“Grasping At Straws: A Ratings Downgrade For The Emerging International Financial Architecture”

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Abstract

Following the Asia crisis of 1997-98, policymakers invested a great deal of energy in designing a new international financial architecture. However many of the policy proposals which have emerged from think tanks and the multilateral agencies have proven unworkable or politically unpalatable. The debate focuses on state-led initiatives. But the assumption that public policy is by definition an output of public institutions is difficult to sustain in an era of global change. This paper considers specialized forms of intelligence-gathering and judgment-determination which seem increasingly important as sources of governance in this era of financial market volatility. These agents - embedded knowledge networks (EKNs) - include the major bond rating agencies, Moody's Investors Service and Standard and Poor's, the focus of this paper. The Basel Committee has put forward a serious proposal to reform the existing capital adequacy framework which uses banks' own internal ratings and external bond ratings to calculate bank risk-weighted capital requirements. The paper shows that there are potentially unexpected consequences from using private rating agencies as a substitute for state-based regulation, due to the organizational incentives that shape the ratings industry. Cementing these organizational incentives into the emerging financial architecture will give rise to negative social and economic consequences.

Keywords: Asian financial crisis, Bond rating agencies, International financial architecture, Embedded Knowledge Networks, Bank for International Settlements, Banks, Capital markets

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INTRODUCTION

Most political scientists spend their time studying obviously political phenomena like elections, political parties and parliamentary debates.[i] We offer a political reinterpretation of what are traditionally thought of as mundane – even arcane – entities and processes from the world of commerce.[ii] In this paper, we argue that the major debt rating agencies, Moody's Investors Service (Moody's) and Standard and Poor's (S&P) are what Sinclair has called embedded knowledge networks (EKNs), and that these (and related institutions) serve to privatize policy-making, narrowing the legitimate sphere of government intervention. More narrowly, we suggest recent efforts to incorporate the outputs of the rating agencies into plans to make global finance less volatile are flawed, and likely to reproduce unexpected and unwanted outcomes.

EKNs are private institutions that possess authority as a result of a history of solving problems and acting as expert advisors in high-value transactions. Rating agencies are key EKNs. Their judgments influence the products we buy, the public services we use, and the scope of our democratic institutions. Their growth is increasingly global as these agencies spread from their US base to influence policy in Asia, Europe and Latin America. Because of this influence, we argue we can view the rating agencies as *de facto* private makers of global public policy (Sinclair 1994a, 451).

We have organized this paper in six parts. The characteristics of embedded knowledge networks as mechanisms of global public policy-making are considered in the first. In the section following, we examine the key dynamics of the new global finance and some of the main characteristics of the rating agencies. In the subsequent element, we consider the effectiveness of the rating agencies as mechanisms of governance. The next discussion investigates some public-private linkages. Subsequently, we focus specifically on the emerging international financial architecture and consider the implications of the new Basel proposals on capital adequacy (Basel II) as these relate to the rating agencies. The final section of the paper ponders the political implications of these private makers of global public policy.

EMBEDDED KNOWLEDGE NETWORKS

What are embedded knowledge networks? EKNs are networks but not in the usual sense of the term. The conventional usage implies “a set of objects tied together in a connective structure by links” (Batten et al. 1995, viii). Our usage is indebted to Powell and Smith-Doerr (1994, 368), who suggest a network can be thought of an "organizing logic.”[iii] Scholars often analyze the organization of social life dichotomously, in either its market or state-centered dimensions (Strange 1994). Some scholars have sought to incorporate hybrid organizational forms, such as community or private associations (Streeck and Schmitter 1985). But these hybrid models still imply control on the part of the state, and put emphasis on the necessity for conscious coordination. We need an understanding of how authority has been reinvented via tools which investigate the *infrastructure* of contemporary commercial life (Cutler et al. 1999; Hewson and Sinclair 1999).

EKNs exercise power in two senses. First, they *control* , by limiting thinking to a range of possibilities, and as a consequence shape the behavior of market actors. On occasion, EKNs *rule*, that is, they exercise veto over certain options, leading to seismic changes in thinking and behavior in the financial markets (Scott 1993, 294). Rule is a less common and less important phenomenon than control, but rule is more visible and may stimulate political challenges to the role of EKNs.

Knowledge is key to understanding where the authority of EKNs is derived. Market actors in the new global finance are overwhelmed with data. EKNs supplement and organize readily available aggregate information through expert and local knowledge. Local knowledge – of “particular circumstances of time and place” – is vital to understanding processes of change and is as necessary as expert knowledge (Hayek 1949, 80-83). This combination of local and expert knowledge gives the agencies epistemic authority in the capital markets (Sinclair 2000, 495). A typical form of EKN knowledge output is some sort of recommendation or rating, which purports to condense these forms of knowledge. This output acts as a benchmark around which market players organize their affairs. Market actors depart from the benchmarks, but these still set the standard for the work of other actors, providing a measure of success or failure. In this way, EKN outputs play a crucial role in constructing markets in a context of less than perfect information.

