Impact of the Credit Rating Agencies on the Financial Crisis 2007–2009

Abstract

The paper presents some ethical aspects of the credit rating agencies (CRAs) market in the light of the latest economic crisis of 2008. A historical background is also shown and how the CRA market emerged. It is emphasised how the functioning of CRAs contributed to the outbreak of the crisis and what were the consequences of over- or underestimated rating grades. The downgrading of a country has a significant influence on the deterioration of the economic condition. Simultaneously, it afflicts the citizens, who have to pay for it e.g. with higher tax rates. It is believed that overestimated ratings lead to a speculative bubble, which ends up with the crisis. The paper indicates the problems connected with the way that CRAs operate and how they relate to business ethics. The fact that those institutions are profit-profile entities, which earn their income from clients, whose financial instruments are assessed, may bring about a conflict of interests. Moreover, it is outlined how the governmental policies of countries left CRAs without any particular control, which in the end was a significant factor, too. Finally, some potential solutions are discussed, and how the approach of CRA managers should change in order to prevent the market from similar situations in the future.

Keywords: financial crisis 2008, credit rating agencies market, ratings, speculative bubble, business ethics

JEL Classification: G24, N20
1. Introduction

The economies of developed countries have been strongly afflicted by the financial crisis of 2007, whose consequences they still bear. Research conducted on the basis of economic recession shows that it has been determined by various factors. Nevertheless, it all started with a crash on the real estate market. Granting credit to insolvent entities resulted in the bankruptcy of Lehman Brothers. However, subprime loans were not the only cause of the outbreak and the development of the crisis.

Over time, people began to take a closer look at the activities of rating agencies, especially at the way by which the ratings were assigned. For a long time nobody paid much attention to it. The freedom of this market aimed to ensure its self-regulation and transparency. As a result of detailed studies it turned out that there had been a significant distortion concerning the functioning of the agencies market. Substantially, a discussion on the ethics of credit rating agencies and potential changes in the scope of their activities began.

From the point of view of business ethics, the existence of credit rating agencies seems an extremely relevant issue of modern economics. The size of their profits and the significant impact of these institutions on the development of the global economic situation imply the need for careful analysis of the manner of their governance and the transparency of the grading system. Credit rating agencies are expected to provide objective, impartial assessments of the financial capacity of entities such as states, enterprises, financial institutions and multinational corporations. Moreover, financial instruments issued by these entities are evaluated, too. The price of credit as well as its availability are determined by a rating mark. A high rating is beneficial for both parties – the lender and the credit recipient. The former is able to estimate the level of risk of the investment, whereas the latter, who emits the financial instrument becomes trustworthy among potential buyers. Therefore, he is entitled to require a higher price. This seems clearly visible especially at the time of the recession when tested and safe investments in instruments with grade AAA gain more importance. The demand for ratings has increased in recent years, especially among entities such as insurance companies, and pension and trusts funds. This is due to the requirements of national legislation. In the financial agreements, where both parties agree that the downgrading either affects the suspension of further tranches of funds or accelerates the repayment of the remaining part of the loan, this type of solution is called a rating trigger.

This article attempts to assess the activities of credit rating agencies in the light of the crisis of 2008 from an ethical point of view. The thesis is that some of those measures were unethical and significantly contributed to the financial breakdown.

The first part presents the historical background of the CRA market and what the factors are which determine the demand for CRA ratings. The second part shows how the agencies reacted to the crisis and how it affected the global situation.
2. Credit rating – its origins and evolution

The motivation for the development of the credit rating agencies (CRA) industry was to intensify commercial transactions and financial services in the United States in the nineteenth century. During this period, commercial information agencies claimed whether a buyer was believed to be able to pay off his financial obligations or not. The qualifications of the market players were insufficient to objectively and accurately analyse all financial operations. There was a need to provide accurate information which was meant to determine the way the investment policy would have been led. Subsequently, it helped to establish contacts with companies of a high degree of reliability. Increasing entrepreneurship followed by an increasing number of investments influenced positively the demand for so-called loan capital in the form of debt instruments in the nineteenth and twentieth centuries. Therefore, a potential lender was very interested in the success of companies which invested his capital.

In 1909 John Moody elaborated the first method of granting credit ratings and evaluation of the probability of financial bankruptcy – similar to the contemporary one. It was a universal letter code and it gained popularity, which made it a role model and a useful benchmark. By the competence of the hired experts market participants increased their trust in the market. It was believed that in this way the high quality of assessments was firmly guaranteed. This measure put certain pieces of information in order, additionally proving how important the trust between engaged business parties is. However, there was also a threat of abuse in the context of asymmetric information.

