**CREDIT RATING AGENCIES: USELESS TO INVESTORS**

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An old metaphor features a soldier who watches a raging battle from afar and, when the skirmish is over, proceeds to bayonet the wounded. Credit rating agencies are like this proverbial soldier; whatever information they proffer generally comes much too late to benefit anybody. They may send out red flags, but these signals often come after the surrender.

Before Enron expired in December 2001, Moody’s, Standard & Poor’s, and Fitch all rated Enron’s bonds as investment grade. Similarly, before the global financial crisis of 2008, the credit rating agencies rated almost all CDOs as investment grade, once again miserably failing the investment community in these assessments.

Europe and Asia were not spared the malpractice by their credit rating agencies. In fact, the unreliability of their credit rating agencies created calls for greater regulation. In September 2009, the EU adopted a new regulation to “enhance the integrity, transparency, responsibility, good governance and reliability of credit ratings.” In light of the recent Greek debt crisis, the EU recently has proposed a more centralized system to supervise credit rating agencies at the EU level.

Following steps initiated by other developed economies, Singapore's central bank in March of this year proposed regulation of rating agencies to ensure independence in the rating process and protection of non-public information. Also, Hong Kong initiated a new regulation that takes effect in June that requires credit rating analysts to be licensed by the city's securities regulator.

In India a similar story unfolded with the Satyam scandal. Credit rating agencies such as CRISIL and ICRA appraised Satyam’s debts as investment grade to investors, who in 2009 found these evaluations worthless. Globally, investors and regulators continue to voice displeasure over credit rating agencies that assign investment grade evaluations of corporate liabilities that are not supported by the facts.

These problems exist because credit rating agencies employ a flawed business model built on an inherent conflict of interest. Since credit rating agencies collect their revenues from the very firms they evaluate, sooner or later a rating failure is likely to occur. Credit rating agencies are not going to “bite the hand that feeds them.” If they would be so naïve, they would lose business because the corporate entities would simply find a different rating agency to evaluate their debt instruments, and they would lose significant opportunities for other consulting engagements like pre-rating assessments and risk management services.

Further, this conflict of interest creates a host of other potential problems since employees of credit rating agencies know how they are compensated, especially analysts and managers. Even if the agencies are smart enough to avoid direct linkages between compensation and ratings, an association is unavoidable. All employees of credit rating agencies know that their continued employment, salaries, and promotions depend on their contributions to the real business of the organization: generating fees from debt issuers.

The result of this fundamental conflict is ratings inflation. Everybody gets a high rating and, when things deteriorate, the agencies are slow to downgrade the debt.

In the U.S., the Securities and Exchange Commission published two reports concerning credit rating agencies, one in January 2003 mandated by Sarbanes-Oxley, and a second on July 8, 2008. Both were disappointing because they did not address the fundamental issues. They labeled the business model a “potential conflict of interest,” thereby trivializing the very real conflicts and enrichment opportunities that exist by limiting negative ratings’ comments. Even when the 2008 report partially admitted the possibility of a conflict of interest, it asked only managers of credit rating agencies for suggestions to improve matters. We might as well let Madoff out of prison and ask him how to run a better Ponzi scheme. If we are going to rescue credit rating agencies from the pit of disutility, something more substantive must be done.

The most direct way of solving this institutional failure is to restore credit rating agencies to the world as it existed prior to 1970. Before 1970, credit rating agencies charged report users instead of those they investigate. This amendment to the credit rating business model would eliminate completely the conflicts of interest. Such an institutional reform would reinstate a natural market mechanism: if users really want information, they will pay for it. Further, if the market is competitive, the price of reports will reflect the value of the information.

A second-best solution rests in the court system. Countries could amend their laws and regulations to hold credit rating agencies responsible for their erroneous ratings. This currently occurs with audit firms, who face the same conflicts of interest. The only real forces to counter-balance these conflicts are fines and lawsuits, such as those imposed against PricewaterhouseCoopers over the Satyam scandal. While not optimal as they address remedies rather than prevention, it at least gives auditors something to think about before acquiescing to manager demands. However, any penalties must be large enough to influence significantly the cash balance of credit rating agencies, and ultimately, analyst and manager behavior. Similarly, the courts could be opened up to investors and creditors who were aggrieved by the foolishness of credit rating agencies that appeased their clients.

Even with such reforms, credit rating agencies may still fail to deliver transparent, useful ratings because of the continued decline of the financial reporting model, the weakness of the current audit reporting format, and the failure of independent auditors to provide high quality audits. All work against accurate ratings by the credit rating agencies since all three can affect an analyst’s report. What is clear, however, is that societies should not allow some hodgepodge of small, insignificant changes to be heralded as reform. Real improvement will come only when substantive amendments are made to our institutions that address the underlying causes. Anything else is mere whitewash.

Relevant EU and SEC documents:

* Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EC) No 1060/2009 on credit rating agencies < <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52010PC0289:EN:HTML> >
* “Report on the Roles and Function of Credit Rating Agencies in the Operation of the Securities Markets,” Securities Exchange Commission, as required by Section 702 (b) of the Sarbanes-Oxley Act of 2002 (January 2003) <<http://www.sec.gov/news/studies/credratingreport0103.pdf>>
* “Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies,” Staff of the Securities Exchange Commission (July 8, 2008) <[http://www.sec.gov/news/studies/2008/credit rating agenciesexamination070808.pdf](http://www.sec.gov/news/studies/2008/craexamination070808.pdf)>

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