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Rating agencies – an example of the market economy!

The following article takes a look at problems in the credit markets associated with rating agencies. It also shows how criticism of the rating agencies alone falls short of telling the full story.

It would be nearly impossible to precisely define the role that the three large rating agencies, S&P, Moody's and Fitch, played in the recent crisis. It is clear, however, that they did in fact play a major role, one in which they failed miserably. In theory, the rating agencies are supposed to act as a sort of matchmaker, bringing together borrowers and suitable lenders by making the creditworthiness of the borrowers transparent. And this is precisely where the rating agencies failed, resulting in a flood of undesirable risk allocation in the credit market. Only after the house of cards finally collapsed did many investors realize that they had invested in allegedly secure bonds that in reality were high-risk. Only after it was too late were these bonds, valued at well over a billion US dollars, quickly downgraded to a more realistic junk status. An inquiry commission1, set up by the US government after the onset of the crisis, confirmed that the large agencies were indeed largely responsible for the overall disaster as a result of their false ratings. The Bank for International Settlements (BIS), in its latest publication from July 2011 analyzing the securitization market, put it in nutshell:

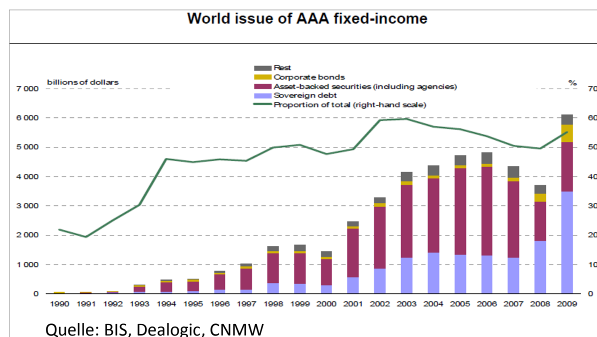
"This demand for assets with (perceived) low credit risk but with higher yields had clear consequences on the incentives for the financial industry to produce such assets." [2]

The rating agencies' behavior was thus "exemplary" – based solely on free-market criteria. They reacted to the increased demand for highly secure investments by quickly expanding the supply. Yet they did so simply by granting their paying clientele, i.e., borrowers, higher ratings than were justified. To make all of it less obvious, they did so primarily via complexly structured products. However, it was the non-paying – and therefore less relevant to the rating agencies – investors who bore the negative consequences of these ratings.

[1] Financial Crisis Inquiry Commission.

[2] Bank for International Settlement: "Report on asset securitisation incentives" 2011, page 5. www.bis.org/publ/joint26.pdf

In the graph from the BIS publication mentioned above[3], we see how the rating agencies took massive advantage of their leeway in evaluating creditworthiness – in favor of their paying clients:



The graph clearly shows how between 1990 and 2006 the proportion of AAA-rated fixed-interest securities exploded from 20% to an incredible 55%. In the rating agencies' view, we must have been living in one of the most solid economies in history. That is, until the outbreak of the financial crisis taught us better. Another cited study[4] by economists from the University of St. Gallen in Switzerland shows how the euro crisis was unnecessarily aggravated by the sometimes mysterious credit ratings awarded to the PIGS countries.

The serious mistakes of the rating agencies notwithstanding, numerous investors also share the blame. They fell for the illusion of a free lunch by assuming that, as creditors, they could outsource the evaluation of the creditworthiness of their borrowers free of charge to the rating agencies. This outsourcing allowed the creditors to avoid the costly build-up of their internal resources. Instead of systematically fortifying their own ability to verify creditworthiness, it was easier to simply take a quick look at the letter grade. Those who were somewhat more critical might have quickly compared the ratings of the large agencies against one another. But typically that's as far as it went. Mostly, it was the academic apparatus at the universities that questioned the criteria behind the ratings[5].

Last but not least, public entities such as the financial regulatory agencies or central banks added to the problem by incorporating the credit ratings of private sector agencies into their policies, thus driving mostly institutional investors right into the arms of the big rating agencies. In the end, the US appears to have learned from its past mistakes. The reforms introduced by the Dodd-Frank Act in 2010 will at the very least restore the importance of the rating agencies to a legitimate level.

At the ARVEST Group, all fixed-interest securities in which we invest, regardless of their ratings, are subject to an additional internal assessment. Our assessment process itself may not be particularly impressive or innovative – it doesn't have to be. What's important is that it guarantees us the ability to take a critical look at external ratings. Thanks to this, we have thus far been able to effectively protect our clients from credit defaults. Those who wish to continue to avoid undesirable risk in the future are asked to remember an old saying: trust is good but control is better!

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[3] BIS: "Report on asset securitisation incentives" 2011, page 6

[4] Gärtner, Griesbach, Jung: "PIGS or Lambs? The European Sovereign Debt Crisis and the Role of Rating Agencies." 2011, www.springerlink.com/content/p7102pv44172k117

[5] See, for example, the interview titled "Ideologie ist kein Massstab" ("Ideology is no benchmark") from July 25, 2011, in *taz*. . www.taz.de/!75076/