In August 2011, credit rating agency Standard & Poor’s (S&P) downgraded the United States’ top-notch AAA credit rating for the first time ever. The company cut the long-term US rating by one notch to AA+ with a negative outlook, arguing that the deficit reduction plan passed by the US Congress did not go far enough.

The decision sent shockwaves through the world of finance and provoked an angry reaction from the US Government. John Bellows, Acting Assistant Secretary for economic policy at the US Treasury, claimed the firm’s analysis contained a major mistake that led it to ‘dramatically overstate projected deficits – by $2 trillion over ten years’.

Regardless of S&P’s ‘mistake’, Bellows said there was ‘no justifiable rationale’ for the downgrade. ‘There are millions of investors around the globe that trade Treasury securities,’ he said. ‘They assess our creditworthiness every minute of every day, and their collective judgment is that the US has the means and political will to make good on its obligations.’

Edward Greene, senior counsel at Cleary Gottlieb in New York and a member of the IBA’s Task Force on the Financial Crisis, says the stinging rebuke reflects the frustrations felt by sovereign states at not getting a chance to review and dispute their rating and provide alternative evidence to be taken into account. ‘This is a pretty opaque process, especially with respect to sovereign debt,’ he says, primarily because it is not clear how much information rating agencies can access. ‘How can they be sure about the overall economic condition of

Who rates the rating agencies?

The US and countries across Europe have been humbled by downgrades from the hugely powerful credit rating agencies. As markets react ruthlessly to their proclamations, and governments topple throughout the Eurozone, IBA Global Insight assesses their influence.

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What is a credit rating agency?
Credit rating agencies exist to assess the creditworthiness of bond issuers. These can be companies or countries that borrow money by issuing IOUs known as bonds. The agencies give the borrowers a rating – expressed as a series of letters such as AAA, Ba3 or D – which tells the buyers of this debt the likelihood of getting their money back. As a result, the scores also affect the rate of return that investors are likely to charge on that borrowing. A lower score (AAA is the highest, D the lowest) makes investors more likely to demand higher rates, potentially making borrowing more difficult.

The three main rating agencies are:
- Standard & Poor’s (S&P) has its origins in 1860, when Henry Poor published a history of the finances of railroads and canals in the United States as a guide for investors. S&P is headquartered in New York.
- Fitch Ratings, founded in 1913 by John Knowles Fitch, headquartered in Paris. In 1924, Fitch introduced the AAA through D rating system that has become the basis for ratings throughout the industry.

There are hosts of other agencies, but these three were the first to be acknowledged by US regulator the Securities and Exchange Commission (SEC) as Nationally Recognized Statistical Rating Organizations (NRSROS). Their combined market share is around 95 per cent.

Greece, for example, given that no one else seems to know what it is’

This is not an issue when the agencies are rating companies, as it is clear they have access to reported information and can hold meetings with representatives of the organisations seeking the rating. ‘With sovereigns it’s basically what’s out in the market and then it’s down to their judgment,’ says Greene. ‘In their rating of the

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Peder Hammarskiöld
Hammarskiöld & Co

US, S&P said they were taking into account the likely political paralysis that would prevent any kind of systemic addressing of the deficit. So they’re making judgments on political stability and political willingness to deal with certain economic problems as much as on economic conditions. It’s pretty subjective.’

Peder Hammarskiöld, senior partner at Hammarskiöld & Co and another member of the task force, believes the downgrade was a mistake. ‘It’s worth noting that the other two main ratings agencies, Moody’s and Fitch, did not follow suit,’ he says. ‘The S&P downgrade seems like a misunderstanding of the real credit power of the US.’

Power and responsibility...
The US downgrade was not the first time that one of the rating agencies had annoyed a sovereign state by issuing a negative assessment of its future ability to pay down debt. When Moody’s downgraded Portugal’s debt to ‘junk’ status in July, citing concerns that the country could follow Greece in needing a second bailout, it provoked a furious reaction. Portugal’s public debt agency, the IGCP, condemned the move as superficial, arrogant and ‘based more on opinion than evidence’.

The key problem was that the reasons for Moody’s downgrade were not clear, says Lino Torgal, executive partner at Sévulo & Associados in Portugal. ‘I respect the rating agencies and understand they have a useful role to perform,’ he says. ‘But it is not always easy to get a clear view of the grounds they use to downgrade you. There is a lack of transparency in the way they work.’

Torgal argues that the downgrade was particularly surprising as it came shortly after Portugal’s newly-elected government announced measures to strengthen financial discipline in the country. Portugal had pledged to introduce an austerity programme as part of a €78bn bailout deal agreed in May with the International Monetary Fund (IMF) and the European Union (EU).

