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# New Approaches to Regulating the Activities of Rating Agencies: a Comparative Analysis

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**Abstract**

Rating agencies have become an important part of the global financial landscape. Formation of credit ratings is specified by the inherent asymmetry of financial market information and general interest in the transformation of a large amount of diverse and segmented financial information in a simple and clear assessment of the credit surveillance of borrowers that is credit rating. The world financial crisis started in 2008 has again put on the agenda the question of rating assessment accuracy and the factors influencing the rating migration. The activity of rating agencies, until recently, has had little regulation, allowing rating agencies to avoid responsibility for inaccuracies in assigned ratings, while investors were suffering huge losses. Therefore there is an actual question of trust in a rating assessment and the necessity of introduction of elements of control.

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*Keywords:* rating, international rating agency, rating process.

## 1. Introduction

Rating agencies have become an important part of the global financial landscape. The importance assigned to the ratings of participants of all financial markets is difficult to overestimate:

- for enterprises involved in raising funds in global financial markets, the necessity to obtain a credit rating, which provides more flexible conditions to raise funds;
- for investors who focus on high credit ratings of eminent of financial instruments to minimize the risk of investing;

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- increased use of credit ratings by monitoring institutions, further strengthened by the adoption of Basel II, acquired the function of licensing, determining the conditions of access to external financing, the choice of investment instruments for the biggest institutional investors. Thus, the rating agencies have practically turned into inspectors of admission to global financial markets of their main participants.

Formation of credit ratings is specified by the inherent asymmetry of financial market information and general interest in the transformation of a large amount of diverse and segmented financial information in a simple and clear assessment of the credit surveillance of borrowers that is credit rating.

In the US, the practice of assigning credit ratings has a history of more than a hundred years, while in the European markets, credit rating services have been developing only during the last two decades. The main reasons contributing to the rapid development of global rating industry are the following: economic and financial globalization conditioned the standardization of risk factors and the need for an adequate instrument for managing investment portfolios; increased regulation of the market capital; development of information and communication technologies to facilitate the process of determining the rating.

The world financial crisis started in 2008 has again put on the agenda the question of rating assessment accuracy and the factors influencing the rating migration. Rating agencies aren't criticised only by the lazy. V.Reding, Eurocommissioner for the legal questions considers that Europe shouldn't allow the three USA private companies (Moody's, Standard and Poor's and Fitch) to scoff at its own economy. He suggests to shatter these three "whales" of credit-rating sphere into six, and to create own rating agency in Europe. The head of committee of banks of the USA Senate T.Dzhonson characterized the activity of rating agencies as "irresponsible". J. Sanio, President of the Federal Financial Supervisory Authority of Germany (BaFin), believes that the rating agencies represent the largest unregulated force in the global financial system. The commission on securities and stock exchanges of the USA (SEC) has recently checked up the work of ten rating agencies (among which there were also three "whales") and has specified a variety of methodological and organizational problems in their activity that questions their competence.

If to study criticism of the international rating agencies for two periods — 2008-2009 and 2011 attentively, a rather paradoxical picture turns out. Three years ago agencies were accused of total, wrongful overestimation of ratings, excessive softness. Now the situation has changed: after decrease of some state ratings (the European countries and even the USA) the criticism has sharply changed its orientation. Now agencies are accused of excessive rigidity, and decrease in ratings becomes the reason of aggravation of financial problems in the separate countries, banks and the companies.

The economic function of the international rating agencies consists of transferring the signals of various risk levels to market participants, thus providing investors with the possibility of correcting portfolios and finding the balance between the risk and profitability in the short term. The basic function of the international rating agencies consists of stabilisation of the markets, but not in their destabilisation. However the opposite takes place in practice, and there is an explanation to it:

- Dynamics of ratings have a clearly pro-cyclic character: ratings grow in a high conjuncture and fall during years of economic crises, strengthening pessimistic expectations of market participants;
- The ratings themselves can carry the function of self-fulfilling prophecies;
- Rating changes very frequently don't occur ex ante, on the basis of the new information, but appears ex post i.e. after there is a change in tendencies in the market. The international rating agencies «reflect past events» (Elkhoury, 2007; Raminsky and Sergio, 2002) instead of forecasting them. This is the tendency both of the financial crisis of 1997-1998, and the present financial crisis.