GLOBAL FINANCE AND THE RATING AGENCIES

The rating agencies operate in what Sinclair has called the New Global Finance or NGF (Sinclair 2000). The NGF amounts to a new form of social organization (Cohen 1996). Most of us are familiar with bank lending (Sinclair 1994a and 1994b). Banks traditionally acted as financial intermediaries, bringing together borrowers and lenders. They borrowed money, in the form of deposits, and lent money *at their own risk* to borrowers. However, in recent years disintermediation has occurred on both sides of the balance sheet. Borrowers have increasingly obtained money from non-bank sources. By the mid-1990s, mutual funds, which sweep depositors' money directly into financial markets, contained around $2 trillion in assets, not much less than the $2.7 trillion held in US bank deposits (*The Economist* 1994, 11). The reasons for this development lie in the heightened competitive pressures generated by globalization, and the high overhead costs of banks (*The Economist* 1992).

Disintermediation is at the center of the NGF. It is changing banks and creating an information problem in the capital markets. In a bank-intermediated environment, lenders can depend on the prudential behaviour of banks to maintain solvency. However, in a disintermediated environment there is an information problem because lenders must make judgments about the likelihood of repayment. Given the high costs of gathering suitable information with which to make an assessment, it is not surprising that institutions have developed to capture economies of scale and provide centralized judgments on creditworthiness.

Bond rating agencies are in the first instance a US development and we therefore should look at US economic history in order to understand how they came into being. Three key features of American economic history initially impaired the quantity and quality of information flows between those with funds to invest and those seeking to utilise those flows. The first variable was space. Economic development in the western part of the United States occurred at great distances from the centers of population on the Eastern seaboard. The second variable was the large number of middle class people with savings, but who were not embedded in the sort of family-business ties that prosperous people might utilise to guide their investment in Europe. Taxes on consumption after the Civil War had raised the propensity to save rather than consume, greatly expanding the size of this group (Ratner et al. 1979, 369). The third

variable was the poor economic and financial data the US and state governments produced at this time compared with other rich countries (Kirkland 1961, 234).

Rating agencies are one product of a process of institutional innovation that has developed over many years. From around mid-century until the First World War, American financial markets experienced considerable growth in information provision. *Poor's American Railroad Journal* appeared in the mid-century. In 1868, Poor's produced the *Manual of the Railroads of the United States*. By the early 1880s this publication had 5,000 subscribers (Ibid., 233). John Moody first began publishing his *Manual of Industrial Statistics* in 1900. This publication proved to be a "'gold mine'" (Ibid., 234).

The transition between publishing data sets and actually making judgments about the creditworthiness of debtors occurs between the 1907 financial crisis and the Pujo hearings of 1912. This crisis - little known today - was as threatening as the 1990s Asian financial crisis. It changed attitudes toward financiers, and expanded demand for bias-free information.

The emergence of what we can identify today as the rating system takes place between the 1907 crash and the Second World War. During this period, with the experience of the market crash of 1929 as a further stimulus, information provision in capital markets radically changes. The Securties and Exchange Commission imposed standardization on information outputs to help make information comparable across corporations. Accounting firms flourished (Smith and Sylla 1993, 42). New rating firms appeared to compete with Moody's, and the rating processes themselves were codified and enhanced.

Rating entered a period of consolidation in the 1930s as rating became a standard requirement to sell any issue in the US after many state governments incorporated rating standards into their prudential rules for investment by pension funds. A series of defaults by major sovereign borrowers, including Germany, narrowed the bond business to mainly US firms and public agencies from the 1930s to the 1980s. This period was dominated by American blue chip industrial firms (Toffler 1990, 43-57). During this time, foreign corporate borrowers were largely excluded from US securities markets.

The current phase of rating growth has a number of central features. Internationalization is the most obvious charactertistic. As noted, cheaper, more efficient capital markets now

challenge the commercial positions of banks in Europe and Asia. Ratings became a standard feature of any Eurobond offer by the mid-1990s. The New York-based agencies are growing rapidly to meet their demand for their services in these newly disintermediating capital markets. Second, innovation in financial instruments is a major feature. Derivatives and structured financings, amongst other things, place a lot of stress on the existing analytical systems and outputs of the agencies, which are developing new rating scales and expertise in order to respond to these changes. The demand for timely information is greater than ever. Third, competition in the rating industry has started to accelerate, for the first time in decades. The basis for this competition lies in niche specialization (for example, Fitch Ratings in municipals and financial institutions) and in the 'better treatment' of issuers by smaller firms. The global rating agencies, especially Moody's, are sometimes characterised as high-handed, or in other ways deficient in surveys of both issuers and investors (Monroe 1995; United States Department of Justice, 1998). While this has not yet produced any significant change in the institutionalization of markets, subsequent to the Asian financial crises of 1997-99 Moody's corporate culture became much less secretive.

