

Kerwer, Dieter

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RATING AGENCIES

SETTING A STANDARD FOR GLOBAL FINANCIAL MARKETS¹

By

Dieter Kerwer

Max Planck Project Group Bonn

kerwer@mpp-rdg.mpg.de

Introduction

Rating agencies are professional service firms that assess the creditworthiness of borrowers and communicate that information to investors. For most of the time since their modest beginning in the early decades of the 20th century, rating agencies limited their activities to the financial markets in the United States. The globalisation of financial markets in the 1990s brought about new opportunities. Rating agencies now rate borrowers world-wide through their global net of local subsidiaries. Public awareness of their existence has increased accordingly. During the 1990s, rating agencies were held partly responsible for the outbreak of the financial crises in Mexico, Asia, and Russia. Many argued that these crises could have been avoided, had rating agencies reported the credit risk involved in investments in emerging markets more accurately. More recently, rating agencies were criticised for their role in the demise of Enron, the US energy company. Rating agencies had given Enron a highly positive assessment even only a few months before the final bankruptcy. Also, their decision to delay the publication of a revised, much more negative credit risk assessment so as not to unduly harm the company in its struggle to avoid bankruptcy, was seen to have favoured Enron at the expense of other stake holders.

Rating agencies have not only come under scrutiny because of performance problems, real or perceived, but also because of their increasing power. After the globalisation of financial markets, rating agencies are seen to have replaced states as one of the most significant forces influencing the global flow of credit. Globalisation analyst and New York Times journalist Tom Friedman compares rating agencies to “blood hounds” that can scare away the “electronic herd”, the mass of global investors, for long periods of time, when they issue a warning. He illustrates the pressure that they can exert even on states with an episode from Canada. In 1995, Bill Clinton’s first visit as American president to Canada raised remarkably little interest as it was overshadowed by the visit of the CEO of Moody’s, the rating agency. Canada at the time experienced fiscal problems but wanted to avoid a negative judgment by the rating agency, which would have made it more expensive for Canada to persuade investors to invest in Canadian bonds. In this situation, the CEO of Moody’s was deemed more important than the President of the United States.

¹ This report is based on a larger research project on the role of private actors in transnational governance. For further references and information, please consult my paper available online (<http://www.mpp-rdg.mpg.de/deutsch/publik1.html>) or contact me.

But is this true? Have rating agencies really become a major new global player in financial markets, so influential that they can even coerce states? In the following, I want to clarify the role of rating agencies in the governance of financial markets. To do so, I shall present a brief sketch of how rating agencies work, and why they have expanded world-wide. I will then analyse in which way they are influential. Subsequently, I offer an explanation for the nature of their influence by conceptualising rating agencies as standard setters. I conclude by raising the question of what a study of rating agencies could contribute to the agenda of economic sociology.

Credit Rating Agencies

Credit rating agencies are financial service firms that assess the credit risk of financial transactions. The credit risk is determined by assigning a “credit rating” to a security or issuer. Comparable scales are used by all credit rating agencies to determine the credit risk. It usually ranges from AAA (credit risk very low) to C (credit risk very high), with D meaning “default”, i.e. a borrower cannot service his debts as promised.

RATING SCALES

	Moody's	Standard & Poor's
INVESTMENT GRADE	Aaa	AAA
	Aa1	AA+
	Aa2	AA
	Aa3	AA-
	A1	A+
	A2	A
	A3	A-
	Baa1	BBB+
	Baa2	BBB
	Baa3	BBB-
SPECULATIVE GRADE	Ba1	BB+
	Ba2	BB
	Ba3	BB-
	B1	B+
	B2	B
	B3	B-
(close to) DEFAULT	Caa	CCC+
	Ca	CC
	C	C
		D

Ratings work like school grades, but they are more ambiguous. Higher grades are always better than lower grades. But higher ratings are not inherently better than lower ratings. Rating agencies always stress that the evaluation of the credit risk does not imply an advice to buy or sell a certain security. An investor has to take care of other risks as well (e.g., exchange rate risk). Furthermore, lower rated securities have a higher yield: the more you risk the higher the future to profit is likely to be. Therefore, an investor may opt for a higher risk for part of his portfolio.

