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Credit Rating Agencies: A Constitutive and Diachronic Analysis.

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Introduction

Credit rating agencies such as Moody's and S&P (Standard and Poor's) have been subject to close examination by policy-makers since the Enron bankruptcy of 2001. Enron operated through a complex set of companies linked by carefully timed payments. The agencies did not spot the precarious financial engineering lurking behind Enron's books, and lost credibility when the company collapsed without any warning. Concerns about what the agencies do and how well they do it were subsequently greatly heightened by the onset of the global financial crisis in 2007. Concerns focused on the role of the agencies in the mortgage market and the transformation of illiquid housing loans into liquid securities. This market seemed to allow for the disconnection between the supply of housing lending to homeowners and the financial markets built around the housing market. This is what at the time was called the 'originate and distribute' model. Many observers have blamed the agencies for the elaborate financial engineering involved and have questioned both their competence and motives. The public panic about the agencies gave rise to new demands for regulation of what until recently has been a largely ungoverned industry.

In this paper we argue these efforts to regulate rating agencies have been largely ineffective, bringing more heat than light to the challenge of governing the credit rating agencies. The current regulation of credit rating agencies is more in the nature of a tax than a carefully designed framework of rules which shape what the rating agencies do in the direction of desired outcomes that expand societal welfare. Indeed, the process of building a regulatory approach has been so drawn out that it now threatens to throw any future agenda of credit rating agency reform into disrepute. Why have governments not been able to regulate credit rating agencies like they regulate other institutions in the financial markets? Why is the regulation we have, or that may be contemplated, seemingly so insubstantial? What is missing in our understanding of the agencies that would allow for effective intervention? What is the problem and what could and should be done about the rating agencies?

We argue that some of the reasons for this failure stem from the nature of rating itself, which seems to be poorly understood by regulators and by the financial industry. Rating agencies are not banks. Indeed, they are not financial institutions. But their specific characteristics seem lost on many trying to understand them and what they do. Beyond this important question about understanding what the agencies actually are and how they function, we argue that rule-making has focused on superficial regulative governance. Normally, this sets the boundaries on what the agencies can do, prohibits specific activities and sets penalties for infractions, although in rating it largely amounts to a licensing system. Most regulation is of this rule-making type. It works well in many areas. But it works badly for banks because of banks' ability to engage in regulatory arbitrage (Rethel and Sinclair 2012). Banks tend to side-step the intent of the law and pursue their ends via other means the law has not prohibited. We think similar problems pervade rating, perhaps even more so because the agencies are not involved in financial transactions (which can be identified specifically for regulatory purposes). In this context, regulation needs to take a different form, which we call constitutive, and address the very purpose of the credit rating businesses. We claim this broader and deeper form of regulation has some hope of reforming credit rating agencies.

The following section of the paper considers what rating actually is and how it works. The next section examines different approaches to rating agency regulation. This is followed by an explanation of why the traditional approach to regulation does not work well in relation to the rating agencies. Last, we set out our case for a constitutive framework for rating regulation before concluding with some thoughts on prospects for rating agency governance.

What rating actually is and how it works

Credit ratings are opinions on the creditworthiness of financial and non-financial corporations, local, provincial, and state governments, countries, and the securities issued by these entities (Sinclair 2005; Abdelal 2007; Paudyn 2013). A credit rating consists of a letter that corresponds to a given probability of default, usually accompanied by a text rationale. Credit ratings may be publicly available or require subscription. Credit rating agencies may charge investors or issuers according to their business model. The three principal credit rating agencies – Moody's, Fitch and S&P – adopted an issuer-pays model in the late 1960s and early 1970s, and provide free access to their ratings, although they charge for additional information.

Table 1
Credit Rating Scales

Moody's Investors Service	Fitch/S&P
Aaa	AAA
Aa	AA
A	A
Baa	BBB
Ba	BB
B	B
Caa	CCC
Ca	CC
C	C
N/A	RD[1]/D

[1] Fitch uses the category Restricted Default or RD to refer to the circumstance where non-payment is selective or partial.

The process through which ratings are assigned by internal rating committees was traditionally obscure. In the last twenty years or so this has changed with more market and regulatory demands for transparency. Regulatory pressure since the Enron bankruptcy has made the process more publicly accessible, although the specific deliberations of rating committees remain entirely confidential. Ratings are not mere calculations. They are judgements made by committees and it is not clear if quantitative or qualitative data prevail in the assignment of ratings by these committees. All the agencies follow more or less the same procedure. A credit rating may be solicited or unsolicited. The former is sought by the issuer and implies cooperation between the two parties. The latter is issued at a credit rating agency's initiative and relies mostly on public information and information internal to the agency. When the rating is solicited, the agency analyses the environment in which the issuer operates and considers firm-specific information obtained through the interaction with managers. Rating analysts recommend a rating to a rating committee of senior agency staff, who determine the rating. The process lasts around a month and the rating is revised once a year or earlier if any particular developments occur.

