## CRA's – why do they have the power to decide the fate of nations?

“Perhaps I am being over-squeamish, but it doesn't feel democratic or sustainable that the fiscal fate of nations and currency zones - and indeed the perceived strength of the financial system - rests on the analytical verdict of three private-sector research firms, the financial record of which has in recent years not been unblemished.”

This is the BBC's Robert Peston in his typically under-stated English way raising an important question about the decision of Standard & Poors (the Credit Rating Agency) to downgrade Greece's credit-rating to 'junk' level, which precipitated a fall in the Euro and share prices. It's a bit like saying that Richard Nixon's democratic credentials were not unblemished.

So how come the holy rating trinity of S&P, Moody's and Fitch, have such power that their estimation can determine the course of events in the markets and the fate of nations? Peston says that these private companies “have been endowed with enormous authority by governments, central banks and regulators”. He describes them as “the gods of the credit markets, and made so by fiat of the Bank of England, the European Central Bank, the US Securities and Exchange Commission and so on”.

“The rating agencies' assessment of the quality of bonds or tradeable debt issued by public sector and private sector is, officially, the last word on the subject - and has been since the early 1970s, when the SEC in the US started using their ratings to assess the strength of securities firms' balance sheets.

So, for example, the Bank of England typically provides credit to commercial banks if those banks provide bonds as collateral to it that are classified as AAA by rating agencies. The ECB operates a lower quality threshold for the provision of funds or liquidity to banks, but still uses the rating agencies as arbiters of the relevant security or collateral quality.

Which in turn conditions the investment decisions of banks, insurance companies and pension funds: if a bond loses its AAA status, the potential size of the market for that bond shrinks, at a stroke.”

These are the same rating agencies that gave companies laden with “toxic debt” AAA ratings.

According to Paul Krugman, the US economic commentator:

“The rating agencies began as market researchers, selling assessments of corporate debt to people considering whether to buy that debt. Eventually, however, they morphed into something quite different: companies that were hired by the people selling debt to give that debt a seal of approval.

Those seals of approval came to play a central role in our whole financial system, especially for institutional investors like pension funds, which would buy your bonds if and only if they received that coveted AAA rating.

It was a system that looked dignified and respectable on the surface. Yet it produced huge conflicts of interest. Issuers of debt - which increasingly meant Wall Street firms selling securities they created by slicing and dicing claims on things like subprime mortgages - could choose among several rating agencies. So they could direct their business to whichever agency was most likely to give a favourable verdict, and threaten to pull business from an agency that tried too hard to do its job. It's all too obvious, in retrospect, how this could have corrupted the process."

A US Senate sub-committee is focussing an investigation into the role of CRA's on Moody's and Standard & Poors. Most of the attention relating to this investigation were centred on Goldman & Sachs "shorting" the housing market. They set up a financial instrument which was designed to fail so as to make Hank Paulson (US Treasury Secretary under George W. Bush) a fortune. Krugman says this is ugly but not illegal. What is more of a revelation is this:

"...the e-mail messages you should be focusing on are the ones from employees at the credit rating agencies, which bestowed AAA ratings on hundreds of billions of dollars' worth of dubious assets, nearly all of which have since turned out to be toxic waste. And no, that's not hyperbole: of AAA-rated subprime-mortgage-backed securities issued in 2006, 93 percent — 93 percent! — have now been downgraded to junk status."

That's a phenomenal percentage. Whatever happened to market efficiency?

"In one e-mail message, an S.& P. employee explains that a meeting is necessary to "discuss adjusting criteria" for assessing housing-backed securities "because of the ongoing threat of losing deals." Another message complains of having to use resources "to massage the sub-prime and alt-A numbers to preserve market share." Clearly, the rating agencies skewed their assessments to please their clients."

Krugman says that "These skewed assessments, in turn, helped the financial system take on far more risk than it could safely handle."

The case of Enron showed the culpability of CRA's in allowing a mountain of off-balance sheet vehicle debt which led to the collapse of Enron. Enron's rating remained at investment grade four days before the company went bankrupt, despite the fact that CRA's had been aware of the company's problems for months.

