Credit rating agencies getting away with bad behaviour

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International credit rating agencies have been at the centre of many financial crises that have cost global investors billions of dollars in lost investment value. Developing countries in particular have urged investors to ignore unsolicited credit downgrades, calling them dictatorial. The agencies neoliberal approach in rating methodologies and recommendations often result in reductions in government spending in order to increase the role of the private sector in the economy, and promote privatisation and fiscal consolidation. This often leaves governments with no choice but to agree on compromise decisions based on austerity policies. Despite instances of inaccurate ratings that have disrupted financial markets, suppliers of funds continue to depend on international ratings.

International credit rating agencies have had their fair share of controversies over the years. They have been at the centre of the major financial crises, from the financial markets collapse of New York City in the mid-1970s; the Asian financial crisis of 1997-98; the Enron scandal of 2001; and the global financial crisis of 2008. All of these crises cost global investors billions of dollars in lost investment value. Rating agencies are meant to give comfort to investors about an issuer's ability to repay the principal debt and interest. Suppliers of funds essentially refer to ratings in determining the level of interest rate that a borrower must pay.

Inaccurate ratings therefore distort both the price of debt instruments and the interest rates payable on them. History has shown[1] that inaccurate ratings create asset bubbles that eventually burst, disrupting the efficient functioning of financial markets.

The three dominant international credit rating agencies – Standard & Poor's (S&P), Moody's and Fitch – which account for over 90 percent[2] of the world's sovereign credit rating business, have been accused of many faults, including false ratings, flawed methodology, encroaching on government policy, political bias, selective aggression and rating shopping. These shortcomings originate from their 'issuer-pay' business model in which the institution being rated pays for the rating which is used by investors. This means that the model has an inherent conflict of interest. Although this has been evident through various crises – most notably the financial meltdown in 2008 – regulatory mechanisms are yet to address this problem.

Despite these known weaknesses, rating agencies are still being referenced in key financial market decisions and in government's macro policy decisions. The rising gap between developmental needs and available financial resources – including poor revenue collection – has also pushed African governments to consider different options to support their budgets. One route to raise capital has been the issuing of sovereign bonds on international financial markets. But to do this successfully, governments need a sovereign credit rating from at least one of the three dominant international credit rating agencies. The number of African countries seeking a sovereign credit rating has thus increased from one in 1994 to 31 in 2018. »

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HOW RATINGS INFLUENCE ECONOMIC POLICY

The credit rating agencies limit government policy scope and shape national economic policy through a neoliberal approach[3] to their method of rating countries and recommendations in their rating reports. The rating methodologies and recommendations promote economic liberalisation policies such as privatisation, fiscal consolidation, austerity, central bank independence, deregulation and reductions in government spending in order to increase the role of the private sector in the economy. The methodologies have economic, fiscal, institutional and vulnerability-to-event-risk as rating factors, each one with its subfactors and weights.[4] The closer the subfactors and their indicators are aligned with austerity policies, the higher the scores each rating factor receives.[5]

In addition, every rating activity by rating agencies is accompanied by a report giving an explanation of the rationale behind the rating action. The explanation has two facets. Firstly, it details what a country has been doing well and what it needs to maintain or improve in order to be upgraded. The report details a recommendation on what ‘prudent’ policies a country must pursue to obtain a higher rating.[6] Secondly, it explains on what factors the country has been downgraded as well as what it needs to change to avoid a further downgrade.

South Africa’s long-term foreign currency sovereign bond rating was downgraded in April 2017 by S&P and Fitch from an investment grade of BBB- to a non-invesment grade (junk) of BB+ and by Moody’s in June 2017 from Baa2 to Baa3 investment grade. The downgrades were accompanied by a rating report[7] showing optimism that the government would continue to be committed to policies on structural reforms and budgetary consolidation. The downgrade report for all the rating agencies outlined similar explanations about the key rating drivers. The rating agencies’ views were that political events, such as the cabinet reshuffle that led to the replacement of the former finance minister and his deputy, would likely result in a change in the direction of economic policy, weaken the standards of governance, worsen public finances and abandon fiscal consolidation. Rating agencies viewed the cabinet reshuffle as a reflection of contrary efforts by the government towards improving the governance of state-owned enterprises (SOEs). The reshuffle was seen as undermining progress towards reducing government spending through abandoning the country’s nuclear programme. These recommendations heavily point towards austerity – fiscal consolidation, efforts to reduce debt and decreasing spending.

The warnings for a downgrade and recommendations needed for upgrade leaves governments with no choice but to come to a compromise on recommended austerity policy direction. Any government that pursues an economic policy contrary to the recommendations of the rating agencies faces imminent sovereign downgrades. A downgrade, especially to ‘junk’ status, may trigger a massive exodus of capital as many institutional investors are mandated to hold investment grade financial assets.[8] By downgrading South Africa in February 2017, rating agencies became significant catalysts for the removal of former president of South Africa, Jacob Zuma. The current investment grade, which is on the balance with Moody’s, has been used to leverage the government policy direction towards austerity and to influence the national budget. If the government loses its last investment grade by Moody’s, its sovereign bonds will fall out of key global market gauges such as Citigroup’s World Government Bond index (WGBI).[9] This would sharply increase the cost of debt and pressurise the exchange rate as investors dispose the government bond. Thus the government has to comply with Moody’s recommendations to avoid further downgrades.