In principle, ratings have an important function: they allow investors to get to know issuers and their plans. Ratings reduce the asymmetry of information between investors and issuers and encourage the allocation of funds to the best entrepreneurs thanks to economies of scale in gathering and diffusing information. Credit rating agencies' work is convenient to investors because it allows them to make investment decisions based on information which would otherwise be costly for them to gather. Furthermore, rating agencies provide a constant monitoring of managers and government officials (or at least the possibility of monitoring). The threat of a ratings downgrade may encourage officials to act in the interests of bondholders rather than themselves. Finally, ratings may act as a governance tool by influencing issuers' financing strategies. Evidence suggests that when evaluating debt issuance decisions firms take into account the potential impact of those decisions on their credit ratings (Kisgen 2006; Hovakimian *et al*. 2009). Indeed, the cost of debt is highly correlated with credit ratings, making firms extremely keen to maintain their ratings at the highest possible level.

Anyone who is familiar with the rating business has probably skimmed through the above paragraph, waiting for the interesting part of this paper. However, misunderstandings of what ratings are and what they are not are more common than one might expect. Fitch states that "ratings, including Rating Watches and Outlooks, assigned by Fitch are opinions based on established criteria and methodologies....Ratings are not facts, and therefore cannot be described as being 'accurate' or 'inaccurate'" (Fitch 2014: 4). On the other hand, in the section of the Dodd-Frank Act dedicated to rating reform the words "ratings" and "accurate" are associated more than once. Notwithstanding its relevance, a rating is not a formal certification of a corporation's financial statements. Credit rating agencies are not liable for their opinions and do not audit the information they use. As will be clearer in the next part of the paper, the mismatching of perceptions about ratings among market participants is one of the causes of the misuse of ratings. The market and regulators often seem to forget that credit rating agencies are actually private entities operating to maximise their profits. Credit rating agencies' authority in the market has increased over time as disintermediation has become a secular trend in global financial markets. Those looking to raise funds increasingly bypass relatively expensive bank borrowing, which bears the costs of bank overheads including failed loans, and seek funding in the capital markets directly by issuing bonds. Ratings are the tools through which credit rating agencies perform their institutional role, and they seem to have acquired a value which goes beyond economic efficiency. Ratings represent an accepted and reliable reference to financial practitioners just as school grades represent a reference for parents, employers or university admissions offices. Even though the educational system may be criticised on different levels, professors' authority to give grades is rarely questioned.

There is a remarkable affinity between credit rating agencies and the rating of restaurants. This comparison helps with understanding the role of credit ratings by showing that the epistemic authority obtained by the rating agencies over time and its consequences are not due to the particular sector in which they operate or to the regulation they are subject to, but are inherently rooted in markets of a specific form. These are markets characterised by the asymmetry of information between customers and providers, scope for subjectivity in product or services' evaluation, and the high costs of product comparison by the consumer. In other words, these are markets in which knowledge intermediation in some form is needed.

The Michelin Red Guide is the world's most famous restaurant rating book. It awards one to three stars to selected restaurants according to quality. Restaurants included in the guide, but not awarded with a star, are deemed to be good restaurants. Unworthy restaurants are not included at all. Credit rating works in a similar way. The big three agencies assign creditworthiness symbols to financial securities around the world. Safer securities are assigned higher investment grade ratings, while the risky ones are considered speculative grade. This latter sort of restaurant is not included in the Michelin guide. There are no 'junk' grade restaurant ratings. In the rating world speculative or junk bonds are included and investors are not told to avoid trading in them. However, if they do buy and sell them, they bear higher risk in exchange for the higher return. A customer may prefer to have dinner in a cheaper restaurant not included in the Michelin Guide, bearing the risk they will consume food they may come to regret.

The Michelin Guide covers 23 countries in Asia, North America and Europe. For each restaurant the guide provides a short description written in the language of the corresponding country, but the symbols are universal. Some American food critics have suggested the guide is biased in favour of French cuisine. Steven Kurutz of the *New York Times* alleged that in New York more than half of the restaurants with stars "could be considered French". The big three are not exempt from similar criticism. As Sinclair (2005: 120) suggests: "Even if rating is increasingly transnational, the mental framework of rating remains largely American". A typical example is the Japanese case. Japanese managers and financial institutions complain about judgments made about the unique Japanese corporate governance system by the U.S. credit rating agencies. According to them, this leads to lower ratings. The Japan Center for International Finance (JCIF), in a 1999 survey of 175 financial institutions and 89 industrial firms found 90 per cent partly or totally disagreed with the following statement: "the rating standards of the U.S. rating agencies (Moody's and S&P) appropriately reflect specifically Japanese factors in areas like corporate governance" (Shin and Moore 2003: 329).

