Credit Rating Agencies

By Miklos Sarvary

Last week has been rich in news about Credit Rating Agencies (CRAs). Both the Financial Times (March 23, 2012) and The Economist (March 17, 2012) had articles on CRAs commenting on how the industry is being reshaped after the scandals triggered by the global credit and fiscal crises. I have followed this industry for over a decade now but I keep being surprised how little progress has been achieved in fixing it.

The Financial Times reports Europe's efforts to regulate the big three CRAs (Standard & Poor's, Moody's and Fitch). European governments are angry because CRAs have downgraded their debt. It doesn't really help the regulatory effort, of course, that its leader is Michel Barnier, a french carrier politician who knows little about economics and probably even less about information markets. His idea of regulation is to put a straight jacket on CRAs, e.g. by making them liable for their decisions or forcing issuers to rotate CRAs. Obviously, simply introducing more competition (e.g. reducing the barriers to entry) would be far more effective in making the industry more careful with the ratings, without mentioning the cost effectiveness of implementing such 'deregulation'.

The Economist reports on the evolution of CRAs in India. It praises the local industry wondering what might explain its success given that local CRAs use the exact same model observed in the US, i.e. exhibiting massive conflict of interest, which, of course, has been in big part responsible for the global financial crisis. One argument advanced is that in India, agencies have been better regulated by the local financial supervisor (SEBI) and India'd central bank. Of course, we all trust Indian government agencies in doing a good job at overseeing and regulating the economy. Is this a joke – really?

The other argument raised is that the CRAs in India have done a better job at diversifying their businesses. I am not sure I understood this argument. Essentially, incompetence and conflict of interest are going to be spread to

other sectors of the economy and we should cheer about this? The article mentions one agency moving into hospital ratings, for example…

When evaluating threats to the industry, The Economist mentions that new entrants might represent a danger. Presumably, these would provide soft ratings to gain market share. Of course, we don't expect that conflict of interest will lead to biased ratings from the incumbents who are comfortable in controlling the market (?). Again, I am lost in the reasoning…. Reading between the lines, the picture gets even grimmer. India has 6 licensed agencies with three large 'local' agencies (CRISIL, CARE and ICRA) leading the pack. Reading on, we discover that CRISIL, the largest (worth $1.3 billion) is 52% owned by Standard & Poor's. In turn, Moody's owns 29% of ICRA. Given the uncertainty surrounding India's economic institutions and the devastating climate of corruption the apparent health of the local CRA oligopoly is rather depressing.

Find article at

https://knowledge.insead.edu/marketing/credit-rating-agencies

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