

METRO in focus

Do the Big Three

AS Europe tries to rescue itself from the brink of economic failure, more and more power is in the hands of the credit ratings agencies, whose verdicts can make or break a country. But what are they, what do they do and do they have too much control? **HAYLEY LEAVER** finds out

FOLLOWING the recent downgrading of the French and US governments by Standard & Poor's, there has been an intense focus on the role and influence of credit ratings agencies.

But, while we may be familiar with AAA ratings and the 'Big

Three' – S&P's, Moody's and Fitch Ratings – is any of us sure what these agencies do?

'Credit ratings are opinions on the likelihood that a borrower will repay a given debt over a medium-term time horizon,' said Daniel Piels, head of EMEA media relations at Moody's. 'Debt can be issued by

corporates, banks, municipalities or sovereigns. Potential lenders need to have a view on whether borrowers have the capacity to pay back a debt on time. Our ratings help bridge the information gap between a borrower and a lender.

'They play a beneficial role in market efficiency, providing the market with a common language for credit. Issuers, investors and other interested parties can discuss and debate the credit risk of any debt issuer, irrespective of its industry or region of operation,' he said.

'It's important to note that they are just one among a range of tools to inform the market's discussion on credit risk, though,' Mr Piels added.

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MOODY'S

Founded:
1909

Number of employees:
4,300 professionals
in 27 worldwide offices

Headquarters:
New York

Revenue for 2010:
£396million

Recently downgraded:
Hungary and Slovenia

FitchRatings

Founded:
1913

Number of employees:
2,000 professionals
in 51 worldwide offices

Dual headquarters:
New York and London

Revenue for 2010:
£415million

Recently downgraded:
Italy, Spain, Belgium
and Cyprus

The number's up

AS PART of the suggested reforms to credit ratings agencies, Finance Watch is keen to abandon the idea of a letter-based ratings system. Greg Ford said: 'The European Commission wants to reduce the reliance of market participants on CRAs. Finance Watch's proposal for achieving this is to delete all references to ratings from regulations, making it difficult for investors to use ratings in their internal rules. The highly emotive letter-based ratings system would be replaced with a simple, boring number that reflects the probability

of default (which is the only thing that investors need to know anyway). The old AAA system should be thrown away completely,' Mr Ford added. 'When France was downgraded recently, people would not have cared so much if they knew what it really meant – that their government's probability of defaulting on its debt had increased a few basis points.' This suggested reform could be used to feed the European Rating Index managed by ESMA, which could compute and publish the average probability of default on its website.

STANDARD & POOR'S

Founded:
1860

Number of employees:
7,500 professionals
in 21 worldwide offices

Headquarters:
New York

Revenue for 2010:
£1.83billion (including
McGraw-Hill Financial)

Recently downgraded:
France, Austria and Belize

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deserve credit?

To publish a rating, expressed on a scale of letters with AAA being the highest, CRAs do research and analysis using microeconomic details on the issuer and their sector, as well as the macroeconomic context, different scenarios that may emerge and information they gain directly from the issuers.

'Moody's credit ratings, which are continuously monitored and forward-looking, will change to reflect the evolving nature of the credit environment,' said Mr Piels. 'So, as credit risk increases, our ratings will change accordingly. Ratings may also

change as a result of refinements we make to our methodologies, which are transparent, publicly available on our website and form the basis of our ratings,' he added.

With these opinions integral to the operation of today's debt markets, there is concern that the CRAs are becoming more like regulators. As issuers need ratings to keep their interest costs down to attract investors, so investors need the ratings to help them decide how to lend.

'Critics say that, in fair markets, information should be made available to everyone and warn that the close relationship between issuers and CRAs has made it difficult for them to interpret information objectively,' said Greg Ford, head of communications at Finance Watch.

'The issuer-pays model, in which borrowers pay for a rating on their own debt, creates an inherent conflict of interest,' he added.

'The CRA wants to please its paying client, whose interests are not the same as the investors who rely on the ratings,' said Mr Ford.

WITH the 'Big Three' accounting for about 95 per cent of the world market, there is a risk of monopoly, which can have dramatic effects in a financial crisis.

'Decisions about creditworthiness have been almost entirely delegated to a small group of agencies,' said Mr Ford. 'This concentrates risk so any mistake or bad practice can have far-reaching consequences for the financial system.'

He added: 'Given their place in regulation and the market's over-reliance on them, CRAs have little choice but to play a pro-cyclical role in a crisis – downgrading on market expectations leading to market fears, asset price falls, losses and further downgrades, etc.'

'Some ratings agencies go further and tell issuers what they should do to get a better rating,' Mr Ford said. 'When the issuer is a sovereign government that fears that a downgrade will add billions to its cost of borrowing, this gives CRAs a huge influence over policy without any democratic accountability.'

To prevent this, the credit rating

industry is highly regulated, at a pan-European level by ESMA, the European Securities and Markets Authority.

Mr Piels said: 'Potential conflicts of interest exist with every business model. In the ratings agency industry, potential conflicts are present regardless of who pays for the rating opinions, irrespective of whether it is issuers, investors or governments. Moody's employs a comprehensive range of tools to manage potential conflicts of interest.'

'We publish detailed information of the performance of our ratings so that investors can make an informed assessment,' Mr Piels added. 'As an example, of all the EU corporate issuers we rate, five defaulted in 2011 and all had very low ratings at the time of default or even one year before default.'

Despite backing rating reforms, Mr Ford concluded: 'There is definitely a role for independent credit specialists to play in assessing credit on behalf of investors, provided they can be relied on to be objective and provided that investors do not rely on them too much.'

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