Similarly, when Moody’s cut Spain’s rating by one notch to Aa2 in March, Spanish premier Jose Luis Zapatero dismissed the downgrade as an insult, insisting that only the Bank of Spain had the ‘information, credibility and truthfulness’ to judge the needs of Spanish lenders. Spanish officials were stunned when Moody’s issued its rating hours before the central bank was due to publish its own far more detailed analysis. ‘Moody’s don’t explain how they come up with these numbers’, lamented one source to journalists.
X-rated

It’s not just their ratings of sovereign states that get the credit rating agencies into trouble; their ratings of companies have also led them into controversial territory. Moody’s, for example, has been accused of outright blackmail in the past. In one notorious case, the agency offered German insurer Hannover Re a ‘free rating’, suggesting that it might like to pay for such a service in the future. When the insurer refused, as it was already paying two other agencies for ratings, Moody’s continued with the ‘free ratings’ but lowered its assessment of the company over time. Following a continued rejection of Moody’s services, the agency lowered Hannover’s debt to junk status. Investors took fright, wiping $175m from the company’s market value in a matter of hours.

The agencies have also been criticised for assuming a quasi-regulatory role, acting as an ‘official’ guide to creditworthiness even though they are run for profit. Conflicts of interest often arise because the rating agencies are paid by the companies issuing the securities – an arrangement that has come under fire as a disincentive for the agencies to be vigilant on behalf of investors.

Crucially, the agencies came under attack for their role in the financial crisis. The main accusation levelled against them is that they failed accurately to reflect the riskiness of complex structured products such as collateralised debt obligations (CDOs). As the financial crisis unfolded, and the assumptions underpinning rating methodologies for such instruments were shown to be overly optimistic, downgrades contributed to a pricing collapse that left the market for structured products virtually non-existent.

For instance, losses on $340.7 million worth of CDOs issued by Credit Suisse Group added up to about $125 million, despite being rated AAA or Aaa by all three of the main agencies. Perhaps most notoriously, they also maintained at least A ratings on AIG and Lehman Brothers right up to mid-September 2008. Lehman Brothers declared bankruptcy on 15 September, while the US provided AIG with its first of four multibillion-dollar bailouts the very next day.

The agencies played an important role in creating a very artificial market for structured finance instruments, says Hammarskiöld. ‘Some of these instruments were so complicated that no one, even their creators, really understood the risks, and many people would not have invested if they were not rated,’ he says. ‘Most experts who looked into the agencies’ role during and after the financial crisis agree that the agencies carry some degree of liability for what happened’.

However, he also notes that most experts also agree that investors were at fault for attaching far too much value to credit ratings without conducting any research of their own.

Inflated credit ratings were the subject of several investigations into the causes of the financial crisis. A report by the US Senate’s permanent subcommittee on investigations issued in April 2011 noted that more than 90 per cent of the highest, or AAA, ratings given to mortgage-backed securities in 2006 and 2007 ‘were later downgraded to junk status, defaulted or withdrawn,’ causing huge investor losses.

Silence is golden

The 2010 Dodd-Frank Act, one of the main US legislative responses to the crisis, sought to address the perceived deficiencies of the credit rating agencies with new governance and compliance requirements. New liability rules and penalties were created, along with the permission of certain private rights of action, restrictions on conflicts of interest, accountability for ratings procedures, required procedures and methodologies, enhanced
Can’t live with ‘em...

Is all this regulation useful? Philip Wood, special global counsel at Allen & Overy and a member of the IBA Task Force on the Financial Crisis, thinks not. ‘We need credit rating agencies,’ he says. ‘They obviously got it wrong on home loans, but only on home loans, and they were far from being the only people to do so. The IMF did too. Even the mighty Greenspan and Bernanke could not tell there was a bubble. I’m very unsympathetic to these regulatory efforts – the credit rating agencies seem to be a target picked up almost at random.’

Edmund Parker, global co-head of the derivatives and structured products practice at Mayer Brown, believes the rating agencies have had a lot of undeserved stick. ‘The original idea of John Moody and Henry Poor was to write reports about companies that allow investors to form a view. All the rating agencies provide is an opinion. The problem is that regulators and investors now rely so heavily on a rating at the expense of everything else. Criticisms of rating agencies should really be directed at the value investors attach to ratings.’ Indeed, so precious have ratings become that France’s AAA status has become central, in many eyes, to the ability of the Eurozone to save the single currency.

