The ratings illusion

The idea of rating an individual, an entity and even a nation has been there for aeons. The historian Herodotus, along with the scholar Callimachus of Cyrene, made lists of the original Seven Wonders, describing them and their worth in soaring rhetoric. Modern day credit rating agencies, however, have a far more recent origin — ironically, they were first established after the financial crisis of 1837 in the U.S. Such agencies (with the first established by L. Tappan in 1841 in New York) were then needed to rate the ability of a merchant to pay his debts, consolidating such data in ledgers. Soon enough, such ratings were being applied to equity stocks.

Demand also rose for independent market information, offering trustworthy analysis of credit-worthiness, with Moody's ratings' publication increasingly focusing on industrial firms and utilities, offering letter based ratings. By the 1920s, the big three of the ratings world (including Fitch, Standard & Poor's) had been incorporated. The passage of the Glass-Steagall Act in 1933 helped formulate the separation of the securities business from banking, with American banks authorised to only hold investment grade bonds, as determined by such ratings. Soon enough, by the 1960s, such ratings had spread over to commercial paper and bank deposits, along with expansion into rating the global bond market (including sovereign bonds), albeit with a business model change — such agencies were starting to charge both the investors and the entity covered.

Yet, despite their vital role in the global financial world, rating agencies fail to inspire confidence, with allegations of improper and inaccurate ratings occurring frequently. Prior to the subprime mortgage crisis in U.S., Moody's had issued an AAA rating to 45,000 mortgage-related securities between 2000 to 2007, which after the crisis had slumped to just six AAA ratings for mortgage-backed securities in 2010. The U.S. Department of Justice launched an investigation in 1996 into a potential improper pressuring of issuers by Moody's. 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. The National Commission on the Causes of Financial and Economic Crisis in the United States (2011) held the failure of rating agencies to be essential cogs in the wheels of financial destruction. Moody's has been fined across various geographies for non-adherence to standard rating protocols. For instance, Moody's has raked up fines of $864 million for its role in 2008 crisis, while incorrect rating practices has led to fines of €1.2m in Europe. Standard & Poor's (S&P) paid $1.4 billion for rubber stamping dicey mortgage bonds.

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Even in India, rating agencies have had a mixed record. Cases such as Amtek Auto and Ricoh India led the Securities and Exchange Board of India (SEBI) to investigate rating agencies and tighten rules and disclosure norms.

More importantly, such rating agencies can have a global impact, affecting the fiscal fortunes of nations, due to flight of capital, as witnessed during the East Asian crisis of the 1990s. Recent downgrades of U.S. and European sovereign debt have been criticised, with the relegation of Greece, Portugal and Ireland to "junk" status, leading to a sovereign-debt crisis, along with ensuing unemployment and eurozone instability. Such credit rating agencies have been criticised for failing to predict the 1997 Asian financial crisis and then downgrading such countries several notches during the event. The lack of recognition of India's economic achievements and its non-correlation with its sovereign rating is an issue that rankles with most Indian economists. Such arbitrary behaviour has led to moves by Russia and China to set up their own ratings agency — S&P cut its rating on Russia to one notch above junk, in 2014, a few months after the annexation of Crimea, a change dismissed by Russia as politically motivated.

Nations perhaps give too much importance to the achievement on such ratings, despite their structural flaws. Consider the conflict in interest — such rating agencies generate a significant

portion of revenues through non-rating activities, and despite maintaining an iron curtain between their rating and non-rating businesses, common management and search for profits lets conflict of interest creep in. Numerous studies have showcased that rating agencies seek to provide issuers, whether entities or nations, with non-rating services, along with potentially influencing a higher rating (for instance, “Non-rating revenue and conflicts of interest”, by R.P Baghai and B. Becker).

In our development journey, we must utilise such rating agencies, preferably indigenous, to help clean house in our corporate sector. To safeguard investors, SEBI can explore reforms so that credit rating agencies do not provide non-rating advisory services to their clients, even at the cost of reduced profits. A fixed operating fee model may also be explored, thereby eliminating incentives to be the “lowest-bidder” with compromised quality. Outstanding ratings and sudden downgrades need to be subjected to greater supervision. Akin to auditors, corporates should be pushed to change rating agencies on a regular basis. The “issuer-pays” model needs to change to an “investor-pays” model, with fees being standardised by the market regulator. However, at the governmental level, our fiscal decisions should be marked by a push towards developing an economy with full employment and innovation, instead of seeking to chase down ratings quarter by quarter.

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