The above mentioned problems have essentially questioned trust in the activity of international rating agencies. The rating is a very influential instrument of assessment which has a very strong impact on the behaviour of the investor. Rating agencies don't have moral responsibility for the owned and offered assessments as well as for the possible losses of the investor. The activity of rating agencies, until recently, has had little regulation, allowing rating agencies to avoid responsibility for inaccuracies in assigned ratings, while investors were suffering huge losses.

Therefore there is an actual question of trust in a rating assessment and the necessity of introduction of elements of control.

## 2. Literature Review and Hypotheses

### *2.1. Changing the role of credit rating agencies in modern economy*

In the midst of the financial crisis of 2007-2008. credit rating agencies and their methodologies have been put under great doubt in terms of reliability, relevance and overall role they play in the interests of the capital markets.

A very illustrative example of such an attitude to the credit rating and their future was the resonance publication of the Bank of England titled "Whither the credit ratings industry?" (Deb P., Manning M., Murphy G., Penalver A. and Toth A., 2011). It was very typical reflection of the growing discontent of investors, government agencies and even researchers from academic circles, all of them questioned the scale and the nature of a possible reform of rating agencies and the products they offer to the market.

S.Moiseev (Моисеев, 2009) relates the activity of rating agencies with the moral hazard and the risk of adverse selection because of the problem of asymmetric information and principal-agent problem. It is fair enough to point out the dependence of the size of payment for services on the level of the rating assignment; dependence on information provided by the issuer, as well as voluntarism in the analysis of information. Many authors (Partnoy F. (1999), Poon WPH (2003)) specify the potential conflict of interests, which is associated with the services provided by the rating agency. As a result, because of the conflict of interests users of a rating: banks, investors and regulators lose, however it does not concern the participants of the process of rating.

Reliability of rating assessment is often associated with the accuracy of the information provided by the object of rating (Peresetsky A., Karminsky A. (2008), Roy P. (2006). An urgent task of regulating the activities of credit rating agencies is to reduce the dependence of supervisory institutions on assessments of rating agencies. P.Gavras (Гаврас, 2012) points out the need to reduce this dependence, assuming that the transfer of private agencies responsible for the regulation can be regarded as a manifestation of ineffectiveness of regulation by the state.

### *2.2. Development of Hypotheses*

*H1: the financial crisis of 2007-2008 has put the issues of rating agencies on the agenda, specifying the need for independent and accurate assessment.*

*H2: the introduction of elements of control over the activities of credit rating agencies will improve the quality of assigned ratings.*

*H3: reducing dependence of supervisory institutions on the assessments of rating agencies will enable the supervisory institutions to form their own opinion on the problems in the area of jurisdiction.*

## 3. Methodology

### *3.1. Research Goal*

The object of is the activity of the international rating agencies and the ratings assigned to them. The aim of the article is to analyses current main trends and activities of international rating agencies, to evaluate them and to make suggestions regarding the necessity of prudential regulation and supervision of their activity.

### *3.2. Sample and Data Collection*

While working on the article the authors used the following research methods: generally accepted quantitative and qualitative methods of research in economic science, including comparative analysis and synthesis, and graphical methods.

### *3.3. Analyses and Results*

**Problems in the activity of rating agencies**

The US mortgage crisis triggered by the financial crisis of 2007-2009 has become the "first crisis rating" as the rating agencies contributed significantly to its development. The global financial crisis has revealed a number of management problems in the significantly expanded financial system: sovereign ratings tend to lag behind developments in the market and macro-economic indicators; Rating agencies do not have time to assess the complex financial instruments and their impact on the market, though they make significant steps in this direction, including the activation of new methodological approaches.

Representatives of rating agencies very often declare that they have a deep analytical knowledge and «a critical amount » of the experience, necessary for an adequate assessment. Practice shows that agencies regularly make the errors leading to financial losses of investors. In the author's opinion, the examples of failed international ratings agencies must be mentioned:

- false information of the main supplier of financial information, *Standard & Poor’s* in cooperation with the auditing firm *Arthur Andersen* regarding the company *Enron* caused the bankruptcy of the above mentioned company in the beginning of 2001;
- bank holding *Lehman Brothers*, which was given the highest rating of investment attractiveness by the agency *Standard & Poor's*, went bankrupt in a few hours after the assigning of the rating. The Agency managed to withdraw its rating in a couple of hours before the recognition of the bankruptcy of the holding company. A similar situation refers to the insurance company *American International Group*.