Although the Michelin guide is one of the most famous and consulted restaurant guides in the western world, being French-oriented is only one of many criticisms of the guide. These are collected by Pascal Rémy, a former Michelin inspector, in L'*Inspecteur se Met à Table* ("The Inspector Spills the Beans"). We will discuss some of the criticisms of the guide due to their similarity to those of the credit rating agencies.

Rémy alleged that the Guide has loosened its standards, favouring profits at the expenses of customer needs. According to him, Michelin has reduced the number of inspectors and their restaurant visits in France over the last ten years. In the same way, Congressional investigations have accused Moody's of being more focused on market share and short-term profits than rating accuracy, after being spun off as stock market as a listed corporation in 2000. Kedia *et al.* (2003) find empirical evidence that Moody's ratings were more favourable than S&P's both for new corporate bond issues and outstanding bonds after 2000. The authors also show that the loosening of Moody's credit rating standards is more relevant for structured finance products and financial firms' ratings that represent the most profitable activities for credit rating agencies. We assume that for both restaurant guides and credit rating agencies the primary aim of their businesses is profit maximisation, and if laxer standards and less monitoring (fewer restaurant visits) do not weaken their reputation, it is optimal to cut costs. Both Michelin and the big three have gained significant market power over time. Their reputations are deep-rooted and this allows them to engage in profitable strategies and operations that may reduce the quality of their services compared to provision in the past.

The agencies' and Michelin's market power also derive from the inability of users to effectively evaluate rating performance. According to Rémy, the results of research conducted by Michelin showed that 90 per cent of customers could not tell the difference between a three star and a two star restaurant. Exploiting customers' lack of 'taste', managers assigned the stars to restaurants regardless of inspectors' suggestions, according to criteria other than food quality, related to marketing strategies. It may be that credit rating agencies could be similarly accused of having exploited investors' lack of expertise when rating CDOs (collateralised debt obligations) and other complex financial products prior to the onset of the global financial crisis in 2007. Indeed, the relatively new nature of these products and their complexity prevented investors from critically evaluating their creditworthiness, and this gave ratings huge value, but also much more scope for subjectivity. Moreover, credit rating agencies increased their involvement in complex financial products well beyond the mere examination of creditworthiness. They participated in the design of the products themselves. However, their subsequent ratings were stronger than might have been expected because of a lack of experience and resources specific to the new products, and perhaps because of the desire to boost the business of rating structured products and especially ancillary services. Similar tendencies can be observed with Michelin. In 2011, Japan had the highest number of restaurants in the world awarded Michelin stars. This generated concern about whether the Michelin guide was adopting lower standards in Japan in order to enter the market and do marketing for the parent auto tyre manufacturing company.

Concerning conflict of interests, Rémy accuses the Guide of being influenced by lobbying activities and by chefs that use the media to threaten Michelin's reputation. The guide's publication director Derek Brown replied: "There's no possible way that we can be influenced like that because we are not working for the profession. We're working for the customers and I can't insist on that enough" (Lee 2004). The issue of lobbying is even more of a concern in the case of credit rating agencies given their issuer-pays business model. Are credit rating agencies really working in the interests of investors? Do they, instead, favour issuers' needs? Investors' needs should be the first concern for credit rating agencies because investors are the final users of ratings, and issuers have no incentive to want ratings if they do not matter to investors. In practice, issuers have asymmetric information about the degree to which ratings really matter to investors. Empirical economic literature shows that there is a significant market response to rating changes (Hand *et al*. 1992; Holthausen and Leftwich 1986; Dichev and Piotroski 2001; Bannier and Hirsh 2010). However, a direct causal effect cannot be clearly identified. For example, market reaction to rating changes may be explained by regulatory investment constraints or by contemporaneously released information. Given this asymmetry, issuers are likely to continue to demand ratings even if they do not have any ascertainable information content for investors. In this sense, an issuer-pays model creates the potential for market distortions, suggesting returning to the investor-pays model would be preferable if practical. Investors would be more demanding about rating standards if they paid, and would have greater incentives to find alternatives, placing a constraint on credit rating agencies' market power. However, as is the case with well-known chefs and the Michelin Guide, governments and big corporations might still retain lobbying power in relation to the credit rating agencies despite a return to the pre-1970 investor-pays model. Their bargaining power is generated by the information they possess about their own businesses, as credit ratings would be less useful if they were not based on private information from inside the company. Moreover, if the investor-pays model, which is vulnerable to the free rider problem because investors may obtain ratings information freely from issuers, hampers credit rating agencies' business model and profits, as was the case in the busy bull market of the 1960s, this might lead to lower quality ratings and the decline of the business sector. This discussion of the best business model to adopt is far from comprehensive, but it shows regulatory intervention into how the rating business is funded may be useless or even detrimental, given the complexity of the issues. Mutual trust between issuers, investors and rating agencies is the key element irrespective of business model.

