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Credit-Rating Downgrades: A Necessary Evil?

> *"A ratings downgrade reflects the view of a particular rating agency and is based on their preferred model, subjective assumptions and decisions. These assumptions and decisions should be clearly disclosed to an extent where they can be critically examined by South African and other academics."*
> Dr Conrad Beyers

1. Introduction

On 22 June, the Catholic Parliamentary Liaison Office (CPLO) hosted a roundtable discussion entitled 'Downgrades: a Necessary Evil?' with guest speakers Professor Stan du Plessis, Dr Conrad Beyers, and Dr Jeff Rudin[1]. Among the issues highlighted were the media hype around South Africa's possible downgrading to 'junk' status; what such downgrading would actually mean to the economy; what these rating agencies are and how they arrive at their ratings.

In March this year South Africa faced a possible downgrade to junk status by one of the big three credit-rating agencies, Moody's. This was later followed by two other rating agencies – Standard and Poor (S&P), and Fitch. This paper will discuss what rating agencies are, the 'black-box approach' (as referred to by Dr Beyers), the importance of rating agencies, and the need to open up the black-box for critique.

2. What Are Rating Agencies?

Credit-rating agencies assess the level of risk attached to investments in countries, municipalities, state-owned entities, and some private companies. Their findings indicate to potential investors whether a given country's bonds (also known as its debt) are a safe or a risky investment. To make their findings, they evaluate current and historical information, and assesses the potential impact of foreseeable economic future events. In so doing, rating agencies can be of use to investors and market participants who make short-term or long-term investments or business decisions.

As a result, investor and business decisions are made largely on the basis of a corporation's or a country's credit rating by rating agencies like Moody's, S&P and Fitch. These are the top three rating agencies, controlling approximately 91% of the global market. The agencies use rating scales to indicate credit worthiness. Though there are slight differences between the agencies, all the scales fall into two broad categories: investment and speculative grades. For example, at S&P 'AAA' is the highest rating and indicates an investment grade, while 'D' is the lowest rating and indicates a speculative grade. South Africa is currently rated 'BBB' which is two ratings above speculative grade or 'junk status'. A 'BBB' rating means that South Africa has adequate capacity to meet financial commitments, but it is subject to adverse economic conditions.

These credit ratings play a useful role in enabling corporations and governments to raise money in the capital markets. For example, instead of taking loans from banks at commercial rates, they can borrow money directly from investors by issuing bonds or notes. They also assist retirement funds and other long-term financial vehicles by placing their members' savings in reliable, solid investments. Historically, government bonds are the safest – though far from the most profitable – form of investment, since governments do all they can to avoid defaulting on debt. Many pension schemes and retirement funds are obliged by law to invest a portion of their capital in low-risk government bonds. When a country's bonds become less secure, signalled by a ratings downgrade, these funds may be required to withdraw their money and invest it elsewhere. A downgrade to speculative, or junk, grade can thus trigger a sell-off of a country's bonds, forcing their price down and further weakening its economy.

A downgrade, therefore, can set off a vicious cycle and make an already struggling economy even weaker. This means that a huge responsibility rests on the agencies, and it is questionable whether they always act with the necessary diligence and prudence. Critics certainly suggest that the agencies' predictions are not always accurate.

3. The 'Black Box' Approach

A black box is a device whose workings are not understood by or accessible to its user. While all of the inputs and outputs are known, the inner-workings of the black box are not known, or very little is known. According to Dr Beyers, the methodologies used by rating agencies to make their decisions are akin to 'black boxes' that are not currently open to independent evaluation and validation. He argues that the methodologies used by rating agencies are often vague and not standardised. There are at least two types of methodologies: analyst models and mathematical models. While methodologies differ somewhat among rating agencies, the core factors evaluated by all of them include institutional strength, economic policy, the general health of the economy, fiscal and public debt dynamics, domestic political factors, susceptibility to external (international) shocks, and monetary policy.

Dr Beyers believes that it is important for the decision-making processes of rating agencies to be made transparent so that they can be scrutinised. The decisions they make affect not only governments, but citizens, the proverbial 'ordinary people'. Furthermore, any downgrade of South African government bonds, together with the potential economic fallout at a critical time, may be regarded as irresponsible without detailed information on how the decision was arrived at. According to Dr Beyers, a credit rating reflects the view of a particular agency which is based on their preferred model, with subjective assumptions and decisions. It is these decisions and assumptions that should be shared publicly so that they can be critically examined by the country which is being rated. In an article for Fin24.com,[2] Dr Beyers said that at least four questions should be posed to rating agencies. These are:

- How specifically are global methodologies tailored to the South African environment?
- On what basis are essentially non-quantitative elements such as the South African government's policies and strategies, or policymakers' commitment to financial restraint, evaluated and quantified?
- What are the assumptions and modelling decisions (e.g. weightings) used in the models, and how are they determined?
- Which assumptions and model specifications will be used to evaluate South Africa's longer-term economic performance?