The failures of credit rating agencies in assessing developing countries, according to statistics of the UN Conference on Trade and Development, are even more ambitious (see Table 1).

Table 1 Statistics of failures of rating agencies (Number of steps of a rating on which one-time revaluation of a sovereign rating has been made)

| States | Year of crises | *Standard&Poor`s* | *Moody`s Investor Service* |
|---|---|---|---|
| Indonesia | 1997 | 7 | 6 |
| The South Korea | 1997 | 10 | 6 |
| Russia | 1998 | 3 | 4 |
| Argentina | 2000 | 4 | - |
| Uruguay | 2002 | 5 | 6 |

The international rating agencies are accused of **non-objectiveness** of the appropriated ratings. In the economic science the activity of rating agencies are connected with a *moral hazard*, risk of *adverse selection* because of the asymmetry of the information and the *principal—agent problem* (Моисеев, 2009). In practice the claims to the agencies are the following: dependence on fee amount on the level of an appropriated rating; dependence on the information of the emitter; voluntarism in the information analysis and offering consulting services simultaneously.

There is a question: what factors do influence **bias** of rating assessment and on how much the assigned rating is **authentic**? At first sight it can seem that reliability of a rating depends exclusively on degree of reliability of the information which is provided within the limits of the certain methodological approach to a rating definition, that is the rating agency at defining the rating should look forward to use that information which possesses the greatest reliability.

Within the frames of the majority of existing techniques of rating, it is forseen to use the public financial reporting of a client as the initial information, and other information presented by a client, as well as the external information. Reliability of the public financial reporting of a client is provided by consecutive performance of principles of accountancy, as well as the principles and procedures of audit. As to other information presented by a client and the external information, the assessment and security of its reliability is carried out by a rating agency independently.

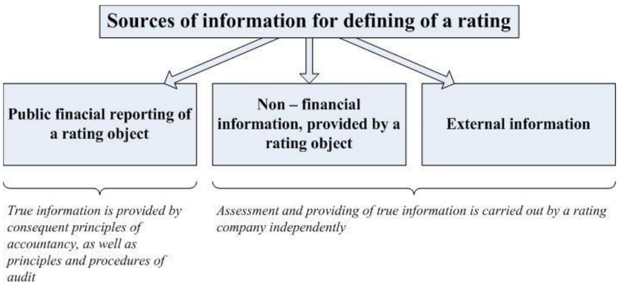



Fig.1. Providing of the trustworthy information used for definition of a credit rating

However, it is necessary to pay attention that reliability of a rating isn't defined exclusively by reliability of the initial information. There can be a situation when the rating defined on the basis of trustworthy information isn't authentic (fig. 2.).

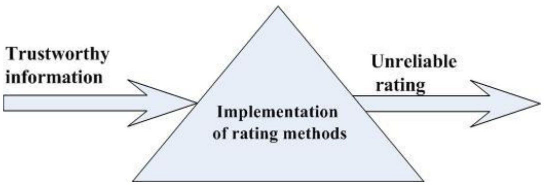


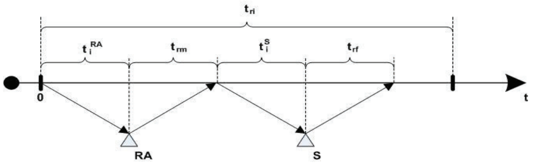

Fig.2. Unauthenticity of the credit rating received on the basis of the initial true information

Such situation can be a consequence of:

- application of inadequate methodological techniques for rating definition therefore the information containing in a rating, doesn't correspond to a real course of events and processes which it reflects;
- errors in the course of implementation of rating techniques .

Events and processes often change essentially, especially in economy, however the ratings assigned by rating agencies, frequently don't change for months, and even for years. Thus, the conclusion is that the information containing in rating agencies ratings isn't true owing to the existence of a time lag. As the events and processes change during each moment of time the information containing in rating, never will be absolutely true if only it isn't defined in a mode of real time. Hence, it is possible to speak only about reliability of a rating at a certain time or about relative reliability of a rating.

