcement actions and other types of SEC oversight, including cases involving Bear Stearns and the Stanford Ponzi scheme" and one empirical study "uncovered several significant and systematic biases in the SEC's enforcement patterns and found indirect evidence to support the contention that 'post-agency employment at higher salaries may operate as a quid pro quo in return for favorable regulatory treatment.'" [19] Yet while these actions were taking place and the role of rating agencies in causing the global recession were known by the US government, Congress and Obama did little to nothing to remedy the overall problem.

Due to the major problems that rating agencies have caused in the recent years, it may lead some to ask the question are rating agencies even needed. The fact of the matter is that they are needed, but they need to play a much less influential role in the financial system than they do now. Instead of enacting small reforms that do nothing to solve the overall problem, a completely new way of interaction between the ratings agencies and the financial markets needs to be enacted. In addition to this, the revolving door between the SEC and members of the financial sector needs to end immediately. Without these changes the rating agencies may very well lead the world down another dark economic alley in the future.

Notes

1: http://www.financialpolicy.org/FPFSPR6.pdf

2: Ibid

3: Ibid

4: http://www.newyorkfed.org/research/current_issues/ci1-3.pdf

5: Ibid

6: http://www.unctad.org/en/docs/osgdp20081_en.pdf

7: Ibid

8: Ibid

9: http://mercatus.org/sites/default/files/publication/59_CRA_history_%28web%29.pdf

10: Ibid

11: Ibid

12: http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf

13: Ibid

14: Ibid

15: Ibid

16: http://rru.worldbank.org/documents/CrisisResponse/Note8.pdf

17: Ibid

18: Ibid

19: http://pogoarchives.org/m/fo/revolving-regulators-20110513.pdf

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