48%

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Corporate Governance

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Individual assignment:

Critical assessment of rating agencies.

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Introduction

History behind credit agencies

According to (Wikipedia; 2020)[1], the need for credit rating agencies started back in 1837. United States economy where busy expanding. So did the distance between customer and business. Business found it more and more difficult to get reimbursed as customers were too far away in order to personally collect. Struggling with cash flow businesses started to stop letting customers buy on credit. This forced the economy in a recession and unemployment came to an all-time high. To resolve this issue mercantile agencies where created. The main objective was to see if mercantile were able to pay their debts. To sustain economic growth.

Three main credit rating agencies

The three main credit rating agencies are normally referred to as the "Big Three". They are Moody`s, S&P and Fitch. Between them, they control 95% of the global market. The role/impact of the "Big Three" is of such a nature that a downgrade in credit ratings from either one of them can send global markets into panic. The opposite is also true without a positive credit rating from one of the "Big Three" investors who are uncertain and will thus not invest in economies. This will lead to factories not being built, cities not expanding and schools or infrastructure build due to not getting the capital they need (Corporate Governance; 17)[2].

The role of credit rating agencies

According to (Truthout; 2008)[3], the role of credit rating agencies is to -

- Provide service to both borrowers and lenders. They give market information on risk associated with certain kinds of debts.
- Provide information that reduces the information gaps concerning investment products and sovereign nations.
- Provide critical information to the financial systems, this helps investors to decide on the quality of financial products or the credit status of a sovereign nation. Credit status refers to the ability to repay debts.
- Provide credit ratings for sovereign countries. This gives investors' insight into the level of risk associated with investing in a countries economy. These risks are not limited to debt repayment but will include overall economic conditions, the volume of foreign, public and private investment. Ratings also assess political conditions.

With the roles of credit agencies clearly stated we can now see that the accuracy and transparency of these ratings are important for international investors. As the ratings information covers a lot of aspects in companies and economies. International investors thus looking to invest in external markets, countries' economies and certain financial instruments. Will first refer to the ratings of the "Big Three". Some institutional investors demand sovereign ratings as a pre-requirement before making investment decisions in external markets.

The regulatory framework within which rating agencies function in South Africa

The objective of the framework for rating agencies is to give supporting guidelines as to what is the proper way to act within the law (SA Government Gazette, 2013)[4]. This includes guides on registration, regulation, code of conduct and rules for credit rating agencies.

Objectives of Act – *2.c improve investor protection 2.d improve the fairness, efficiency, and transparency of financial markets and 2.e reduce systemic risk* (SA Government Gazette, 2013)[4].

Duties of a registered credit rating agency according to SA regulations (SA Government Gazette, 2013)[4] is -

7.d to ensure that its business interest does not impair the independence and integrity of its credit ratings or the accuracy of its credit rating services.

7.f.i to prevent, identify, eliminate manage or disclose any conflicts of interest of the registered credit rating agency its analysts and employees

7.f.ii to protect confidential information made available to its issuer, including prohibiting its analysts and employees from using such information to enter into transactions

7.h to regularly monitor and evaluate the adequacy and effectiveness of its systems, internal controls mechanisms and arrangements and take appropriate measures to address any deficiencies.

7.i ensures that at all times it has the necessary knowledge and experience to issue credit ratings and perform its credit rating services.

Code of Conduct

A code of conduct is a set of organizational rules or standards regarding organizational values, beliefs, and ethics. A register credit agency must adopt, publish and adhere to a code of conduct that adopts the principles contained in a relevant international code of conduct (SA Government Gazette, 2013)[4]. The International code of conduct fundamentals for credit rating agencies is intended to offer a set of robust guidelines, have practical measures concerning protecting the integrity of the rating process, ensuring that investors and issuers are treated fairly, and safeguarding confidential material information provided to them by issuers (IOSCO CRA Code, 2015)[5].

Enforcement mechanism

The enforcement mechanism can be positive or negative. Positive enforcement mechanism comes in the forms of incentives, appraisal, and recognition. A negative enforcement mechanism comes in the form of penalties and punishment. This is most probably the biggest shortfall of regulators. There is no certainty that rating agencies adhere to standards. The IOSCO (2015)[5] notes, "neither IOSCO nor any other international body currently is in a position to determine whether or not a given credit rating agency complies with its code of conduct in the manner in which its public statements indicate". This is the concern of the international regulator. This for me shows that there is a gap in the way CRA`s are getting managed, as the old saying goes you lead from the front and not the back. If the top is not adhering to the standards the bottom will never follow.

Examples of credit rating failures

Eron

Eron was one of the best companies in America. The firm started with the market to market accounting (Investopedia, 2019)[6]. This means that you can realize profits before there was any profit. Eron also moved there losses to other companies they owned SPV. This made the company more valuable and the share price kept on climbing.

Why did this continue for more than 2 years? The reason why the authorities took so long to find the scandal is because one of the big 5 accounting firms where being paid to look the other way. Arthur Anderson was part of the big 5. They were the same as these large audit companies PWC, KPMG, Ernst & Young, and Deloitte. Arthur Anderson frim was questioned for their transparency as they failed to report. Arthur Anderson even assisted with destroying financial records. This lead to the company's closure as they were unable to survive the scandal.

One of the reasons that led to the Eron scandal is due to rating agencies being on an issuer-pay revenue model. This means that rating agencies as a profit organization gets paid by the companies they are rating.