The growing interest in the services offered by rating agencies fell in two particular periods in the twentieth century. The first was the Great Depression in the early 30s in connection with the cyclical occurrence of economic recession. The second was in the 70s, when the global stock markets reacted very negatively to the so-called ‘Oil shocks’. The incessant demand for CRA services was related to the constantly occurring crisis phenomenon, regardless of more effective, more precise methods of prevention and counteraction against them. Besides, the asymmetry of information is still a phenomenon which is undesirable by entrepreneurs, so they want to avoid it at all costs. Its negative consequences can lead to the purchase of a defective financial instrument that had not previously been properly assessed or rated. This problem was first presented by the American economists George Akerlof, Michael Spence and Joseph Stiglitz.

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3 Ibidem.
Fabian Dittrich indicates that the demand for CRA services is currently driven by five factors acting simultaneously i.e.:

1. increasing complicatedness and complexity of the investment policy, along with an increasing number of market participants who remain mostly anonymous;
2. weakening tendency to obtain funds through financial intermediaries, which correlates with the transfer of risk from banks to capital markets. As a further consequence, it allows the credit risk to be divided into tranches. Its first feature is based on the payments, in the transaction or scheme, being dependent upon the exposure or pool of exposures. The second one is that the hierarchy of tranches determines the distribution of losses during the transaction or scheme;\(^6\)
3. increasing public debt of the State which incurs higher and higher financial liabilities on the capital markets;
4. standardization according to the United States, due to its global dominance on the capital markets;
5. the creation of regulations controlling the activities of credit rating agencies.\(^7\)

These factors also led to the outbreak of the recent financial crisis. The creation of innovative financial instruments and regulations of CRA activities are reflected in the analysis issued by them. The significance gained by CRA means that they can induce the issuers of securities, such as states or international corporations, to take certain measures to improve their rating grades. Ultimately, the CRAs were to act as the so-called gate keepers, in other words objective security guards. However, numerous financial crises such as the Asian crisis caused by ‘creative accounting’ and ineffective corporate control, began to raise objections as to their role. Moreover, the fact that they had become profit-profile organizations questioned the objectivity of the presented reports and analyses.\(^8\)

3. The history of credit rating agencies in the late nineteenth and early twentieth centuries

3.1 Standard & Poor’s

Standard & Poor’s rating agency was founded in 1860 and their publications of financial reports covering the US rail industry became very popular among investors. Due to the economic potential of rail transport, the assessments were updated on a regular

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\(^6\) Rozporządzenie Parlamentu Europejskiego i rady (UE) nr 575/2013 z dnia 26 czerwca 2013 r. w sprawie wymogów ostrożnościowych dla instytucji kredytowych i firm inwestycyjnych, zmieniające rozporządzenie (UE) nr 648/2012, CELEX: 32013R0575.


\(^8\) C.A. Frost, Credit rating agencies in capital markets: a review of research evidence on selected criticisms of the agencies, State University of New York at Buffalo, June 2006, p. 22.
Reports were being prepared by Henry Varnum Poor, who in 1868 along with his son William Henry, set up the H. V. and H. W. Poor Company. H. V. Poor published the *Manual of the Railroads of the United States*, whose first edition (2500 copies) sold out in a few months. For more than thirty consecutive years, he had been one of the most influential players in Wall Street.\(^9\) For 20 years before the Great Depression the company had been significantly developing. In 1923 Standard Statistics developed its first stock market index, which included 223 US companies.\(^11\) The Great Depression, which broke out in late 1929 and 1930, caused the economic downturn and in 1930, hit hard by the crisis, Poor’s Publishing company went bankrupt. After the merger of Standard Statistics and Poor’s Publishing in 1941, the company changed its name to Standard & Poor’s Corporation and its first president was Clayton A. Penhale. S&P then published the new *Bond guide* assessing 7000 of national bonds.\(^12\)

In 1946 S&P entered the era of automation by introducing the IBM Punch Card system to collect information on US companies. In 1950 earnings from subscriptions exceeded 5 million brands and doubled over the next nine years. S&P became a widely-known, affluent company, which led to its appearance on the New York Stock Exchange in 1962.\(^13\)

