1. CREDIT RATING AGENCIES WHY THEY ARE IMPORTANT

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Credit rating agencies: why they are important

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Rating agencies still represent an important defence for investors against any abuse by senior management

Last week I discussed some of the shortcomings of credit rating agencies (CRAs) - companies that investigate the general credit-worthiness of issuers of loans/bonds and then provide ratings and opinions that can be used by investors.

These issuers can be companies (e.g. Bank of Cyprus), special purpose entities, non-profit organisations, state and local governments (e.g. State of California, County of Orange), as well as 'sovereigns' (e.g. Cyprus or Greek government bonds). Using a quantitative as well as a qualitative analysis, CRAs assign a rating to each entity based on the perceived riskiness of its creditworthiness. The higher the risk, the lower the lower rating.

Market efficiency

CRAs' role is to help make the markets more efficient, by improving transparency and disseminating information to investors, thus lowering borrowing and lending costs. They also make it possible for small companies/governments, start-up companies, or other relatively unknown entities to raise capital by having their debt rated by the agencies.

Ratings also prove useful to the

issuers as well as government regulators (such as the Central Bank, or the Securities and Exchange Commission), as they provide an independent source of verification.

Improving transparency in the market and helping to disseminate information is considered the traditional CRA model.

Another explanation behind the need for CRAs is based on a 'coordination theory', which states that agencies provide a coordinating role between issuers and investors.

That is, investors receive an enormous amount of information and the agencies provide a guiding hand to make the right decisions. At the same time, the agencies act as a compass to issuers in the complex world of financial markets.

A third explanation behind the role of rating agencies is the transformation of inside information (that they may have due to the close contact with the issuer) into public information that can be used by investors, regulators, etc.

Why have they become increasingly important?

One would think that due to technological advancements and the improvement in the quality of information provided to investors, the role of the rating agencies would have diminished in recent times. However, on the contrary, they have become increasingly important.

One reason is globalisation. Nowadays, companies and individuals can invest their money in places far away from their home soil (a key reason is to diversify their portfolio). Thus, rating agencies help to provide useful information that otherwise would have been difficult to obtain.

A second reason is the introduction of highly complex financial products. Investors have neither the expertise nor the time to analyse the risk embedded in these securities.

A third explanation behind the increasing role played by the CRAs is the wave of financial scandals that led to the loss of billions of investors' money. Thus, despite some of the shortcomings of rating agencies, they still represent an important defence for investors against any abuse by senior management.

Conflict of interest

Traditionally, CRAs earned money by publishing the ratings and charging a subscription fee. This still seems to be the case with smaller CRAs.

However, the major agencies now earn their money by charging the issuer for the services they offer.

This method can obviously produce a conflict of interest as it could provide an incentive for the agencies to provide favourable ratings to companies with strong business ties.

However, proponents of this approach argue that using a "subscriber-based" fee structure would eventually lead to a vast number of bonds being unrated, since investors would only be interested in the ratings of the larger and more liquid bonds.

Overall, and despite some very striking shortcomings of CRAs discussed last week, they are still a very important player in the financial markets.

Their actions affect the economic future of the issuers they rate, but also the investments of millions of individuals/companies around the world.

Having a clear understanding of how they operate is extremely important for investors, regulators, and issuers as well.

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