The two major agencies dominate the market in ratings, listing around US$30 trillion each (Moody's 2001). Both Moody's and S&P are headquartered in New York. Moody's was recently made a stand-alone corporation by parent Dun and Bradstreet, the information concern, while S&P is a subsidiary of McGraw-Hill, the publishing company. Both agencies have numerous branches in the US, other OECD states and in emerging markets. A distant third in the market is Fitch Ratings, which is the culmination of recent mergers between Fitch Investors Service (New York), IBCA (London), Euronotation (Paris), Duff & Phelps (Chicago) and Thomson BankWatch (New York).

An increasing number of domestically-focused agencies in developed countries and especially emerging markets opened during the 1990s, including Japan, China, India, Malaysia, Indonesia, Thailand, France, Canada, Israel, Brazil, Mexico, Argentina, South Africa, and the Czech Republic (Greenberg 1993; www.everling.de).

The categories of issuers covered by the agencies have changed over time. Initially, the focus of rating activity were railroads, industrial corporations and financial institutions in the US. After the First World War, US municipalities and foreign governments sought ratings. With the defaults of the 1930s and the creation of the Bretton Woods system, the rating firms

retreated to higher-rated industrial firms in the US in addition to US municipalities. As noted, in this era of rating conservatism, sovereign rating coverage was reduced to a handful of the most creditworthy countries. With the end of the Bretton Woods system and liberalization of financial regulation, the narrowness of the system that prevailed for half a century from the 1930s to the mid-1980s was challenged by the rise of a vibrant junk bond market in the US. This enabled lower-rated companies to raise capital by selling debt on the bond markets for the first time. In this new market, rating helped to price debt rather than exclude it from the markets, as had been the case in the era of rating conservatism.

The outputs of the rating agencies are consumed by key capital market actors, including pension funds, investment banks, other financial institutions and government agencies. Moody's have 4,000 clients for their publications and estimate around 30,000 people read their output regularly (Chmaj 2000). Annual fees range from $15,000 to $65,000 for heavier users, who also have the opportunity to talk to analysts directly. Increasingly, outputs are produced on-line. The "relationship-level clients" may also attend conferences and take part in other events related to credit quality. Moody's actively puts its analysts in front of journalists and, like Standard & Poor's, issues press statements on credit conditions regularly. Standard & Poor's produce a wider range of products in both traditional and digital format. Their core weekly publication, *CreditWeek*, has some 2,423 subscribers. *Global Sector Review* is bought by 2,988 clients (Bates 2000).

During the Bretton Woods era – the era of rating conservatism - the rating agencies did not change the way they did business dramatically. There were no competitors and the rating institutions took on a gravitas in keeping with the nature of their task. Events like the unforseen collapse in New York City's finances in the mid-1970s did not give rise to any fundamental change.

More recently, perceived rating miscalls are a significant issue for the agencies as these potentially erode the reputational assets the agencies have built up since the 1930s. The 1990s saw more of these events as financial volatility grew in an increasingly liberalized world economy, including the Tequila crisis of 1994/95 and the Asian financial crises of 1997/99. At the same time, derivatives and other new financial technologies stimulated a number of corporate collapses in the US.

Two main strategies characterized the responses of the agencies to these problems. Like other financial industry institutions, they ran to catch up with financial innovation, spending money on staff training and hiring. They pushed harder for analytical innovation in their own products. S&P created new symbols to indicate when, for example, ratings were based on public information only and did not reflect confidential data. Second, the agencies, especially Moody's, sought to change their cloistered, secretive image and became more transparent and willing to justify their ratings. This latter strategy may be more to do with reducing market and public expectations about rating as improving their product.

THE ADDED-VALUE OF BOND RATING

Why people pay for the work of the bond rating agencies is a matter of controversy. Bond traders and pension fund managers have paradoxical views on rating agencies.[iv] On the one hand, they typically hold the rating agencies in high esteem. Indeed, market participants often treat the rating agencies and their views with reverence. In addition to respect for the reputation of the agencies, there is an awareness of the influence of the rating agencies in the markets. Even if a trader or issuer of bonds does not agree with a particular judgment of the rating agencies, the professional has to take account of others acting on that judgment in the market. Rating agency outputs therefore comprise an important part of the infrastructure of the capital markets – as facts of the marketplace - which form the basis for subsequent decision-making. Here, rating agencies are important not so much for any particular rating they produce, but for the fact that they are a part of the market itself. So, traders commonly refer to a company as an 'AA company' or some other rating category, as if this were a fact, an agreed and uncontroversial way of describing and distinguishing companies or countries.[v]

On the other hand, market traders certainly do express negative views of the agencies and their work. These criticisms can be voluble at times. A common idea is that the agencies are simply one source of information, whose views have to be considered alongside those of other sources. This view, which is often expressed by investment bankers, seems to be made most often when rating agencies make inconvenient judgments about an issue of bonds offered for sale, or when an issuer tries to deflect attention from a rating announcement just made about them. In these circumstances, ratings will be characterised as simply an opinion,

one of the many sources of information used by financial market operatives to make their investment decisions.