The 80s saw a further growth of the company, especially on the international area. The first issue of Credit Week was published in 1981. It provided a dependable analysis of international credit markets. The high reputation of S&P meant that in 1983 the Chicago Mercantile Exchange began to trade *futures* contracts based on the S&P 500. Furthermore, it resulted in the fact that in 1984 S&P became the first rating agency which opened an official office in London. Over the next 20 years it opened offices in 20 different countries around the world. In the mid-90s S&P was already all over the world, including places such as Canada, Hong Kong, Singapore, Argentina, Brazil and Russia, and it had a growing number of offices in the United States.\(^14\) Nowadays, S&P also deals with hedge funds (Hedge Fund Index). It is the majority shareholder of CRIS – the Indian rating agency market leader, whose primary activity is the same as S&P. The size and the impact of S&P on the world economic situation reflects the fact that in 2008 the company had about 6300 employees in 20 countries around the world.\(^15\)

### 3.2 John Moody – the age of market dominance

The company John Moody & Company was founded in 1900. In the same year, based on the studies and assessments carried out by Moody’s, *Moody’s Manual of Industrial and Miscellaneous Securities* was released.\(^16\) Unfortunately, in 1907 after

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\(^11\) Ibidem.

\(^12\) Ibidem.

\(^13\) Ibidem.

\(^14\) Ibidem.

\(^15\) Ibidem.

the stock market crash caused by the lack of funds for maintenance of capital, Moody was forced to sell his business. However, in 1909 Moody returned to the financial market with a new idea. Instead of the previous services based on collecting information and reporting the status of enterprises or other economic entities, he decided to offer analysis on the value of collaterals. Then, Moody started a new research activity involving the bonds of railway enterprises. As a result, his company was the first that evaluated securities and collateral values on the public market.\footnote{17}

In 1909 Moody’s Analyses of Railroad Investments described and explained to their customers the research methods that Moody used to evaluate the operations, management and finances of railway companies. In 1914 Moody’s rating activity embraced bonds issued by US and other cities. Until 1924 Moody’s ratings covered almost 100% of the US bond market.\footnote{18} Significantly, in 1970 like other operating agencies, Moody’s began to charge both the investors and issuers of financial instruments for its services.\footnote{19}

3.3 Fitch Ratings – the third of the ‘dominators’ in the rating agencies market

Fitch Ratings Incorporation was founded on December 24, 1913 by John Knowles Fitch in New York. Fitch Ratings is the smallest of the three NRSRO agencies.\footnote{20} (Nationally Recognized Statistical Rating Organizations), accompanied by Moody’s and S&P. It covers a smaller market share than the other two agencies.\footnote{21} Fitch Ratings is currently an interdependent company of the Hearst Corporation and FIMALAC S.A.\footnote{22} In April 2012 Hearst increased its share to 50%. Fitch Ratings has its main headquarters in both New York City and London. It was appointed to the prestigious NRSRO in 1975 by the US Securities and Exchange Commission.\footnote{23} The technology and research methods used by Fitch are very valuable. In September 2011 IBM purchased the software ‘Algorithmics’ (risk analytics software) from Fitch for $387 million.\footnote{24}

4. The financial crisis of 2008

4.1 The rating agency Standard & Poor’s in the face of the financial crisis in 2008

In 2013 Forbes magazine published an article which described the civil suit lodged by the US Department of Justice against S&P.\footnote{25} There was a requirement for $5 billion compensation for the losses that investors bore as a consequence of the assigned ratings. The lawsuit numbered 119 pages. S&P was accused of up- and

\begin{itemize}
  \item \footnote{17} Ibidem.
  \item \footnote{18} Ibidem.
  \item \footnote{19} Ibidem.
  \item \footnote{20} http://www.sec.gov/answers/nrsro.htm, \textit{(accessed January 3, 2015)}.
  \item \footnote{21} \textit{ibidem}.
  \item \footnote{22} http://www.fitchratings.com/web/en/dynamic/fitch-home.jsp, \textit{(accessed January 3, 2015)}.
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downgrading in terms of securities backed by mortgage debt. The aim was to obtain additional orders from investment banks which had issued those securities. Furthermore, allegations referred to the agency’s statements that the assessments were totally objective. Exaggerated speculation and insolvent borrowers led to the collapse of Lehman Brothers, which was later followed by the economic recession. The lawsuit, which additionally applied to the entire company of McGraw-Hill, was supported by 16 states and the District of Columbia. The fact that the attention of the government focused mainly on the S&P, while Moody’s and Fitch perpetrated similar actions is worth considering.\footnote{Ibidem.}