The assignment of a rating is a lengthy process. Usually, the rating agency is approached by an economic entity planning to borrow money by bonds. Then the rating agency proceeds with an in-depth analysis of this firm or government agency. This involves an analysis of official and confidential documentation and by personal interviews with the management. To arrive at a certain rating, the agencies look at a combination of factors. First, the financial condition of the firm is determined. At the level of the firm, the risk of a default is mainly seen in the risks involved in the business strategy and the financial risk, i.e. the risks involved in the strategies in which businesses are financed. Rating agencies also look at factors beyond the single firm, e.g., the condition of the economic sector in which the firm operates and the country in which a borrower is situated. The product of credit rating agencies consists of a published rating. In important cases, the media report about changes in ratings. That way, credit ratings are publicly available. One of their main advantages is their simplicity. They make it easy to compare the risk of borrowers that are very different from each other. Therefore, ratings have increasingly become a precondition for access to financial markets.

The rating industry itself has become influential well beyond the United States. The traditional U.S. rating agencies now boast a truly global network of offices that cover the major financial centres. In several countries, local rating agencies have been founded. This is not only true for highly industrialised countries but can also be observed in emerging economies (Adams et al. 1999: 189). Local rating agencies try to capitalise on their more detailed knowledge of the industry compared to that of their international competitors. Newly founded rating agencies in Germany, *Euro Ratings* or *Unternehmens-Rating Agentur* for example, try to exploit their knowledge of the *Mittelstand*, the dynamic sector of small and medium sized enterprises. Their claim of superior local knowledge makes them more attractive to these firms because the latter can expect to be evaluated in an appropriate manner. Presumably, these local rating agencies also appeal to investors who feel that the analysis is superior. Nevertheless, these local rating agencies have not challenged the position of the U.S. rating agencies. On the contrary, often these local rating agencies enter into joint ventures with one of the big American rating agencies or are taken over by them. For example, in the early 1990s, Standard & Poor's took over the local French rating agency "Agence d'Evaluation Financière".

Another indicator for the increasing importance is the number of sovereign ratings, i.e. ratings of foreign countries. These ratings are of pivotal importance for the rating of financial interments, etc., because they place a ceiling on the credit quality that can be achieved. Moody's reports an increase in the number of sovereign ratings from more or less 10 in the 1980s to nearly seventy in 1999 (Adams et al. 1999: 196). In the same year, Standard & Poor's lists 79 sovereign ratings.

The Impact

Rating agencies are gatekeepers for markets, especially bond markets but also the market for asset-backed securities. Credit ratings are essential signposts for investors operating in these anonymous markets. By condensing the highly complex contingencies of credit risk into a single measure, rating agencies contribute to transforming uncertainty into calculable risk. Without rating agencies, investors would have to analyse each investment opportunity individually. For large institutional investors, this would be difficult. Since they need to diversify their portfolio by investing in many different securities, it is hard to accumulate adequate knowledge on each. Thus, economists point out, rating agencies contribute to the efficiency of large and liquid bond markets by reducing transaction costs that arise between borrowers and lenders. Their constitutive role in setting up global financial markets became visible in the 1990s when large capital flows into emerging market economies were preceded by the publication of credit ratings for these markets.

However, it is questionable whether the role of rating agencies can be reduced to that of efficiency enhancing financial market intermediaries. A first, very fundamental observation is that their very existence increases the investors' risk appetite. Once a rating has been issued, their analytical basis is assumed to be correct. Rating agencies are thus absorbing uncertainty for investors, making unpleasant surprises about credit risk more likely (Strulik 2001). A second problem is that rating agencies are biased. Given that there are many factors influencing the creditworthiness of a borrower, rating agencies are relying on rules of thumb. These rules of thumb are influenced by a neo-liberal ideology (Sinclair 1994). In the past, rating agencies have been persuaded to reconsider further downgrades by austerity programmes with sometimes dubious usefulness. Mass layoffs by firms or a reduction of state expenditure by countries, e.g., by cutting essential public services, is a common sacrifice that rating agencies demand for avoiding downgrades. The third and probably the major problem is that rating agencies increase market volatility during times of crises. Rapid downgrades of firms and countries during the Asian crises have exacerbated the outflow of capital from these countries and thus contributed to their ruinous effect (Adams et al. 1999).