As credit rating agencies consider their ratings to be opinions, they are likely to argue that enabling a regulator to suspend ratings would amount to a restriction of free speech. ‘People who work at ratings agencies like to see themselves as journalists,’ says Hendrik Haag, a partner in the Frankfurt office of Hengeler Mueller and the Chair of the IBA task force. ‘But in many ways, this is because they don’t want to be held accountable or liable for what they say. They have to recognise that the role they now have in the financial system gives them a lot of responsibility and I wish they

given the repercussions that this has, there is a real mismatch between the methodology used to reach an opinion and the effect it has on the market’

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would be a little more open to that and become more accountable to the public about their methodology."

Wood defends the agencies’ actions during the current sovereign debt crisis. ‘They are just doing their job,’ he says. ‘People say they are terribly mean, but that’s their job. The ratings they have given countries like Greece are hardly surprising. It’s usually pretty obvious why they give a particular country a particular rating. Obviously the sovereign states absolutely hate it, but the ratings don’t strike me as completely wrong. Governments simply don’t like the harsh, ruthless judgment of capital markets.’

According to Wood, the apparent conflict of interest whereby organisations pay for their own rating does not mean that all ratings are inherently untrustworthy. ‘It’s wrong to assume that people will always act wickedly,’ he says. ‘In any case, it would be impossible to find another model, because no one else is prepared to pay for ratings’. Hammarskiöld agrees. ‘It will be difficult to get the investors to pay,’ he says. ‘You have a free rider problem if you do that.’

It’s not wrong for credit agencies to make money either, according to Torgal. ‘Profit is not the main driver for rating agencies,’ he says. ‘Providing information that is accurate and correct should be their main driver, and their profits flow from that. However, they should be a little bit more controlled, because if they work only for profit and they receive large fees from contracts entered into with entities that don’t have any credibility, that’s not a good way for them to work.’

Most observers recognise that the agencies fulfill a vital role. ‘If you look at a manager who’s running a large bond fund that will have to invest a couple of million every day, it’s simply not possible to use the conventional tools of investor information like prospectuses and so on to make that decision, because that person would never finish reading in a particular day,’ says Haag. ‘There is a role for people who have an informed view on the creditworthiness of an issuer – for example – that’s available to the outside world.’

Parker’s view is that if the rating agencies weren’t there, investors would still need to require a level of interest payments to compensate them for a particular creditworthiness and a regulator would still want to see a spread of investment in assets of a certain level of credit quality. ‘What would you use if you didn’t use a rating?’, he asks.

The huge power of the rating agencies should be more controlled by some sort of regulation

Lino Torgal
Sérvulo & Associados

Clear as mud

However, concerns remain about the transparency of the agencies’ methods. ‘As far as I can tell, there are discussions within the agency and some are in favour of a particular rating, some are against, and there is yelling and shouting and at the end of the day you have a slight majority saying “OK we vote them down.” That’s not a transparent process’, says Haag.

‘Given the repercussions that this has, there
is a real mismatch between the methodology used to reach an opinion and the effect it has on the market."

According to Torgal, to produce a rating on a sovereign state, an agency might ‘put some junior researcher on the case, who will stay in the country and research for a while, file their report without any real and substantial correspondence with anyone about what’s going on, and then a short time later the agency issues the downgrade. The process often bears little relation to current reality.’ Earlier this year, one EU source called it ‘scandalous’ that an agency had rated Greece by sending a single person to the country twice a year for half a day.

Torgal’s conclusion is that the huge power of the rating agencies ‘should be more controlled by some sort of regulation,’ possibly under the aegis of the IMF or the World Bank. Hammarsköld feels there should be more competition in the market for ratings. Forcing companies to rotate the agencies they use might help. ‘Companies have to rotate the auditors they use, so why not rating agencies as well?’, he asks.

Concerns also remain about the agencies’ sense of timing. Frequently they seem to issue ratings at the worst possible time for a company or a country – the Portuguese downgrade in July is often cited in this regard – in a way that is guaranteed to inflict maximum damage on the entity being rated. ‘That’s part of their independence – they claim they just do it when they think they should,’ says Haag. ‘That’s a bit short-sighted. They must appreciate the impact of what they are doing and there should be clearer rules in that regard.’

On the other hand, he adds, one has to remember that they were criticised very heavily for reacting too slowly in 2008 with regard to structured products and now they are being criticised for acting too hastily in their judgments on sovereign debt. ‘It’s difficult for them to get it exactly right,’ Haag says. However, in a time of unprecedented market volatility, the role of the investors’ opinion formers will remain under the microscope.

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