Due to the decline of confidence in the credit rating agencies after the events of 2008, they were taken under supervision and have been trying to regain their reputation. In the interview for Forbes magazine Marcin Petrykowski Regional Director for Central and Eastern Europe in the Standard & Poor’s rating agency talked about what changes had been implemented in S&P to respond to the criticism that befell the company represented by him: ‘The industry has undergone some evolution. Since 2008 we have invested approximately $400 million to show how strongly S&P demarcates the commercial aspect from the analytical one. The expenditure we bore contributed to the improvement of methodology and risk assessment models, so as to take advantage of the new knowledge acquired as a result of the crisis. Moreover, we incorporated better solutions, creating patterns and models for the future.’\footnote{Ibidem.}

In the market there is a new regulator, ESMA the European Securities and Markets Authority. It ensures the transparency of the agencies’ activities and oversees the financial markets.\footnote{Ibidem.} Petrykowski also mentions the positive effects of the internal work the agencies have done, and a new method of risk management: ‘The rating agencies now take a closer look not only at the risk of the relationship with a client, but also put a greater emphasis on the risk management and the so-called monitoring of compliance with the provisions of various types and rights, both global and local.’\footnote{Ibidem.} He added that due to the continuous work on the agencies reputation, they paid special attention to allow their clients to be able to compare objects within the same industry in different places. The aim is to increase market transparency.\footnote{Ibidem.}

4.2 Moody’s and the financial crisis – low ratings undermine a chance to stabilize most indebted countries

One of the criticisms faced by the agencies in the context of the crisis concerns the assignment of very low rating grades to the most indebted countries. This has led to a situation in which European Union countries, such as Greece and Spain, counted
solely on financial assistance in the form of subsidies granted by the European Commission. Low ratings undermine confidence, which in turn leads to further difficulties in borrowing money on international markets at very high interest rates.\textsuperscript{31}

In 2010 Moody’s downgraded Ireland significantly to the level of Aa2. The reason for it was a weak prospect for economic development due to a high rate of public debt and troubles of the banking system in the country.\textsuperscript{32} A similar case concerned Cyprus, whose rating in 2012 was lowered to B3, which in Moody’s nomenclature means that government bonds are considered to be precarious. The problems that Cypriot banks faced were closely correlated with the banks in Greece. The agency said that after being subsidised, Cyprus’ debt would grow to 140% of GDP. This ensured a lack of economic growth over the next five years.\textsuperscript{33}

The so-called rich countries of Euroland did not manage to avoid the negative ratings either. In 2012 Moody’s lowered the rating forecast of Germany, Netherlands and Luxembourg, although those countries performed the highest GDP per capita in the European Union. However, it was justified by the possible exit of Greece from the Eurozone, which would adversely affect all Eurozone countries as well. Moreover, South European countries such as Italy, Spain and Portugal also needed to be supported. The Italian credit rating was downgraded to Baa2 level due to the deepening economic stagnation in Europe. Consequently, this led to a very high cost of credit to the Italians and increased their public debt. Despite this, Germany and the Benelux countries received the highest grade of their loans and bonds – Aaa.\textsuperscript{34}

The activity of the banks is regarded as one of the main causes of the financial crisis. It was clearly noted in the analysis conducted by Moody’s, too. Both the assessments of European and US banks were significantly reduced. In 2012 15 banks’ ratings were lowered. Two powerful and well-known banks Citigroup and Bank of America received Baa2, taking into account moderate bonds’ risk. Moody’s lowered its assessment of 15 banks – 5 American, 3 French, 2 Swiss, 3 British, 1 Canadian, and 1 German. The banks were divided into 3 groups. The first group included banks deemed stable e.g. the Sino-British HSBC, JPMorgan Chase and the American Canadian Royal Bank of Canada. According to Moody’s, those three institutions were characterized by high capital and cash flow. However, it was pointed out that their connections with the Euro Zone countries may be a threat to them because of the growing public debts of those countries. On the other side were placed institutions such as the American Citigroup, Morgan Stanley, Bank of America and the British Royal Bank of Scotland (RBS).\textsuperscript{35}

\textsuperscript{31} A. Heuser, \textit{3 agencies with the power to make or break economies}, TED Talk 2013, http://www.ted.com/talks/annette_heuser_the_3_agencies_with_the_power_to_make_or_break_economies, (accessed January 3, 2015).
European banks, especially Italian and Spanish ones, were most severely treated. In July 2012 Moody’s Investors Service lowered the ratings of 13 Italian banks, including the largest ones – UniCredit and Intesa Sanpaolo. It was determined by a decision made by the Italian Prime Minister concerning long-term debt of Italy. The agency’s decision was justified by saying that the government led by Mario Monti would not be able to handle the public debt and consequently support the domestic banks. Aforementioned group included also Banca Carafirenze, Banca IMI, Banca Monte Parma, Credito Emiliano SpA GE Capital, Casa Depositi e Prestiti Banca Popolare and Friuladria. The threat of clients who were unable to buy Italian bonds induced Moody's to downgrade Italian bonds by 2 points accordingly.36