Besides the business model, another difference between the Michelin Guide system and the credit rating agencies is the anonymity of the restaurant inspectors and the randomness of the restaurant visits. This procedure guarantees the performance of the chef on the day of the visit to be average, other things being equal. This is difficult to translate to the credit rating business, in which cooperation with managers and private information represents a value added to agencies and investors. At the same time, as is the case with restaurants if they knew the inspector was visiting, issuers are keener to provide positive information than negative to the raters. The only condition under which the rating business would be perfectly informative is one in which investors are able to exactly evaluate rating performance and consequently adapt their own behaviour. In that case, issuers would have no incentive to give biased information if they want ratings to work for them. However measures of rating performance are necessarily long-term in nature, and historical data is not readily available to investors. Unless regulators find a way to reconcile anonymity and private information, or to prevent issuers from giving biased information, possible regulatory provisions seem to be weak in this context.

Many authors and credit rating agency experts ascribe the privileged position of the big three to the regulatory framework in which credit rating agencies operate. The necessity to be recognised by the SEC (U.S. Securities and Exchange Commission) and references to ratings in financial regulation are thought to be the causes of undeserved power on the part of the credit rating agencies. However, the parallel with Michelin shows that the same privileged position leading to the same problems may occur without any regulatory intervention. For example, White (2010), Partnoy (1999, 2007), Cornaggia & Cornaggia (2011) among others think that restrictions on institutional investors ability to invest in speculative grade securities rated by the big three may have enhanced credit rating agencies' market power by forcing investors to rely on ratings. However, the heavy reliance on ratings by investment managers is easily explained by reference to the restaurant example without regulation. If you plan a dinner with your boss, you may not want to take the risk of taking him or her to a bad restaurant, and so you may consult the Guide before making a reservation. Even if the restaurant turns out to be disappointing, you can always blame the Guide. This is why an investment manager may choose to invest in securities rated by the big three rather than other competing agencies. They are guaranteed by the credit rating agencies' reputation. If failure does occur the agent may not be condemned because he or she has relied on globally recognised credit rating agencies. The Red Guide has existed for more than 100 years, selling 30 million copies in France alone, without any regulatory intervention. The Guide acts as a certification and information provider. Even though the criticisms highlighted here may suggest the Guide's information quality has decreased over time, its certification value has become so important this suffices to maintain its market power. Given the similarities between restaurants and the ratings market, it seems reasonable to think the credit rating regulatory framework has only played a subordinate role in strengthening the rating agencies' market power.

Forms of rule

We argue attention to rules governing behaviour is actually mistaken when it comes to finance and rating agencies. The global financial crisis occurred not because of rule-breaking but because some relatively simple but crucial social relationships came apart and prevented market actors from transacting with each other, as they had prior to the crisis. This breakdown involves quite different sorts of rules to those normally considered by regulators. What fell apart are what we call the constitutive rules of global finance. These are the rules that make financial markets work. Following John Searle, these rules are the social practices, like trust, that make transactions possible between market participants (Searle 2005). Without these rules there can be no markets. Regulation, in the sense of rules governing behaviour, was not the primary issue behind the crisis, and so changing the regulative rules of finance will not prevent crises of similar seriousness in future. Searle suggested it is possible to distinguish regulative rules that "regulate antecedently or independently existing forms of behavior…" from a much more architectural form of rule (Searle 1969: 33). These other "constitutive rules do not merely regulate, they create or define new forms of behavior". He goes on to suggest that chess and football are only possible with rules. The rules actually make or constitute the game. The point which follows is that the public and elite panic has focused specifically on the regulative form of rules and on those who allegedly broke these. But we argue that this is not the problem. Constitutive rules were damaged in the crisis, the basic social foundations of market interaction, such as trust and confidence in transactions, and this is why the crisis was so profound. Finding bad guys is not the answer.

The regulative approach is associated with the hegemonic way of understanding finance. This has dominated economic thought about finance for at least thirty years or more and has had a major influence on policy-makers. This tradition we label the exogenous approach (Sinclair 2009). Exogenous accounts of finance assume market participants are constantly adjusting their behaviour – for example, whether they buy or sell bonds and stocks – based on new information. In this context, market prices are assumed to always reflect what other market participants are prepared to pay. If this is the case, reason exogenous thinkers, prices are never inflated or false. They must always be correct. So the idea of a 'bubble economy', in which assets like houses, stocks and oil futures deviate from true value to a higher, false value, is rejected. Similarly, regulation is an external imposition by institutions and governs activities in markets which they conceive to be natural interactions.