During the junk bond era of the 1980s, some professionals took the view that the agencies were guilty of limiting access to the capital markets to blue chip corporations (Toffler 1990, 43-57). Others, including pension fund managers, have at times suggested credit rating is not timely enough and is focused on applying the - presumably no longer relevant - lessons of the past to the future (Liu 1997). Of course, the most common cause for hostility is the view that the rating agencies have somehow made a 'mistake' in issuing a rating lower than expected by the issuer of the debt (*The Economist* 1997, 68). More recently, another cause of hostility has been the penetration of Europe and Asia by the major American rating agencies, with implications for established market practices in those places (Roberts 1991, 83; Appell and Goad, 1998).

Academics cannot agree on the significance of the agencies. The most widely held view suggests rating agencies solve the problem in markets that occurs when banks no longer sit at the center of the lending process. Rating agencies solve this information problem efficiently, this view suggests, because they are able to gather information from many different issuers and issue comparable ratings. Rating agencies may also establish "rules of thumb" which make market decisions easier or less costly (Heisler 1994, 78). The agencies adopt various versions of these views at different times as justifications for their activities. Agency officials typically add the claim that they have access to confidential information not available to the markets. Their rating judgments are, they insist, more likely to be accurate as a consequence.

In the late 1960s and early 1970s, raters began to charge fees to bond issuers to issue ratings. Now 75 percent of the income of these agencies is obtained from fees charged to issuers.[vi] In Canada, the Dominion Bond Rating Service gets more than 80 percent of its revenue from rating fees, while the Canadian Bond Rating Agency makes 50 percent of its revenue this way (Kilpatrick 1992). It has been suggested by a number of scholars that charging fees to bond issuers constitutes a conflict of interest (Fight 2001).[vii] This may indeed be the case with some of the smaller, lower-profile firms desparate for business. With Moody's and S&P this does not seem to be a significant issue. Both firms have fee incomes of several hundred million dollars a year, making it difficult for even the largest issuer to manipulate them through their revenues. Moreover, any hint of rating inflation would diminish the reputation

of the major agencies, and this asset is the very basis of their franchise. In the case of rating agencies in Japan and the developing world, financing typically comes from some combination of ownership consortia, which often include financial institutions, and government agencies. This casts real doubt on the independence of their work within the financial community.

Comparisons between the role of the Law Merchant (a form of private medieval commercial law) and bond rating agencies are useful. The Law Merchant developed as a way of enforcing contracts by making judgments on trade disputes and keeping records of these actions available for scrutiny by merchants engaging in intra-European trade. This mechanism backed-up merchants when their names were not well known to potential new trade partners in geographically distant places. Rating agencies share a number of characteristics with the Law Merchant. They too are responsible for keeping an eye on who is violating the norms of financial and commercial practice (Milgrom 1990; Cutler 1998).

PUBLIC-PRIVATE DYNAMICS

Rating agencies have close - sometimes difficult - relationships with governments.[viii] The degree to which ratings have been subject to government 'utilization' has grown since the late 1970s as financial markets have become more sophisticated and extensive (Hawkins et al. 1983, 131-161). This has increased the importance of ratings by making the judgments of rating agencies more significant in the transactions of investors and traders. Government regulation in the US has reinforced an oligopolistic ratings market and made it harder for new entrants to launch ratings businesses.

Public utlization of ratings goes back seventy years or so. The Depression, the consequent sharp decline of credit quality, and the problems of domestic financial institutions it brought about led the US Office of the Comptroller of the Currency (OCC) to rule that bank holdings of publicly rated bonds had to be 'BBB' or better to be carried on bank balance sheets at their face or book value. Otherwise the bonds were to be written down to market value, imposing losses on the banks (Cantor and Packer 1994, 6). Numerous state banking departments also adopted this rule. New OCC rules in 1936 prohibited banks from holding bonds not rated 'BBB' by two agencies. This had far-reaching consequences because 891 of 1,975 listed bonds were rated below 'BBB' at the time. This action effectively closed down the high yield

bond market for the next forty years, until 1977. The bond business and bond rating became quiet predictable occupations.