Another actual problem is **timeliness** of a rating. Difference of the timely information from the untimely consists of the following: the timely information allows its users – the subjects to, make decisions, in due time to react to a situation change, but untimely doesn't. Accordingly, the degree of timeliness of the information is higher, the shorter is the time interval between the event and the moment of time in which it becomes known about to the user of the information (Галасюк, 2002). With increase in a time lag of providing the information to the user there comes such a moment of time when the information doesn't reflect a real situation any more. The reaction of users of this information on the change of a situation isn’t timely any more as it doesn't answer the terms and requirements of a current situation. The information during this moment of time turns from timely to the untimely.




where

RA – rating agency; S – the user of a rating; $t_{ri}$ – interval of a relative invariance of a rating; $t_i^{RA}$ - interval of providing of the information to a rating agency; $t_{rm}$ – an interval of implementation of rating techniques (assessment) by a rating agency of the subject; $t_i^S$ - interval of receiving of the information on a rating by a user of a rating; $t_{rf}$ – interval of making and implementation of the economic decision by the user of a rating.

Fig.3. The scheme of movement of information streams in time

According to fig.3 condition of timeliness of a rating in the mathematical form can be presented as follows:

$$t_i^{RA} + t_m + t_i^S + t_{rf} \le t_{ri} \quad (1)$$

It is also necessary to point out that in modern economic conditions providing of timeliness of a rating becomes more and more a challenge. Tendencies of development of economy testify that speeds of course of economic processes increase essentially. First of all, it concerns the markets of liquid assets, especially the financial markets. As a result duration of “an interval of a relative invariance of a rating” ( $t_{ri}$ ) is essentially reduced.

The majority of rating agencies don't inform the so-called “an interval of a relative invariance of a rating”. It leads to the fact that the users of ratings have no possibility to estimate, whether the appropriated rating is timely at the moment of making of the economic decision or not. To achieve the greatest possible level of timeliness of ratings in the conditions of acceleration of the course of economic processes the international rating agencies, according to authors, should:

- To provide the maximum timeliness of the information for creating of ratings;
- To minimize duration of procedure of assignment of a rating;
- To accelerate procedures of forwarding of the information on ratings to its users;
- To reconsider the appropriated ratings with the interval of time this doesn’t exceed «an interval of a relative invariance of a rating».

The chronic problem of rating agencies is that they are constantly criticised for their charged **payment** for the rendered services. Many authors (Partnoy, 1999) specify the possible clash of interests: the rating agency can underestimate «a rating without demand», for the purpose of constraint to receive fee for «a rating on demand». However it is necessary to point out that in research papers investigating distinction in ratings on demand and without demand, there is no acknowledgement of the above mentioned criticism. In research paper of Poon W.P.H. (Poon, 2003; Solovjova, 2012) we deal with the analysis of *Standard&Poor`s* ratings of 265 companies from 15 countries in the period of 1998-2000. The author concludes that alongside with other equal conditions ratings without demand are lower than ratings on demand. This fact can be explained by the effect of self-selection: only the companies which are confident of their financial position order a rating. In its turn, rating agencies explain this effect by the conservative approach to exhibiting «a rating without demand», based on the incomplete information on the rating subject.

Because of the interests clash users of ratings lose: they are banks, investors and regulators, but not the participants of the process of rating themselves. According to the authors of the article, the best solution of this problem which will lower the stream of criticism and will eliminate the clash of interests is that the assignment of ratings should be carried out **free** of charge. The international organisation of commissions on securities calls these ratings «*unsolicited ratings*», these are the ratings, which agencies appropriate without a formal order from the emitter or the borrower. In these cases the payment for assignment of a rating isn't planned and meetings or information exchange between agency and the client aren't foreseen (IOSC, 2003). Suggesting the above mentioned solution to a problem, the authors realise that

- decrease in income of rating agencies is possible. However, agencies can earn on credit analytics and on granting the consulting services;
- refusal in granting of the documentation of internal character is possible. In this case there is a question of objectivity and quality of the appropriated rating. The international agencies insist on the access to the internal information which provides a higher quality of the analysis. However the research of some central banks proves the opposite. In October, 2008 the Research Institute of the Central Bank of Finland (Peresetsky, Karminsky, 2008) published the results of the analysis according to which the models of ratings based only on the generally accessible information, have as good forecasting ability, as the models which rely on the internal information. In the National Bank of Belgium (Roy, 2006) they have come to a conclusion that gratuitous ratings at the basis of public information don't compete with the official ratings and are even more careful. Granting the ratings without the order will allow to expand a number of subjects having a rating, to avoid rating "purchase", as well as to encourage the flow of new participants of the rating market, thus to improve the quality of the offered services.