One of the roles of CPA, as mentioned above, is to provide critical information to the financial systems. Eron credit rating was an investment grade four days before the scandal

(The Telegram, 2002)[7]. This is the highest rating a company can receive at that time. This forces a person to believe that something is wrong with how we conduct ratings. According to the New York Times 2001[8], the credit rating would have not made any difference to the collapse of Eron. I do agree, the rating four days before the scandal yes. But the ratings for the past year or two years would have completely change the perception of people and investors. It would have saved thousands of people their pension funds as executives were making millions. That`s why I agree with Mutize[10], credit rating agencies must start seeing the impact that they have on business and the term business as usual needs to end.

Unfortunately, we all need to fall before we can walk. As a society, we learn best from our mistakes. After the scandal, the new Sarbanes-Oxley Act was created. This leads to better disclosures and increased penalties for financial manipulation (Investopedia, 2019)[6].

After the court cases, the harshest sentence was for CEO J. Skilling who received 10 years in prison. In my option, this was not enough hard work people lost their whole life's earnings in pension funds that took years to build and will never be returned. That`s why more institutions need to take responsibility for their actions and need to be held accountable. As they are the specialist in the field.

Financial crises 2007-2008

The financial crisis started in 2001. The U.S. economy experienced a short-lived recession. To keep the recession at bay the reserve bank did what it normally does. It dropped the interest rates from 6.5% to ultimately 1% in order to get the economy growing again. Unfortunately, this creates a problem as this was the lowest the interest rate was in 45 years. With interest rates, so low banks became more willing to give loans (Investopedia, 2019)[9].

Banks saw an opportunity to make more money. They creating subprime-mortgage deal. Credit rating agencies – Moody`s and S&P gave the subprime-mortgage idea a triple-A states. This was for people that were more risky meaning the banks would not have borrowed them money for a mortgage if the reserve bank's interest rate was normal. To make matters worse the regulators SCC that borrows money to investor banks also loosens there control and increased the leverage of the top 5 banks to 30-40 times their normal leverage(Investopedia, 2019)[9].

For the first couple of years, this worked as the U.S. economy started growing again. But with the interest rates now growing. People started to fail to pay their home loans. Investors didn`t first see this as a problem as they now own the house. They can now resell the house and get their money back. But with more and more interest increase as the economy started normalizing more people defaulted. Investors now had an oversupply of houses that nobody was buying. With an oversupply, the price of houses started to drop. Responsible people that were paying their mortgage also stopped paying (Investopedia, 2019)[9]. Because when people signed their mortgage there house was, for example, $ 100 000.00 now with an oversupply of houses the price of the house is now $ 10 000.00. People thus refused to pay for a house that is not worth its original value.

With people now not repaying their debt, banks were forced to report bankruptcy. Creating a snowball effect on the financial system. As people borrowed from banks – banks from investors – investors from investor banks – investor banks from SCC.

As mentioned above one of the credit rating agencies ' responsibilities is to provide service to both borrowers and lenders. They give market information on risk associated with certain kinds of debts. Subprime mortgage where a high-risk tool from the beginning as it makes logical sense that you don`t borrow money to people that can`t repay other debts. But yet credit rating agencies gave it a triple-A status.

Why are CRA still failing investors

The first reason for credit rating agencies to fail is due to the issuer-pay business model (The conversation, 2019). This refers to a model where the company that is getting rated needs to pay the rating agencies for their rating. Rating agencies are a profit organization and this can lead to problems when findings have been picked up.

The second problem is the relationship between the rating agency and the company that will on a later stage start effecting the rating – good or bad. As the rating agencies interact with the company when finding are made. They see as to why or what is the reason for a situation to occur. Form the example above we can see that the aftereffect is much bigger than the initial problem.

The third concern still arises from the statement from the international regulator that "neither IOSCO nor any other international body currently is in a position to determine whether or not a given credit rating agency complies with its code of conduct in the manner in which its public statements indicate". If this is the standard set form the top credit rating agencies will never refine from their practices. As they keep on failing to report and point out financial warning even when the signs are there.

The last factor is that the market share is dominated by only three main rating agencies. This makes it for the start-up company extremely difficult to survive. The negative of having only three rating agencies is that the standards will not improve rapidly as compared to a competitive market.

Conclusion

The impacts of rating agencies are valued and needed. The concern is that the way business is conducted needs to change.

A suggestion is to change the current issuer-pay business model to an NPO as which must regulators are based on. An international non-profit credit rating agency (INCRA) is an example of what needs to happen. This will also improve on the user/rating agency relationship as the rating agency has no obligation to interact with companies. This will allow for direct and transparent reports from agencies.

Governments need to support and assist up and coming rating agencies in order to divide market share to a fairly even based oppositions. So that the standards of national and international rating agencies can improve through healthy competition.

Credit rating agencies must start adapting as they are becoming more and more responsible for the rating they sign off on. As an example according to the conversation[10], "Earlier this year the European Securities and Markets Authority fined the Fitch group of companies in France, Spain and United Kingdom a total of €5 132 000 for failing to maintain independence and avoiding conflict of interest".

Finally, credit rating agencies need to be held liable like any other CEO of a business for happening within or outside his control. Credit rating agencies need to be held accountable for the information and the authority they have, "with great power comes great responsibility" (Stan Lee). As the Sarbanes-Oxley act was created in order to criminal charge employees of a company a similar act must be created for rating agencies. Thus by criminalizing misconduct direct or indirect of the agency's control people will become more hesitant to create or support fraudulent activities.

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