The potential adverse effects of credit ratings are magnified by the fact that it is hard to hold rating agencies accountable. Downgrades can do much harm, yet rating agencies will almost always turn a deaf ear to any complaints. Negotiating with borrowers would risk tarnishing the rating agency's image of being a neutral information provider. As a consequence, despite the fact that rating agencies have become increasingly influential in global financial markets, it is very hard to hold them accountable for their action. Rating agencies seldom have to justify their decisions, let alone provide compensation for the adverse consequences of mistakes. The breach between the magnitude of potential damages for borrowers and the possibilities of a remedy gives rise to an 'accountability gap'. Why is it that rating agencies have power without responsibility?

Explaining the Impact

Rating agencies are influential because they exert their influence in a specific way but also because there is only a very small number of them, with very limited competition. An explanation of the influence of rating agencies will have to take into consideration both, the market for ratings and the market for securities which are framed by ratings.

Rating agencies operate in a distinct market, the market for credit ratings. As private firms, rating agencies need to generate revenue from their credit risk assessment. Since the information is only useful if it is public, it is hard to persuade the users of the information, the investors, to pay for a rating. Rating agencies therefore charge the issuers of bonds, not the investors for their services. Two American firms dominate the US and the global market, “Moody’s” and “Standard & Poor’s”. A third firm, “Fitch” is hardly an important competitor. Also, the firms do not really compete for customers. Most borrowers need to have two independent ratings, so that in the case of a new issue of bonds, both rating agencies are likely to do business.

The dominant position of only two agencies in the market for credit ratings is an important factor for the explanation of their influence. How did it come about? The first fact can be explained by “positive network externalities”. Just as the usefulness of a telephone increases for an individual with the number of participants in the network, so does the usefulness of credit ratings increase for an investor, if the agency issues many other ratings. Only then is it possible to reliably compare different credit risks, which is essential for the orientation of investors. This network effect implies high sunk costs which amount to a formidable entry barrier for new agencies.

In spite of these difficulties, there are a few smaller rating agencies that have a special area of expertise (e.g., “Fitch” specialises in banking), and that try to expand to become a full fledged rating agency. A further explanation is needed in order to understand why firms that manage to overcome the problem of sunk costs do not succeed in competing successfully with the incumbents. Such an explanation can be provided by the status-based model of market competition (Podolny 1993). The model is based on the hypothesis that markets often develop a status hierarchy in order to limit competition. The more status brackets a market develops, the more firms can thrive in it without unleashing too much competition. Investment banks, for example, only do deals with firms that are perceived to be equal to their own reputation. Top investment banks will not jeopardise their reputation by doing deals with high risk clients. In the market for credit ratings no such status hierarchy develops and therefore the number of firms is very limited. The reason is that contrary to investment banks, rating agencies do not automatically send a reputation signal by agreeing to rate a firm. If a firm poses a high credit risk, the rating agency’s reputation is not tarnished, as long as it issues a low rating. Market dynamics is only one factor that explains the dominance of the incumbent rating firms. Another important part of the explanation is that rating agencies are used for the purposes of regulation. The rating standard has been used in regulation designed to mitigate excessive risk taking in financial markets. Its purpose has been to create flexible rules that automatically adjust to different levels of risk; rules referring to ratings impose lower regulatory requirements if the rating signals a low level of credit risk and vice versa. In the United States, three types of regulatory requirements have been designed that vary according to the magnitude of risk they address (Adams et al. 1999: 153). The rating standard of creditworthiness was first used to define investment restrictions for financial institutions. In 1936 already, U.S. regulators prohibited banks to invest in low quality debt instruments. A second major use of the rating standard has been to adjust capital reserve requirements to the credit risk involved. Since 1975, the Security Exchange Commission (SEC) is using ratings to adjust capital requirements for investment banks and similar institutions to their risk exposure. Finally, regulators have defined disclosure requirements with reference to the rating standard. Since 1982, issuers of highly rated bonds can use simplified forms to register them with the

SEC. The problem with this type of regulation is that the observation of ratings has become compulsory for most investors. On the other hand, U.S. regulatory authorities only recognise those rating agencies for regulatory purposes that are well established in the market place. This makes it virtually impossible for newcomers to compete with the established firms because even if investors were interested in their type of analysis, for legal purposes they would need to observe the ratings of the incumbents. Thus, in addition to the barrier offered by the structure of the market there is a formidable regulatory barrier to market entry.