The next important development was the adoption of Rule 15c3-1 by the SEC in 1975, the net-capital rule. Under this rule brokers who underwrote bond issues had to keep a certain percentage of their financial capital in reserves - a haircut - of the market value of the securities they had on their books. However, the rule gave "preferential treatment if the instruments had been rated investment-grade by at least two 'nationally recognized statistical rating organizations' (NRSROs)," who would get a "shorter haircut" (Edwards 1994). The SEC did not define an NRSRO. Despite this, the NRSRO concept has subsequently been incorporated into many regulatory initiatives. Moreover, "state authorities, self-regulatory organizations and great swathes of the US mutual fund industry have adopted ratings to define, control and advertise risk" (Edwards 1994, 27). The NRSRO concept remains vague and unspecified in law but very significant in the market. The most explicit statements of the NRSRO criteria are contained in SEC "no action" letters given to Fitch Investors Service, Thomson Bankwatch and IBCA. The criteria mentioned in these letters by the SEC are: conflict of interest scrutiny; appropriate institutional separations to avoid mixing investment advice and rating; adequate financial resources; adequate staff; and sufficient training (Rose interview). Moody's and S&P were simply deemed to be NRSROs. SEC control of NRSRO designation limits competition to those agencies that can demonstrate that they are "nationally recognized." This has been difficult for the two Canadian agencies, who have thus far been denied NRSRO status, even though harmonization of securities disclosure laws between the US and Canada under NAFTA means that Canadian bonds can be sold in the US without going through SEC procedures. However, this is contingent on the issue being rated by two NRSROs. Therefore, the Canadian agencies risk being uncompetitive in Canada because they are not NRSROs (Rose interview). While the SEC seems to be sympathetic to their plight, it has clear concerns about the credibility of the Canadian (and other foreign) agencies.[ix] Interestingly, in early 2001 one of the two Canadian agencies (CBRS) was bought out by Standard & Poor's.

In August 1994, the SEC took the first steps to changing the NRSRO system by issuing a 'concept release' seeking comment on NRSRO ratings in SEC regulation, the process of becoming an NRSRO and the SEC regulation of NRSROs (SEC 1994). This release, which has now been transformed into a proposed rule, was made at the initiative of middle-level

officials, who were trying to get the Commission to take a stand on the issue (Rose and SEC official interviews). Lobbying has been intense during the past seven years. This effort to establish formal procedures for designation and monitoring of NRSROs has been attacked by the established rating agencies who invoke the effectiveness of the market test of ratings as the most approriate means for keeping rating accurate, and suggest that future extensions of the regulatory use of ratings should be carefully considered on a case-by-case basis (Standard & Poor's 1995). However, as Cantor and Packer observe, the current system "clearly favors incumbents" as new entrants to the rating business cannot become "nationally recognized" without NRSRO status (Cantor and Packer 1994, 8). As of late August 2001, there is no sign of any resolution of this issue.

The initiative to make the NRSRO status more transparent reflects the intensified competitive conditions of the global economy and its emphasis on removing barriers to entry, including the US need to reciprocate where S&P and Moody's have been incorporated into foreign rating agency regulations (such as in Japan or Mexico). In these conditions, state intervention is becoming more codified, institutionalized and juridified. Rules are more elaborate and made formal, with fewer tacit understandings (Moran 1991, 13). This tendency both devolves state activities onto nominally private institutions, like the rating agencies, which now find themselves increasingly part of disclosure rules, and sets the rules in which these networks operate (*Ibid*., 14). The latest example of this tendency is the Basel II capital adequacy proposals which mandate rating agency outputs for less sophisticated banks (BIS 2001). By invoking agency judgments in more and more regulation, and by potentially codifying rules under which agencies can be established and operate, socially contestable public policy-making is protected from demands from the polity. Indeed, the agencies emerge in a strengthened position to apply their judgments to public agencies with the conviction that they are socially-sanctioned judges of prudent economic and financial behavior.

EMERGING INTERNATIONAL FINANCIAL ARCHITECTURE

The New Basel Capital Accord proposals published for comment in January 2001 must be read as another moment in the relationship between public regulation and the rating agencies (BIS 2001). We assume here that non-metropolitan and most emerging market/developing country banks will be subject to rating agency review rather than their own internal ratings. Our view is that further incorporating these de facto regulatory institutions into de jure

regulation will produce perverse outcomes for the financial markets and global public policy. We make thirteen points in support of this view below.