NEOLIBERAL POLICY APPROACH

The neoliberal policy influence of credit rating agencies does not resonate with developing states such as South Africa, which are grappling with challenges such as unemployment, inequality and poverty. A focus on economic efficiency in such an environment compromises other more important factors such as social injustice and promotes exploitation of both resources and people. Neoliberalism de-emphasises public goods that are driven by equality, environmental concerns and social justice, and are not conventionally monetised, ignoring the government’s social objectives.[10] Restricting governments to a neoliberal policy direction is tantamount to undermining the basic elements of democracy as

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a government can no longer actively participate in economic redress, leaving a trail of economic misery, rising unemployment and economic inequality. It has been proven that free market policies sometimes do not lead to economic efficiencies.[11] On the contrary, they often produce economic inefficiencies by replacing state-owned monopolies with private-owned monopolies, privatising profits. A 2016 report by researchers at the International Monetary Fund (IMF)[12] find that rating agencies' neoliberal policy recommendations, such as free movement of capital and fiscal consolidation, result in increased economic inequality, shift economic power to corporations and benefits to the elite class, in turn negatively impacting the level and sustainability of economic growth.

COUNTRIES THAT HAVE COMPLAINTS

There has been growing dissatisfaction with the dictatorial policy tendencies of the three international rating agencies by a number of rated countries in Africa. In 2015, the Zambian government urged investors to ignore an unsolicited credit downgrade from the rating agencies.[13] It challenged the correctness of its rating, which it said was imposed without being discussed with the country's representatives. In 2017, Namibia rejected Moody's decision to downgrade the country's credit rating to junk status.[14] It said the downgrade was contrary to the progress it had made in policy implementation and the country's generally stable economic outlook. The government of Nigeria also strongly disagreed with its downgrading. It questioned both the general rating premises as well as the agency's conclusions.[15] The government believed that its chosen policy direction would have positive results as the economy had successfully emerged from a recession and recorded important improvements across a broad range of sectors. In 2018, Tanzania criticised Moody's decision to assign a low credit rating with a negative outlook on the country's first international credit rating.[16] Tanzania rejected the rating, arguing that it hadn't been thoroughly consulted on its policy direction.

CREDIT RATING PROCESS

The first major problem is that the rating process is centred on a lead analyst who recommends a rating to the ratings committee according to his/her ideological persuasion. This is how the credit rating process works:[17] after an issuer contracts a rating agency, the ratings agency assigns an analytical team (lead and support analysts) to gather information about the country from different sources they deem credible. The analytical team should consult the country through meetings before making recommendations to a ratings committee that is convened by the lead analyst. The lead analyst also determines the size and composition of the ratings committee based on the size and the complexity of the credit analysis.

The second problem is that rating agencies are bound to be concerned about the relevance and sustainability of their revenue sources because they are profit-driven businesses. They will fight for policy space to protect their income. Thirdly, the individual analysts and employees of a rating agency face no criminal liability, despite the fact that rating misconduct usually manifests itself through members of the analytical team. Lastly, the credit ratings industry is highly concentrated on the ‘big three' credit rating firms that seek to maintain dominance in the industry through discouraging any activities that may lead to a loss in their market share. They are unwilling to allow completion,[18] suggesting that it could lead to poor ratings.

REGULATORY RESPONSES

Following the 2008 global financial crisis, the US, the European Union, China and South Africa all introduced legislation to address the flaws in rating agencies' operations. Although strict civil laws are necessary to deter misconduct and encourage compliance, enforcing only civil regulations is both an ineffective and expensive way of curbing credit rating misconduct. Tighter scrutiny of credit rating agencies by investors, regulators and the media is also not effective. Despite these regulatory responses, rating agencies are still being caught on the wrong side of the law. Recent cases are proof of this. But there is still the possibility that a great deal of wrongdoing goes undetected.

Early in 2019, the European Securities and Markets Authority (ESMA) fined the Fitch group of companies in France, Spain and United Kingdom a total of approximately R85 million for failing to maintain independence and avoid conflicts of interest.[19] Fitch UK, Fitch France and Fitch Spain issued ratings on Casino Guichard-Perrachon, Fondation

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Nationale des Sciences Politiques, and Renault. This was despite the fact that they knew one of their shareholders – which indirectly owned 20 percent shares in each of the Fitch group companies – was also a board member of the rated companies. In 2018, China suspended licences held by Dagong Global Credit Rating, one of China's biggest agencies. Dagong was found guilty of submitting false information to regulators and charging borrowers very high fees, actions that regulators said compromised the rating agency's independence. In South Africa, the Financial Sector Conduct Authority (FSCA) recently found the Global Credit Rating Agency (GCR) guilty of failure to avoid a conflict of interest. The agency was fined an administrative penalty of R487,000.[20] The CEO of the GCR undertook to an issuer, whose credit rating had expired, that the GCR would issue a credit rating. This was contrary to the rules that required the CEO to act separately from the agency's rating analysis team. At the time of undertaking, the issuer was in the process of procuring the services of a rating agency, a process in which global agency was one of the bidders.

SHORTFALL IN REGULATORY MECHANISM

The continuing infringement by credit rating agencies on rules and analysts' conduct that compromise the independence of their opinions shows there is a major shortfall in the current regulatory mechanism. Although problematic, abandoning the 'issuer-pay' business model is not the solution and will push some rating agencies out of business. The only solution is to criminalise rating misconduct such as breaching conflict of interest. The strict monitoring, scrutiny and penalising of credit rating firms alone will not be enough to deter bad behaviour. Individuals responsible for breach of conflict of interest rules should face criminal prosecution. If this does not happen, analysts will not hesitate to take chances.

In addition to this, there should be a continental regulatory framework and a continental regulatory authority that governs the operation of international rating agencies in Africa to save the continent from rating abuse. The aim of the framework should be to deal with rating misconduct and address unfair and exploitative business practices.

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