If the explanation for the quasi monopoly of a few dominant agencies in the market is convincing, then there is reason to believe that the established rating agencies will retain their dominant position for some time to come. This dominant position as such is seen to be problematic because it gives a few agencies such a large influence over the larger financial markets. In order to explain the way in which rating agencies exert influence, I propose to understand rating agencies as standard setters. This comparison of the process of credit rating with standardising is a useful lead. On the one hand it preserves the insight that rating agencies are not merely neutral information intermediaries but that they also establish a common understanding of what constitutes credit-worthiness; on the other hand, 'standardising' avoids the connotation that there is an inevitable monopoly, since standards (as opposed to regulations) are not mandatory and often have to compete with other standards.

In order to gain insight into how standards co-ordinate behaviour, a useful starting point is a definition of a standard as any rule based on expertise that can be adopted voluntarily. In this sense standards are "advice given to many" (Brunsson 1999: 114). Examples of such standards are technical standards, the rules of international sports associations, or the OECD's recommendations of how to best run an economy, and many others. It is clear that such a definition aims at a vast area of rule-making in modern society. Standardising in this sense is a mode of governance in its own right. Standardising is similar to hierarchical rule-making in that it can only effectively co-ordinate action if the outcomes are seen to be desirable; it differs in the way this underlying legitimacy for rules is secured. In a world of autonomous actors, the legitimacy of hierarchical rules depends on the authority of the rule setter; and the validity of such rules is restricted to a limited range of actors, e.g., the members of an organisation. But standards depend on the legitimacy of the underlying expertise. Because adopting them is voluntary, they do not have to be limited in application to be acceptable.

Standards, in the sense of expertise-based voluntary rules, not only differ from hierarchical rules, but also from the more conventional understanding of 'standards'. They are not technical standards specifying the desired properties of a technical artifact, nor are they just specifications of the minimum or maximum level of protection or risk defined in regulation, such as environmental emission standards. Rather, the underlying paradigm is that they are rules aimed at promoting certain organisational procedures or structures.

Most importantly, the view of rating agencies as standardisers, i.e. as co-ordinating by setting expertise-based, voluntary rules points to a systematic reason for the accountability gap. Standards face an accountability problem whenever they are hierarchically enforced by a third party. This blurs the clear accountability criteria that usually apply in the pure cases. As a rule, in a hierarchy the top of the pyramid, where the rules are set, is held accountable. In the case of standards, by contrast, the user of a standard is responsible, since per definition the adoption of a standard is voluntary. Whenever standards are made mandatory the legitimacy pattern should shift to the hierarchical model. However, often this is not the case, because

third party enforcement is also justified by the legitimacy of expertise. In this case, the standard setter acquires power by third-party enforcement, which is not checked by corresponding accountability. This suggests that the accountability gap concerning rating agencies is largely due to the fact that they are being instrumentalised for regulatory purposes.

Conclusion

The activity of rating agencies and other types of standard setters is an attractive research topic for economic sociology. The genesis and the effect of standards offer a rich field of study on the social construction of markets. I see two major advantages of an analytical focus on standardising. First, contrary to diffusion studies a focus on standardisation allows an action-oriented analysis of where new best-practice models come from. Second, by dissociating rule-making from the coercive power of states, it points to a new role of the state in structuring markets: as an enforcer of rules made elsewhere.

It is probably fair to say that standard setting has not been a high priority item on the research agenda of economic sociologists. The Handbook of Economic Sociology—probably still the authoritative overview of the field—does not feature a single article on standard setting. Recent interest in some of the more conspicuous cases, for example the international quality standard ISO, indicates that this neglect of standardisation is coming to an end. The study of rating agencies supports this trend by showing that a vision of rule making that includes standards is useful for an analysis of economic life.

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