1. *Rating agencies are pro-cyclical*. The primary difficulty with basing the capital allocation of banks on credit ratings is that these same ratings have been found to be pro-cyclical. While the rating agencies claim to rate firms 'through-the-cycle', in practice their ratings reflect a point-in-time approach. The BIS has confirmed that in fact the rating agencies give only modest weight to cyclical economic conditions, and their ratings exhibit systemic changes over the course of the business cycle (Bank for International Settlements, 2000, 8 and 142). Ratings of lower-rated firms are more volatile, and downgrades are typically associated with further downgrades, while upgrades are not necessarily associated with further upgrades. This pro-cyclical behaviour will generate perverse results for the goal of enhancing financial stability. Banks which use external ratings for allocating capital will will always have the least amount of capital put aside at the point when they need it most, when the business cycle is about to turn and non-performing assets are set to rise. A downturn in the business cycle will cause the ratings on firms to deteriorate, forcing banks to put aside greater capital at the worst possible time when the economy is heading into recession. Should ratings decline unexpectedly, as occurred this year with Californian utilities or in 1997 with Asian sovereigns, banks will not have the capital in place in advance of the event. Thus the trend-following behaviour of ratings will exacerbate, not reduce, the risk of financial crisis and contagion as banks will be undercapitalised when market conditions are most difficult.

2. *Basel II will raise the cost of capital in developing countries*. The new capital adequacy framework will stunt the growth of firms in developing countries by raising their cost of capital relative to firms in the wealthy countries. The new framework raises the cost of capital in several ways. First, it allocates a higher risk weighting to non-rated assets than rated-assets. Over 80 percent of rated corporations and 70 percent of rated banks are located in OECD countries, and a higher per capita income is associated with higher ratings.[x] By default, most firms in emerging markets are unrated and so loans to these borrowers will accrue a higher capital charge which will be passed on to the borrower. A World Bank study found 581 OECD-based industrial firms would see their cost of capital decline by 1 percent under the new framework, whereas only 15 non-OECD firms would pay less. Instead non-OECD borrowers would face an average increase of 1.5 percent. In

the banking sector, the disparity is even greater with OECD banks paying 2.4 percent more as compared to 6.4 percent for non-OECD banks. This higher cost of capital will create an incentive for borrowers in developing countries to seek other means of financing which are potentially risk-enhancing, such as off-balance sheet financing, use of financial derivatives or borrowing from unregulated non-bank financial companies. It will also create disincentives to adopt more sound risk assessments, increasing the volatility of LDC banks' capital requirements and worsening the availability of credit to cash-strapped firms in a crisis. In the past, this combination of factors created financial crises which ended with large bail-outs from the rich countries who were affected by contagion. Second, non-US borrowers are sensitive to the rating on sovereign debt, which sets the rating ceiling for all firms in its jurisdiction. This sovereign ceiling penalises well-managed firms located in countries with a low sovereign rating. This sovereign ceiling becomes more punitive when you consider that studies have found that sovereign ratings of low-income countries were downgraded excessively relative to OECD countries, and that bank and non-bank ratings in these low-income countries did not recover when the sovereign rating was upgraded (Ferri, 2000).

3. *Rating agencies are not liable for their own failures.* Implicit in the idea of incorporating credit ratings into the system of global regulation is the view that these private agencies will be held accountable for their judgments and their mistakes. Up to now, rating agencies have not been held accountable under the law for negligent behaviour, despite attempts to hold them accountable following the collapse of Orange County and other public and private entities. The rating agencies have been able to avoid liability by claiming that they are offering only an opinion of creditworthiness, not a measurement, allowing them to escape prosecution under freedom of speech laws. Whereas the accountancy profession has been held liable under Generally Agreed Accountancy Principles (GAAP), no parallel exists for credit ratings and any attempt to standardise ratings in this way way has been resisted by the rating agencies. This lack of a common standard makes it difficult for a regulatory agency or a court to establish an independent benchmark for measuring a rating agency's performance. However, even if the rating agencies were found liable for negligence in their duties, they would not have the capital available to settle such disputes without quickly going bankrupt. As a result, the cost of failure would fall on investors, or on taxpayers following a government-sponsored bail-out.

4. *Ratings agencies have authority but not accountability.* As discussed, rating agencies are hybrid forms of authority, operating between the state and the market, which have acquired public authority due to their professional expertise, their specialist knowledge, their reputation and their acceptance by market actors (Sinclair, 1994 and 2000). In the US, credit ratings have been explicitly incorporated in regulation since 1931, with ratings restricitions written into laws governing banks, pension funds, insurers, broker dealers and mutual funds (Bank for International Settlements, 2000, 54; Sinclair, 1999, 157). Ratings are also incorporated into regulation in Canada, the UK, France, Italy, and Japan. Despite this official role, no public oversight of the rating agencies actually exists. They have escaped democratic mechanisms of accountability despite playing a part in the operation of credit markets. This lack of accountability undermines their legitimacy and has led to calls from the Investment Company Institute, an interest group representing institutional investors, for the supervision and legal accountability of rating agencies.