The endogenous account, by contrast, says that financial crises begin primarily inside finance and that markets are social institutions with a history of their own. For Keynes, the 'animal spirits', or passions of speculation, give rise to risky activity. Typical of the endogenous perspective is the idea that market traders do not merely integrate information coming from outside the markets in the wider, real economy, but are focused on what other traders are doing, in an effort to anticipate their buy/sell activities, and thus make money from them (or at least avoid losing more money than the average).

Keynes provided what remains perhaps the best intuitive illustration of the importance of this internal, social understanding of finance in his tabloid beauty contest metaphor, first published in 1936 (Keynes 1936: 156; Akerlof and Shiller 2009: 133). Keynes suggested that the essence of finance is not, as most suppose, a matter of picking winners, based on an economic analysis of which assets should rise (or fall) in value in future. More relevant was anticipating what other traders in the market were likely to do. Keynes compared finance to beauty contests that ran in the popular newspapers of his time. These contests were not, as might be assumed, about picking the most attractive face. Success was achieved by estimating how others would vote and voting with them. So, for Keynes, markets are driven not by the fundamental analysis of commodities and companies, but by the much more immediate social dynamics of anticipating the future actions of others.

The exogenous-regulative approach to understanding finance, crises and by extension the rating agencies, suggests the solution to the problems created by the agencies can be found by tinkering with the rules that regulate the agencies. But the confidence financial markets had, prior to

2007, reached such a frenzy that it became an episode of 'irrational exuberance', like so many financial manias in history. The 'bad news' about subprime lending was actually quite modest in summer 2007, but in the context of the preceding mania this was enough to act as a tripwire and cause panic. The panic created widespread uncertainty about the quality of financial institutions and their balance sheets. It is this uncertainty that effectively brought the financial markets to a halt, forcing government intervention.

This alternate account of the origins of the global financial crisis points the finger at euphoria rather than rule-breaking as the source of eventual breakdown. Given this, simply amending the rules of behaviour is not the right remedy to the problems of banks or credit rating agencies. The problems are not regulative but constitutive, and change needs to be pursued at this much more architectural level. In the next section we discuss the rules-based approach to governing the agencies, and show how it failed. After this we will suggest possible constitutive solutions based on an endogenous understanding of credit rating agencies.

Rules for the rating agencies have failed

Since their appearance in the U.S. financial market, state and federal regulators have considered credit ratings a convenient tool for determining credit worthiness and have employed ratings to set banks' capital requirements[1] and to regulate the securities' market.[2] In the municipal bond market they were essential as early as the 1920s as bonds issued without ratings increasingly would not sell without the issuer offering higher interest. Initiatives to use ratings in regulation in the United States started during the Great Depression in the early 1930s, and expanded up to the Enron crisis in 2001. On the one hand, the recourse to credit ratings has enabled state and federal regulators to protect investors against credit risks while keeping the regulatory framework flexible and dynamic. On the other, the reliance on ratings may have enhanced the market power of the incumbent credit rating agencies. The formal adoption of ratings in regulation could be understood to have conferred on credit rating agencies a "regulatory license", as suggested by Partnoy.[3] However, we identify a different mechanism through which regulation has affected the rating industry. In our view, the use of ratings in financial regulation has *certified* the reliability of ratings, encouraging the market to rely on them more than it would have given a different regulatory approach.

Ratings are heavily employed in private contracts, as governance tools to solve or ameliorate principal-agent conflicts, and by banks in their internal risk evaluations. Demanding one or more ratings has become a standard practice in the market. Investors may base their decisions on information sources other than ratings but securities issued without a rating may be deemed 'suspect' or 'problematic' and be discarded in favour of rated ones. Indeed, ratings seem to be recognised as necessary market 'standards' by participants (Kerwer 2005). This is confirmed by a survey by Cantor, Gwilym and Thomas (2007), in which fund managers were asked about their use of ratings (see Table 2). The survey shows that ratings are used mostly because they are mandated by clients and far less because relying on ratings is deemed to be a good investment strategy by the professionals. Other reasons cited for the use of ratings are herding behavior and regulatory requirements.

Table 2
Use of Ratings in Investment Management

Motivation (percentages)	Fund Managers	Plan Sponsors
Mandated by regulation	20	4
Mandated by clients or internal guidelines	80	56
Most other managers (plan sponsors) do it	14	20
Good Investment Strategy	12	20
Source: Survey by Cantor, Gwilym and Thomas (2007)		