The situation of the Iberian Peninsular bank was deteriorated by the previous downgrading of Spain. As a result, the rating of 28 Spanish banks was reduced approximately by 1 to 4 points. However, Moody’s experts stressed that the rating reflected the real situation of the banks, their ability to repay debts as entities independent on the level of the country’s public finances. Taking into consideration that the situation of Spain and the United States in the real estate market was quite similar, the involvement of banks in this sector of the economy was perceived adversely by the agency. It was anticipated that probably insolvent borrowers may have forced banks to continuously benefit from further external assistance within the upcoming years. It made then Spanish Minister of Finance Luis de Guindos make a formal request towards the Eurozone countries for financial support. The Eurozone declared an amount of 100 billion EUR to cover the assets, which mostly accounted for the real estate sector loans.37 The forecast of the European Financial Stability Fund (EFSF) was changed from stable to negative. The agency explained that this decision ‘is the result

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of recent changes in the assessment of Moody’s credit forecasts for the bonds of Eurozone countries that are guarantors of the EFSF.” However, the EFSF rating was affirmed at Aaa due to ‘complete and total guarantees’ of the euro area.38

Annette Heuser, executive manager of the Bertelsmann Foundation, gave a speech on TEDGlobal 2013 presenting the problems which had arisen from the oligopolisation of the credit rating agencies market:39

(1) little competition and dominance of 3 agencies results in a lack of development of those institutions and improvement of provided services;

(2) agencies are profit organizations – their clients pay for their own ratings, which causes a conflict of interest;

(3) distorted transparency of the agencies’ operations – there is a limited access to the used methodology and macroeconomic indicators which determine the level of rating.

Nowadays, economists and financial experts struggle to develop some ways to solve those problems. In the aforementioned speech there was an idea presented which concerns the first rating organization of a non-profit character. This agency is called INCRA. It was designed and set up by Annete Heuser along with her team from the Bertelsmann Foundation. In 2007 in Poland, as in Germany, the first Polish rating agency named EuroRating was founded. It was officially registered as a CRA in the European Union and was subjected to the European Securities and Markets Authority (ESMA).

5. Recapitulation

To sum up, the latest economic crisis was caused by many different factors. It seems relevant to take into consideration that some actions taken by credit rating agencies were rather unethical, especially due to their focus on potential profits. However, it is worth emphasizing that most of the implemented measures were not under any control for a long time period. The fact that Lehman Brothers and many other American or European commercial banks went bankrupt was due to the inappropriate assignment of so-called ‘subprime loans’ to clients, who in the end turned out to be insolvent and they lacked creditworthiness. Both previous US governments under the reigns of George W Bush and Bill Clinton, as well as the current one led by Barack Obama did not intervene effectively in order to prevent the global economy from financial breakdown.

In terms of rating agencies, the mentality of the Wall Street environment played a pivotal role. Substantially, a correlation between austerity plans and the behavioural nature of bankers contributed to it as well. Subsidizing fallen financial institutions in the US and Europe meant that even the most indebted banks, enterprises and states in the South Europe were assured that US government, the European Commission and

39 A. Heuser, op. cit.
the International Monetary Fund would always help them without any particular restrictions or conditions. Hence, this kind of approach seems unethical as well. As a consequence, it might lead to another breakdown on stock markets in the long run. It has already brought about social, political and even military conflicts, which affect the whole world.

The problems connected with credit rating agencies should be resolved as quickly as possible. Hopefully, this market will become more diverse through the emergence of the new non-profit German organization INCRA or Polish EuroRating. On the basis of previous experiences, there is an urgent need to introduce some independent, international audits, which will be responsible for guarding, and preserving transparency of those institutions. The introduction of some legal code, particularly covering legislation of this type of organizations seems more and more necessary. The EU authorities representing and enforcing the European law (the Council of the European Union, the European Parliament and the Commission) have the ability to issue some regulations, will become directly a part of national legal systems.

On the whole, it is important to change the attitude of the people involved in this sector and those responsible for the functioning of credit rating agencies. These institutions should provide their clients with reliable assessments and reports, and more importantly, their funding cannot be provided by the entities audited by them. Otherwise it will break the rules of business ethics again.

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