5. *Weak institutions in LDCs will undermine ratings.* The reputation of the global rating agencies depends on a track record built up in the US, where both market and non-market institutions have supported and enhanced their success. Can this track-record be repeated in the context of emerging markets where the judicial system, the supervision of banks, the sophistication of investors and the level of financial disclosure are far different from the industrialised countries? Under Basel II, domestically certified rating agencies will provide the risk assessment used to determine capital requirements in their jurisdiction. In the future each country can be expected to have a local ratings champion which will compete with the global agencies. Domestic ratings will become politicised as private interests lobby in order to be awarded the highest possible rating. Given the evidence of corruption and bribery in many regimes around the world – termed crony-capitalism during the recent Asian crisis - do international regulators wish to use the outputs from potentially compromised firms to minimise banking sector risks?

6. *Incentives for ratings shopping*. More generally, the multiplication of ratings for firms combined with the structure of Basel II will create incentives for ratings shopping. Studies of the existing rating agencies have shown that the smaller agencies consistently provide higher ratings than the global leaders. This problem will only worsen as banks seek out the highest ratings available on the market in order to reduce the capital charge on their loans. Any rating agency which does not want to lose market share will be forced

to compete in this market. Rating agencies are private-sector companies driven by a profit motive. They earn their fees largely from the entities which they rate, creating a principal-agent problem. Either the compensation structure of the industry must be changed, or an international rating agency will have to be created in order to provide a benchmark against which to compare the output of domestic rating agencies.

7. *Basel II only addresses banks but not other financial services.* The line between financial products and their providers has blurred considerably over the past two decades, due to innovation by firms that are eager to move into other more profitable lines of business. Non-bank financial institutions offer loans, lines of credit, credit cards and electronic cash – services which were previously the domain of commercial banks – while commercial banks are increasingly involved in the securities industry. Despite these trends, the regulation of financial services remains stubbornly segregated owing to the historical development in the US where banks, pension and insurance companies, and securities dealers are supervised by different public regulators, or even responsible for their own self-regulation. This segregated approach has been overhauled in countries like Canada and the UK where 'super-regulators' have been given supervisory responsibility across product lines. Despite this trend, Basel II remains stubbornly trapped in the outdated 'pillars' model employed in the US. The Basel Supervisors may cooperate with their counterpart in the securities area, but the fact remains that there is no global capital adequacy framework for the securities industry. By addressing the risks of traditional lending but disregarding the risks associated with capital markets, Basel II increases the cost of the former with respect to the latter, creating incentives for regulatory arbitrage (Kerwer, 2000).

8. *Credibility of analytical tools*. Perhaps one of the least explicable things about the analysis undertaken by rating agencies is their non-utilization of probabilistic tools in their assessment of creditworthiness. This issue was highlighted by staff of the International Monetary Fund in the September 1999 *International Capital Markets* volume (IMF 1999, 196). Rating agency analysis is characteristically qualitative and can only anticipate the future based on rules of thumb derived from past experience. This may explain why the rating agencies have been subject to periodic criticism for applying the lessons of the past to the present.

9. *The new system will be unwieldy and create moral hazard.* Basel II may look good on paper, but in practice its full implementation will be highly bureaucratic. The external ratings framework is intended as a step towards the internal credit ratings approach where individual banks determine their own capital allocation using their own modes. No one doubts that building these proprietary credit risk models will be an expensive and time consuming endeavour, requiring the accumulation of credit risk expertise and vast investment of senior management time. Assuming these obstacles are somehow overcome and the models are put in place, this approach will still be infeasible for a number of operational reason. First, adequate historical statistics of the probability of default and the recovery given default do not exist, even among the most sophisticated banks. Second, mapping the internal credit ratings of thousands of individual banks onto a uniform and consistent set of global capital buckets will be a monumental task. The Basel Supervisors will be required to evaluate, test and approve each bank's internal credit risk model before then deciding how to graft the bank's internal ratings onto a global template. The functioning of this system will further reguire periodic checks to ensure it is being implemented as planned. Third, the completion of this tasks will require the Basel Supervisors to make an equal investment in expertise, management time and resources – often relying on local regulators or central banks to fulfil this role. It is easy to imagine than many banks will be left to their own devices, with loopholes and accounting methods being exploited in order to generate the lowest possible capital charge. Fourth, this arrangement is fraught with moral hazard, and is not likely to work in practice – particularly in developing countries – given the experience with past failures of banking regulators in even the most developed countries.

10. *Comparability Issues*. One of the key claims made by rating agencies about their work is the comparability it generates. An investor should be able to compare risks between Brazil and Borneo, California and Chile. However, as the Asian financial crisis of the 1990s demonstrated, these claims are hard to accept. The institutional chasm between developed and developing countries is so vast that the analytical techniques do not yet support comparability claims.