CRA's are still being paid millions of dollars a year to report on the performance of collateralised debt obligations (CDO's) that have lost most of their value despite having been issued in many cases with AAA stamps of approval.

The fees, known as "ratings surveillance" payments, are paid to the agencies ahead of any payments to investors under the terms of the CDO contracts - and *without regard to how accurate the original ratings were*. Whatever happened to payment by results?

The top two US rating agencies - Moody's and Standard & Poor's - were "unduly influenced" by investment bankers who paid their fees and wilfully ignored signs of fraud in the lending industry in the lead-up to the financial crisis, according to a congressional investigation.

Emails and other documents released recently by the Senate subcommittee on investigations, ahead of a full report, showed that positive ratings for complex mortgage-backed securities and CDO's were sometimes used as a negotiating tactic between the firms and bankers.

“The credit rating agencies allowed Wall Street to impact their analysis, their independence and their reputation for reliability,” said Carl Levin, Democratic senator who heads the Senate panel.

In 2007, a Moody’s analyst told a Merrill Lynch investment banker that a rating could not be finalised until the “fee issue” was resolved. The banker responded: “We are OK with the revised fee schedule ... We are agreeing to this under the assumption that ... you will work with us further ... to try to get some middle ground with respect to the ratings.”

**An independent European rating agency?**

In response to Greek situation, and the action of S&P, Guido Westerwelle, German Foreign Minister, called for an “independent” European rating agency, which could avoid the conflicts of interest that US-based agencies faced.

Officials in Brussels are impatient to see what affect new rules for CRA's, which were drawn up in the wake of the 2008 financial turmoil, will have when they come into effect in December. The regulations were approved last year after a tussle between regulators and the agencies. The agencies had been blamed for underestimating the risks of mortgage-related bonds. The EU rules will require rating agencies seeking to operate in Europe to register and be supervised for the first time. They also oblige the agencies to disclose information about the models and methods on which their ratings are based, and to meet revised corporate governance standards.

However, this is tinkering with the problem. Why should they fate of nations be left in the hands of profit-making organisations that operate on the basis of a free-market philosophy, organisations that are responsible for the impoverishment of millions of people around the globe?

Even in the US questions are being raised about the need to dispense with some of the more exotic financial instruments. Frank Partnoy (a former derivatives salesman at Morgan Stanley), for instance, writes:

“Financial innovation, particularly the abuse of derivatives, was at the core of each of these disasters, just as it is today. Unlike other forms of business innovation, which are directed at creating new products and services, the focus of financial innovation has been to avoid regulation, to enable institutions to take risks they should not take or do not understand, to take advantage of false and fraudulent credit ratings, and to manipulate results for tax or accounting purposes. Those are not productive forms of innovation.

Synthetic collateralized debt obligations, the product regulators are now scrutinizing, are a typical example. They are dangerous and of little or no social value. But they aren’t new. Fred Carr, a major customer of Drexel Burnham Lambert, Michael Milken’s former firm, created early versions of C.D.O.’s during the 1980s, and the synthetic form of the C.D.O.

— in which there are no actual assets, only derivatives referring to assets — was big business more than a decade ago."

**Democracy for the CRA's – but not for us**

Meanwhile in Britain, after the formation of the coalition government, we face a situation where the new government accepts that in order to stabilise their finances, it believes it has to do what 'the markets' and the CRA's are demanding. We live in a democracy, or so we are told. Yet the fate of millions of people – their jobs, their services, their living standards – is to be determined in order to appease private companies which weren't elected by us. The Guardian reported that "leading credit rating agencies yesterday called upon Britain to speed up efforts to cut the record budget deficit or risk losing the country's top credit rating." You couldn't have a clearer threat than that. Cut sufficiently or we will downgrade your country rating.

Did the government tell them to mind their own business. Apparently not. The Treasury said it agreed with Fitch's conclusion. A"spokesperson" said:

"Fitch's report makes the case clearly for an acceleration of deficit reduction, particularly in the light of events in the Euro area sovereign debt market in recent months. The government agrees and that is why it is committed to significantly accelerating the reduction of the structural deficit."

Or to put it another way: please don't downgrade us Sir, we are doing what you want!

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