It is necessary to point out that the suggested solution of a problem is very radical and its introduction is connected with various difficulties. The first step to the introduction of the above mentioned suggestion can be introducing **of adjustable pricing** on services of ratings. The state can establish the fixed tariffs for ratings, disregarding the size of the business of the client and importance of a rating. It will allow to minimise stimulus for agencies, and customers to falsify ratings deliberately or influence the process of their assignment.

There are well-known examples when rating agencies couldn't foresee the events in due time (a problem of used **methodology**), which had serious economic consequences: the largest financial crisis in Asia, Russia and in a number of other developing countries (1997-1998), bankruptcies of companies *Enron*, *WorldCom*, defaults of bad quality mortgage securities (2007-2008). Taking into account the above mentioned as well as the influence of ratings on behaviour of investors, the international rating agencies <u>must take responsibility for the accuracy and efficiency of ratings</u>.

**Regulation as a response to the shortcomings of activities of credit rating companies**

The activity of rating agencies requires adequate, reasonable regulation.

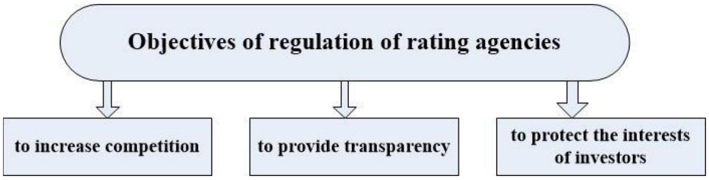



Fig.4. Objectives of regulation of rating agencies

The main objectives of the regulation (*see Figure 4*) of rating agencies are the following:

- to increase competition. The lack of competition among rating agencies should be eliminated by introducing the system of NRSRO (nationally recognized statistical rating organizations) with liberal thresholds of inclusion of new members;
- to ensure transparency. Previous lack of transparency in the activities of credit rating agencies should provide broad obligations to reveal the used information;
- to protect the interests of investors. Protecting the rights of investors should be strengthened by ensuring the objectivity of ratings and by eliminating conflicts of interest.

The sounded criticism of rating agencies stimulated to work out of new concepts and legal acts regulating their activity.

On July, 21st, 2010 the US President Barack Obama signed the **Dodd-Frank Act** (http://www.sec.gov). The Act is meant not to admit new financial crisis and to provide creation of the strong base to the economic growth. The Act will allow to bridle Wall Street, to avoid a new crash of 'To Big To Fail' corporation, and also to protect the clients of financial services. The document contains more than 2000 pages, therefore we will touch upon only separate part of the Act - regulations of activity of rating agencies. The basic changes in activity of rating agencies are the following:

- creation of new department in SEC (US Securities and Exchange Commission). Creation of new department of rating agencies in SEC will have a power to fine agencies. There will be the controllers possessing necessary knowledge and experience. At least once a year SEC will inspect agencies and make its conclusion to the public;
- the requirement to agencies to open estimation methodology, sources of reception of the information about the companies which have rating, the list of the carried out assessment;
- use of the information from independent sources. The requirement to agencies to consider the information which arrives not only from the companies which have a rating, but also from the other sources which are reliable;
- cancellation of the 436 (g) in the Securities Act which assumes that the credit ratings provided by agencies, don't fall under action of articles 7 and 11;
- the right to forbid activity gives SEC power to stop agency activity for providing of an inappropriate rating to a real situation;
- education. The requirement to rating analysts is to have higher education and to take qualification examinations.

The new European legislation concerning rating agencies was developed in 2009-2010 and in 2011 on January, 1$^{st}$ came into force. It obliges credit rating agencies to be the registered participants of the market, and also to open a question of the potential conflict of interests in its own methodology. For supervision of the financial markets the megaregulator was created, it is ESMA – (European Securities and Markets Authority). ESMA can apply sanctions, temporarily withdraw the right of a rating agency on release of credit ratings or even to cancel registration if considers that it breaks any legislative requirements (for example, putting itself in a situation of the conflict of interests).

On June 20, 2013 new rules for rating agencies entered into force (EC, 2013; EC, 2014). The new rules require the following:

- verification of rating methodologies. Agencies need to disclose the key factors on the basis of which decisions are made about the rating assessment;
- protecting the interests of investors. For example, ratings of companies and banks must be published not less than twice a year. A sovereign ratings (the changes and revision) - only after the close of European trading platforms;
- limitation of owners of rating agencies in their third-party assets. If someone has more than 5% of the shares and any assets in the agency, he must relinquish either from the assets or from his rating in the agency;
- ethical standards. CRA III also deals with ethical standards in the publication of information on awarding or reviewing ratings. For example, the rated company must, not later than 1 day before, obtain release or notice from the agency about the change of the rating;
- increasing competition. The new regulations provide the maximum reduction in the monopoly of the three international parties. The rules require a company to obtain a second compulsory rating by any agency, if its market share is not less than 10%.