11. *Negating the Market in Reputation.* Institutionalizing rating agencies in Basel II will - given the high barriers to entry - undermine the reputational constraint enforced by the

ratings market. Any degrading of reputational enforcement will loosen inhibitions on inflating ratings to satisfy issuers.

12. *The buck does not stop here.* In a world in which private liabilities often, as in the LDC debt crisis, end up as the responsibility of tax payers, rating agencies institutionalised within Basel II have few incentives to improve their performance. Indeed, Basel II may create moral hazard in the agencies just as it is supposed to reduce this risk in the markets as a whole.

13. *Policy homogeneity.* Given what we already know about the output of the rating agencies (Sinclair 2000) a major role for the agencies in Basel II will add to pressures toward the emergence of a monolithic corporate and public policy culture.

PRIVATE MAKERS OF GLOBAL PUBLIC POLICY

How has the development of embedded knowledge networks in the new global finance - typified by bond rating agencies – changed the basis of effective policy-making? We suggest that rating agency activity does not just constrain policy but contributes to the generation of market actors themselves.

Coordination is an important consequence of the rise of the new global finance. Social networks which reduced the transactional uncertainty of markets in the past (such as banks and business ties) are now much reduced in effect by the increased social distance between market participants created by globalization. We can think of the new relations as at times consensual and at other times coercive. The process is consensual when it gives rise to wide agreement on a set of ideas amongst the relevant group about the basis for transactions (control). It is coercive when the EKN must use sanctions (such as rating downgrades) against firms and governments to bring behavior into line (rule).

As we have argued, rating agencies offer to solve the information problem between those with funds and those seeking them, adjust the 'ground rules' inside international capital markets, and thereby shape the internal organization and behavior of those institutions seeking funds. Their views on 'the acceptable' shape the thoughts and actions of those

dependent on the agencies. This anticipation process limits the scope of concrete policy initiatives. The coordination effect of EKNs, as exemplified by rating agencies, is therefore to narrow the expectations of creditors and debtors to a set of norms, shared amongst all parties.

The agencies see themselves as "quasi-regulatory institutions" (O'Neill interview). They are well placed to adjust government challenges to their prerogatives, as the hesitancy with which any new effort - including Basel II - to further pull them into regulation demonstrates. Nevertheless, a significant feature of their relationship with public authority is the tendency of government to use quasi-regulatory outputs as substitutes for their own action. As noted in the section above, this quasi-regulation poses grave risks for global financial stability.

CONCLUSIONS

Global change makes the public-private distinction at the heart of traditional studies of public policy increasingly invalid. Public policy can also be made by 'private' institutions or networks when the outputs of these private institutions shapes the basic norms which produce action in governments and business organizations.

Rating agencies were examined in this paper as an example of the private making of public policy. Their specific structural power – and hence their influence on public policy – is derived first, from the disintermediation trend in global finance and the information problem it produces in capital markets, and second, from their internal construction (and outward behavior) as embedded knowledge networks, purveying judgments perceived as endogenous and therefore legitimate by other actors.

While the mechanism we discussed in this paper offers greater understanding of markets (and is therefore attractive as a way of generating self-regulation in global finance, as evidenced by the Basel II capital adequacy proposals), EKNs lack two other resources we normally associate with public policy making. First, non-elite societal legitimacy. Endogeneity within the markets is not equivalent to a wider social legitimacy. Second, an executive capacity to respond to crises. EKN rule capacity is less effective than their more defuse control function. Without the ability to respond constructively in times of crisis, private makers of global

public policy are likely to suffer from periodic crises of confidence. Are these the agencies the agencies to bring about global financial stability?

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[i] This paper builds on some of the ideas and concepts developed in Sinclair (2000).

[ii] The authors would like to thank Adrienne Héritier, Helmut Wilke, and Dieter Kerwer for helpful comments on an earlier draft of this paper.

[iii] One astute commentator suggested we substitute ‘institution’ for ‘network.’ Aside from the definition of network offered in the text, the problem with ‘institution’ and the reason we prefer network is that institution is a synonym for organization.

[iv] Interview with Gary Jenkins, Managing Director, Barclays Capital, London, February 13, 2001.

[v] Interview with Leo C. O’Neill, President, Standard & Poor's, New York, August 18, 1992.

[vi] Interview with Joanne Rose, Vice President and General Counsel, Standard & Poor's Ratings Group, New York, February 1993.

[vii] Edward Comor suggested this view to Sinclair.

[viii] This section is drawn from Sinclair (1995).

[ix] Interview with SEC official, Washington, DC, March 31, 1994. Also see Kilpatrick (1992).

[10] Based on a sample of 980 non-banks in 40 countries, 84.5 percent of the rated firms are based in high-income countries (p.10). Based on 959 banks in 57 countries, 73.4 percent are based in high-income countries (p.12). Ferri et al.

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