After the Enron collapse in 2001 and the subsequent strong attacks on the agencies by market participants, the press and politicians, and regulators became more critical of the agencies and started to investigate the industry. This led to the International Organization of Securities Commissions (IOSCO) code of conduct in 2004 and the U.S. Credit Rating Agency Reform Act of 2006. IOSCO's Code of Conduct focused on the quality of ratings and on credit rating agencies' independence, conflicts of interest, and responsibilities to the public. Several investigations subsequently reported that on balance credit rating agencies complied with the IOSCO code with a few exceptions (European Committee of Securities Regulators report 2006; the French securities regulator, *Autorité des Marchés Financiers*, report 2005). One issue was thought problematic: the provision of ancillary services to issuers by the agencies. For example, credit rating agencies may give advice on the structure of debt issues in order to help the issuer obtain higher ratings from themselves and other agencies. But this practice puts the rating agency in the position of "auditing its own work" (Mishkin 2003: 8). Credit rating agencies may in these circumstances have incentives to issue more favourable ratings than they would have done otherwise in order to expand their consulting business. The fact that credit rating agencies decided not to abandon the provision of ancillary services such as this in order to comply with the IOSCO code of conduct should have set alarm bells ringing at the SEC. Instead, the SEC seem to have underestimated the significance of the issue.

The U.S. Reform Act became law on September 29, 2006 with the aim of fostering competition in the credit rating industry together with establishing accountability of credit rating agencies and increasing the transparency of the rating process. Specifically, the act establishes a new registration process to create a clear route for a rating agency wishing to gain Nationally Recognized Statistical Rating Organization (NRSRO) status with the SEC. Any rating agency with at least 3 years of experience and meeting certain quality requirements can register with the SEC, according to the new system.[4] However, the introduction of a formal process of recognition of NRSROs has had little substantial effect. Even though the number of NRSROs has increased after the reform, new entrants have mainly focused on niche markets and rate a relatively small number of issues.[5] The oligopoly of the 'big three' has not been threatened by the new NRSRO process. Indeed, the market shares of Moody's, S&P and Fitch (based on revenues) were still about 40 per cent, 40 per cent and 15 per cent respectively as of 2008 (Caouette, Altman, Narayanan, and Nimmo 2008: 82.). Reducing regulatory barriers has not been enough to increase competition because the historical advantages of the major agencies and economic barriers are still at work. In order to compete with the 'big three,' significant financial resources and expertise are needed, given the degree of internationalisation of the rating business. In fact, the key element in the rating business is global reputation, which represents a very significant barrier for new entrants. Incumbents' reputation also negatively affects investors' demand for the product of startup credit rating agencies. For example, portfolio managers, who do not directly bear the risk of debt defaults, prefer to stick to the well-known 'big three' even at the expense of quality. Indeed, they would incur some costs if they had to justify recourse to minor (and thus non-standard) agencies' ratings.

This attempt to reform the system failed because it did not address a fundamental issue: understandings of the role of ratings differ between the credit rating agencies themselves, and issuers and investors. Credit rating agencies state that their ratings are merely opinions. Issuers actually want them because they represent a market 'certification', irrespective of any specific regulatory requirements. But issuing an opinion does not necessitate the same amount of effort, responsibility and caution as does certification in, say, maritime or aviation safety. Credit rating agencies do not, as we have noted, audit the information they use. Ratings are based on public information mixed with private data, and in the case of unsolicited ratings only public information. Moreover, as the number of clients increases, fewer resources are devoted to a single rating. "Certainly the relationship between an issuer and the credit analyst is nothing like the relationship the issuer has with the engagement partner of its external audit firm or with the corresponding attorney at its outside law firm. The credit analyst "only has very infrequent personal meetings with company management, is responsible for the ratings of dozens of issuers, and is not paid based on any relationship with any issuer" (Frost 2006: 17). New regulatory provisions can be effective only if they challenge the differing understandings of the role of ratings between issuers and investors on one side and credit rating agencies on the other. Similarly, there is a gap between how rating agencies understand their role and the expectations of policy-makers and regulators. For example, U.S. Senate committee staff have at times characterised credit rating agencies as 'outside watchdogs', although the agencies have never portrayed themselves as such.

Heightened criticism of credit rating agencies emerged as a consequence of the global financial crisis which started in 2007. This criticism suggested the credit rating agencies should be held responsible for the crisis, having enhanced the market for complex financial products with their ratings. The complexity of structured finance products together with its spectacular growth in terms of relative market value is acknowledged to have played an important role in increasing the business of credit rating agencies. "From 2000 to 2007 Moody's rated nearly 45,000 mortgage-related securities as triple-A [...] In 2006 alone, Moody's put its triple-A stamp of approval on 30 mortgage-related securities every working day" (U.S. Financial Crisis Inquiry Commission 2011: Conclusions: XXV). This process, in which favourable ratings were issued to senior tranches of structured products, means that the underlying non-investment grade assets went to the market with very high ratings. These ratings determined not only the ability and incentives of 'regulated' investors to buy risky products, but also made them more attractive for non-regulated investors reassured by the good reputation of 'the big three.' Credit rating agencies participated closely in the creation of these investment opportunities by supplying preliminary feedback on the rating of the tranches. As became apparent in the summer of 2007, credit rating agencies had failed to manage the ratings of structured products effectively, possibly due to weakened reputational incentives, perhaps because of weak resources, or both. "Moody's [...] relied on flawed and outdated models to issue erroneous ratings on mortgage-related securities, failed to perform meaningful due diligence on the assets underlying the securities, and continued to rely on those models even after it became obvious that the models were wrong" (U.S. Financial Crisis Inquiry Commission 2011: 125-126).