4. The Fallibility of the Agencies

Examples abound of how rating agencies often get it wrong, but despite these, they still wield significant power. For example, the big three rating agencies gave no indication of the energy company, Enron's, financial troubles until just four days before the company filed for bankruptcy in 2001. They also infamously gave the fourth largest investment bank in America, Lehman Brothers, their top rating (triple A) a day before the company filed for bankruptcy. A few years later, the agencies were partly blamed for America's subprime mortgage crisis because they were "giving unduly high ratings to mortgage-backed securities"[3]. The role that the rating agencies played in the subprime crisis was so instrumental that the Congressional Commission into the disaster stated, in its report of 2011:

> *"We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction. The three credit-rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval."*

So why are rating agencies taken so seriously despite their shortcomings? It is in the best interest of corporations to have their debt rated by a credit agency because potential investors often base part of the decision to buy stock or company bonds on the credit ratings of the company's debt. Similarly, foreign direct investment for a country relies heavily on the country's credit ratings. The fact that rating agencies are paid by the bond issuer (or investment-seeker) rather that the investor, helps maintain the perceived power that they wield. However, it is arguable that this power is seriously compromised because their ratings are essentially opinions about credit risks. This was a point reiterated at the roundtable by Dr Jeff Rudin, who argued that rating agencies use non-scientific methods to form their opinions. However, despite the methodology used, the ratings of the agencies do impact on a country's economy.

All the speakers agreed that the perceived impact of a downgrade ought not to be as calamitous (in the short term) as the news headlines have proclaimed. Prof Du Plessis argued that South Africa's fiscal policy over the last 20 years has done exceptionally well in reducing its debt and that this may mitigate the adverse effects of a junk status rating. However, he did emphasise that there are underlying fiscal challenges that will have a negative impact on South Africa's economy in approximately five to seven years if not addressed. A downgrade to junk status, he said, would be like "shouting fire where there is no possibility of fire; it does not help us to think seriously about [the underlying fiscal] issues".

South Africa will not be the first country in recent years to face the prospect of being downgraded to junk status. In recent years Portugal, Spain, and Italy have either been hovering just above junk status or have indeed been downgraded. But while these countries are still struggling to service their debt, downgrades have not been catastrophic. Greece, on the other hand, has been struggling to recover financially ever since it was downgraded to junk status in 2010.

5. Regulating the Agencies

The fact that the findings of rating agencies have the potential to cause major havoc in economies has urged many to call for closer scrutiny of their operations. Since the subprime mortgage crisis many governments have moved to put in place some form of regulation, but "these moves have been inadequate and largely symbolic.[4]" One of the reasons behind the need for regulation is that there can be a clear conflict of interest – rating agencies are paid by the very issuers whose products they rate. On the one hand, the agencies have to satisfy the issuers' need for a high rating while, on the other, they seek to provide accurate information to the investing public. According to a world-renowned economist, Joseph Stiglitz[5], this can be likened to what university professors call 'grade inflation'.

In 2014 the European Commission adopted "package of measures designed to apply stricter new rules for the regulation of credit rating agencies". These include, for example, stricter disclosure requirements for bond issuers and originators and sponsors of structured finance instruments, and new reporting requirements regarding the fees charged by rating agencies. Hopefully, at some point, a requirement for greater openness and transparency will also come into play.

6. Conclusion

It is clear that the power of rating agencies cannot be overestimated. They make it easier for potential capital-market investors to evaluate the creditworthiness of potential borrowers, and they give a 'seal of approval' to public and private entities that run their financial affairs responsibly and sustainably. However, because rating agencies do often get it wrong, there should not be an over-estimation of the accuracy and reliability of their work. There should be an understating that rating agencies are ultimately business entities with the self-serving interest of extracting maximum profits. It is also worrying that the opinions of only the three largest credit-rating agencies matter most. Perhaps a greater degree of competition in the sector would itself lead to more openness and more objectivity. That would serve both lenders and borrowers better.

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[1] Of Stellenbosch University, Pretoria University, and the Alternative Information and Development Centre (AIDC), respectively.
[2] Conrad Beyers, et al (2016): *Junk downgrade: A self-fulfilling prophecy?* Fin24.com, 21 April 2016. Available online at http://tinyurl.com/hmync2g
[3] The Economist (2014): *Credit where credit's due*. 19 April 2014. Available online at http://www.economist.com/news/finance-and-economics/21601020-ratings-industry-has-bounced-back-financial-crisis-credit-where
[4] Herbert Kawadza (2016): *Who will rate the rating agencies?* Sunday Times, 15 May 2016.
[5] *Ibid*