Introduction of responsibility for exposed ratings encourages strengthening financial position of rating agencies. According to the author, it is **necessary to establish standard requirements to the size of their own capital**. On the one hand, it will allow to lower sensitivity of agencies to risks, and on the other hand — will make their proprietors and managers have a more serious attitude to ratings. The minimum capital owned by agencies represents the analogy of requirements to owned capital of auditor firms which exist in many countries (Rosenkranz, 2009).

However, a very urgent task of regulating the activities of credit rating agencies could be the reduction of dependence from the institutions supervisory assessments of rating agencies. According to the opinion of P.Gavrasa (Гаврас, 2012) " ...the use of ratings assigned by agencies in the regulation equivalent to regulation of the privatization process, which is essentially a function of the state, and the refusal of the government from one of its main responsibilities in the interests of gaining such anticipated benefits as reducing the costs of regulation, increasing the efficiency and nuances."

Thus, the transfer of private agencies responsibility for the regulation can be regarded as a manifestation of ineffectiveness of regulation by the state, because the state, in effect, transfers regulatory authority to private firms, but still retains responsibility for the overall result. This can lead to tragic consequences, both for investors and for the state as a whole. The above can confirm the following:

- The objectives of rating agencies and regulators are different. Rating agencies tend to maximize profits and shareholder value, while as the regulator is trying to ensure the stability of the financial system as a whole;
- professionalism and reputation of the rating agency. Licensing and regulation of agencies are surprisingly limited (Katz, Salinas, & Stephanou, 2009). Selection of an agency is associated with recognition of the market, but not with systematic regulation or licensing standards;
- unfair assigned ratings. Even with an excellent track record of the rating agency, confidence in the regulatory process may be affected by the fact that the ratings, in their inherent nature of the error, depend on judgment. Wrong ratings will mislead those who depend on them, which could potentially cost a lot. Rating agencies

regularly warn that their ratings are just opinions, and that the agencies are not responsible for the inclusion of the results of ratings in regulation.

Of course, the principles of Basel II have increased interest in credit ratings and their models, have linked the level of bank reserve rules with the ratings of the borrower or tool. Some researchers question the principles of Basel II on the basis of calculation of capital adequacy on the basis of credit ratings. Many regulators have their own methods of calculating credit banks, and of course we are not talking about the abolition of the provisions of the Basel principals, but it is important that the regulator has the possibility of using alternative criteria for the calculation of capital adequacy.

The alternative to the rating assessment may be periodic stress testing of systemically important banks (such experience is available from the ECB). According to the author, it is necessary to extend the practice of regular stress tests on all areas where ratings are used as a measure of regulation (banking, management of pension, insurance reserves, investment funds and so on). This measure will allow the regulator to form an opinion about the problems in the sphere of jurisdiction. If the regulator will be not able to predict "the next" crisis, it will have to share the responsibility with the rating agencies.

## 4. Conclusion

1. Formation of ratings is a special kind of activity which has a demand in the market economy.
2. The crisis of 2008-2009 has its impact on the market of rating services, it revealed a number of drawbacks and discrepancies in activity of rating agencies. For improvement of the activity of rating agencies and increase of trust in them, the authors of the article have made the following suggestions: assignment of ratings should be carried out free of charge, which will lower a stream of criticism and will eliminate the clash of interests. The first step of implementation of this suggestion could be the introduction of adjustable fees on services of rating agencies; it is also essential to establish standard requirements to the size of their own capital.
3. Various structures of supervision use ratings for regulation of financial activity in these connection ratings have a licensing function that predetermines a particular interest to them both from the side of investors, and the state structures. An important task of regulating the activities of credit rating agencies is the reduced dependence of supervisory institutions from assessments of rating agencies.
4. The alternative to the rating assessment may be periodic stress testing of systemically important banks (such experience is available from the ECB). It is necessary to extend the practice of regular stress tests on all areas where ratings are used as a measure of regulation (banking, management of pension, insurance reserves, investment funds and so on). This measure will allow the regulator to form an opinion about the problems in the sphere of jurisdiction.

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