In response to the problems of the financial system that led to the financial crisis, in 2010, President Obama signed the Dodd-Frank Act into law. The Act also addresses issues related to credit rating agencies, focusing on the level of public oversight and accountability, standards of liability and concerns about conflicts of interest. The intention was to reform the rating system, but the measures suffer from the haste needed to repair past inertia. The most representative example of the lack of foresight and thoughtfulness in the Act is the repealing of Rule 436(g). After the repeal, credit rating agencies would be potentially exposed to 'expert' liability when, with their consent, ratings were included in Asset-Backed Security registration statements. This was a liability to which they were not exposed before having always been protected as opinion-givers by the First Amendment to the U.S. Constitution. The immediate reaction of credit rating agencies was to not allow debt issuers to include their ratings in prospectuses or debt registration statements. This reaction by the credit rating agencies was not anticipated by Congress. Agency reaction, which led to the "repeal of Rule 436(g) prompted severe dislocation in the trillion dollars asset-backed securities market ..." (Ishmael 2011). Rule 436(g) of the Dodd-Frank Act was repealed by the Asset-Backed Market Stabilization Act of 2011. This episode reveals the continuing leverage of credit rating agencies and the limited ability of regulators to reform the rules governing the system. The use of ratings is so deep-rooted in financial markets that, even if substitutes to ratings exist, they find it hard to compete against ratings. This circumstance, more than favourable regulation, gives credit rating agencies such strong bargaining power. As Sinclair (1994) anticipated, rating agencies have become more socially and economically powerful than their 'bean counter' image suggests. An increase in transparency, accountability and competition may be achieved only by substantially changing the rules of the rating business itself, starting with greater understanding of ratings amongst market participants.

More effective rule

Attending to a new framework of regulative rules for credit rating agencies could provide some short-term political relief to politicians, but is unlikely to make credit rating more effective. We think there is another approach to the rating agency problem. This approach addresses the core purposes of credit rating agencies rather than just trying to limit their actions. The broad aim must be to make the agencies self-regulating, in the sense that they come to organise their work around the broad purpose of their work, which should be determined by regulation. The justification for prescribing what business credit rating agencies are in is that their work has systemic implications. Physicians are licensed and are disciplined by self-regulating professional bodies because the consequences of their misbehaviour are considered very serious. While lives are not at stake here, livelihoods are, and potentially on a global scale. Rethel and Sinclair (2012: 26) considered the same issue in banking. Drawing on Searle (2005), Cox (1987) and Sinclair (2005), they looked at the problem along two axes. On one axis they considered the logic of bank practice, distinguishing between a synchronic approach and a diachronic one. Drawing on Cox, the synchronic mentality is concerned with short-term instrumentalities and the diachronic with understanding linkages, longer-term implications and the complexities of creating and producing. The synchronic mentality is characteristic of financial speculation and the diachronic of investment for growth. On the other axis they considered regulation, distinguishing between regulative rules which limit behaviour, and constitutive rules, which make institutions and behaviours, like the game of chess, what it is. Rethel and Sinclair suggested that contemporary banks are typically synchronic and regulative in character. We argue this is a fair characterisation of the credit rating agencies today too. But historically, from their origins until some point around the new millennium, the agencies could instead have been characterised as diachronic and constitutive in outlook. Indeed, this was their very purpose, what gave them a role in the otherwise synchronic world of finance. Their role was traditionally to act as a disciplinary agent, as a mechanism of governance, as a restraint on the narrow and short-term motivations of finance. The transformation of this mentality into a synchronic and regulative one is what really needs to be reversed if the agencies are to make an effective contribution to financial market governance in the future. The puzzle is: how is this return to the traditional credit rating agency mentality to be achieved, and what does it comprise?

The first step is to clarify the business of the agencies and make them stick to this work. Because of the systemic risks attached to the agencies we cannot allow them to engage in any business activities that threaten the integrity of their core business. Such activities might undermine the quality and reputation of their core business, imperilling their functioning. Like a banking license, a license to provide credit rating services should prohibit other work such as advising, or force divestment, where associated units have undertaken other work in the past. Sarbanes-Oxley had this effect, forcing accounting firms to sell their other non-audit businesses, such as their legal units. Prescribing the business they are in will make the agencies less likely to focus on non-core, potentially more profitable activities that might compromise their reason for existing.

