Chasing Unreliable Ratings

What is the issue?

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- Nations give too much importance to credit rating agencies despite their structural flaws and inconsistent record.
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- This calls for reforming the ways in which rating agencies operate.
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How did the rating ecosystem evolve?

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- Modern day credit rating agencies were first established in early 19th century U.S., which rated the ability of a merchant to pay his debts.
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- Soon, such ratings were being applied to equity stocks and demand also rose for independent market information, offering trustworthy analysis.
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- The big three of the ratings world (Moody, Fitch, and Standard & Poor) had already reached a commanding positions in the 1920s.
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- By the 1960s, ratings had spread over to commercial paper, bank deposits, and the global bond market (including sovereign bonds).
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- Despite their vital role in the global finance, rating agencies are marred with frequent allegations of impropriety and inaccurate ratings.
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What were some of the highprofile rating failures?

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- Rating agencies are accused of having failed to predict the 1990s East Asian

crisis and then for overly under-rating them when the event unfolded.
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- The U.S. Department of Justice launched an investigation in 1996 into a potential improper pressuring of issuers by Moody's.
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- Such agencies have been subject to a range of lawsuits, especially after Enron's collapse and during the recent subprime mortgage crisis in the U.S.
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- Moody's had been completely oblivious of the building bubble in the run up the sub-prime mortgage crisising in the U.S. in 20017.
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- Subsequently, the "National Commission on the Causes of Financial and Economic Crisis" had held that the the failure of rating was partly responsible.
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- Also, Standard & Poor's (S&P) paid $1.4 billion for rubber stamping risky mortgage bonds as safe.
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- Recently, the relegation of Greece, Portugal and Ireland to "junk" status is said to have lead to a sovereign-debt crisis in these countries.
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- This had worsened the unemployment situation and the Euro zone stability.
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What are some structural issues?

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- Popular rating agencies can have a global impact, affecting the fiscal fortunes of nations as they can potentially trigger capital outflows.
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- **Inconsistencies -** In Indian, ratings have had a mixed record and SEBI had to intervene in some cases and tighten rules and disclosure norms for agencies.
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- Many Indian economists also believe that there is a lack of due recognition for India's economic achievements in most reports of foreign based ratings.
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- Notably, such inconsistencies have led to moves by Russia and China to set up their own ratings agencies to provide better information to investors.
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- **Conflict of Interests -** Most rating agencies generate a significant portion of revenues through non-rating activities, which makes them structurally flawed.
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- Despite maintaining an iron curtain between their rating and non-rating businesses, common management gives ample scope for conflict of interests.
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- Numerous studies have showcased that rating agencies seek to provide issuers, with non-rating services, along with potentially influencing a higher rating.
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What is the way forward?

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- The services offered by rating agencies are indeed crucial in the market and hence we too need to nurture strong indigenous rating agencies.
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- But we also need to place multiple safeguards to minimise market distortions, by ensuring greater supervision over anomalous upgrades or downgrades.
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- Corporates can be mandated to change rating agencies on a regular basis and "issuer-pays" model needs to change to an "investor-pays" model.
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- Also, SEBI can explore options to bar credit rating agencies from providing non-rating advisory services.
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- Above all, government fiscal decisions should not be skewed towards chasing ratings and rather be focused on employment generation and innovation.
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Source: The Hindu

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