We argue that the second element in bringing about a constitutive transformation of the rating agencies back into what they traditionally were and what they need to be in future is much greater clarity and openness about the subjectivity and limits of credit ratings. Because ratings combine quantitative data and qualitative information they are not objective, replicable forms of knowledge, even if issuers and investors want them to be this. They are subjective judgements about what might probably happen in the future. Occasionally, observers express shock when they realise ratings have this standing. This may be because the agencies, although always acknowledging that ratings are judgements in the small print, are happy to take advantage of the authority that can be derived from the production of knowledge people mistake for science.

Open and direct acknowledgement of the subjectivity of ratings could take a similar form to that required of home lenders who typically have to state directly and without qualification that 'your home is at risk of foreclosure if you do not keep up your payments', or similar. Requiring all ratings websites and contracts to undertake ratings to display a similar warning that ratings are subjective judgements about the future would make all parties more aware of the challenges inherent in rating, encouraging parties – issuers, investors and the rating agencies – to be more judicious. We think the repeated acknowledgement of subjectivity will help to reposition rating back to where it was before the explosion in structured finance stimulated hubris about the scientific possibilities of financial knowledge.

Our third major mechanism through which to push rating agencies back toward a diachronic and constitutive way of operating is to encourage community norms amongst credit rating agencies. Such norms have always existed, even if rating agency officials were eager to deny they were even aware of the activities of other rating firms. But membership in a professional society or industry association would make scrutiny of these norms possible, enable their enforcement, and help to systematically socialise industry participants into good and bad ways of operating. We envisage this as a self-regulating organisation, but one that, like those for medical practitioners and other professionals, is compulsory for firms to operate and for their employees to work as credit rating agency professionals. While professional and industry bodies have elements that are rent-seeking about them as they can exclude rivals, we think the self-interest in improving standards, in training, and in promoting the work of the agencies outweighs these costs.

This is not an exhaustive view of how to turn around the agencies, but we think they focus squarely on the root causes of the problems with rating agencies. Those problems will not be solved by rules governing the behaviour of rating agencies. Nor do we consider other ideas such as the creation of a public sector allocator of ratings or even a new international organisation to do this work addresses the issues effectively. The logic of this last proposal seems to rest on the idea that random allocation or forced reallocation of rating contracts will somehow improve the quality of ratings, but we think it risks providing income to new firms that the market would not otherwise judge worthy of the business. For this reason we think it a suboptimal approach.

Conclusions

Credit rating agencies are very poorly understood institutions and thus far the efforts to govern them through regulation have been weak and ineffective. Governments and other observers have taken a regulative approach to governing the credit rating agencies, and this is where they have produced weak interventions. If we want to produce better ratings and rating agencies we need to approach the challenge like a driving instructor does. The first task here is to train the new driver to control the car effectively. Only after this has been achieved are the minutiae of a specific jurisdiction's road rules relevant. It is the same with rating. The global financial crisis revealed that the credit rating agencies were no longer operating under conservative, diachronic constitutive norms. Devising the means through which these norms can be rewritten in an organic way, via self-regulation, is necessary for making the agencies the wise watchers of the capital markets once again. We argue this can be done by prescribing the business the agencies are in, and proscribing peripheral activities. Acknowledgement of the limits of rating will limit hubris by all parties. Encouraging the development and enforcement of community or professional norms in the rating industry is also required. None of these will turn rating into science. Nor need it. But the diachronic and constitutive approach advocated here will help to prevent credit rating agencies becoming the catalyst to another global financial crisis in the foreseeable future.

Notes

[1] In 1973 the U.S. Securities and Exchange Commission (SEC) adopted new broker-dealer net capital requirements based on bond ratings issued by credit rating agencies registered as Nationally Recognised Statistical Rating Organizations (NRSROs). Since 2001, banking capital regulations under the Recourse Rule have enabled banks to hold lower capital for purchases of higher-rated securities. Basel II makes use of credit ratings for bank portfolios in one of three alternative frameworks for assessing capital requirements.

[2] For example, credit ratings were used as eligibility criteria for companies seeking to use 'short form' registration when registering securities for public sale. In 1936, the U.S. Comptroller of the Currency formally prohibited banks from buying speculative securities. To identify eligible securities banks were explicitly instructed to rely on at least two 'recognized' bond rating manuals. Immediately, credit spreads between investment grade and speculative grade bonds widened, and issuers started to seek ratings before issuance of their bonds.

[3] Partnoy (1999, 2007) argues that the most successful credit rating agencies have benefited from an oligopoly market structure that is reinforced by regulation.

[4] Before the reform, the national recognition of NRSROs was based on a "No Action" letter, a document the SEC sent to NRSROs to authorise them implicitly (by committing to no action against them by the SEC).

[5] On its website the SEC states that 10 credit rating agencies are currently registered as NRSROs, eight of which are registered for issuers of asset-backed securities.

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