

Power of the credit ratings agencies crashes and burns, so what's next?

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During the good times it was convenient for millions of investors to not do their own thinking and simply rely on the rating given. *Photo: Bloomberg*

AT A TIME when global bond markets are turning their backs on credit ratings agencies, the corporate regulator ASIC is slapping itself on the back for helping Australia become the second country in the world to win endorsement from the European financial services watchdog over its regulation of the industry.

Australian Securities and Investments Commission chairman Greg Medcraft said yesterday the European Securities Markets Authority's backing of Australia's credit rating agency regulation will facilitate Australian debt issuers' use of their Australian-issued credit ratings in the European Union.

While it is a good thing that Australia has strengthened its regulation of rating agencies, they are rapidly losing their relevance in debt markets, which is a clarion call to regulators to start focusing on what is becoming relevant so they can ensure that is properly regulated, instead of chasing their tails.

To put it into perspective, Standard & Poor's recently downgraded the credit ratings of 12 European countries, including France and Spain. The market didn't flinch but instead appeared to reject its evaluation out of hand by buying up government debt bondholders. Long-term French bond yields hardly moved and borrowing costs fell at the country's sale of €8.59 billion (\$A10.65 billion) in bills. Spain, whose rating was cut to an A-rating, sold debt at half the interest rate of a month ago.

Ditto for the US, which lost its AAA credit rating last August yet US treasuries have continued to outperform AAA-rated corporate bonds. Indeed, the US is currently borrowing at less than 2 per cent interest on long-term bonds, while Australia, still rated AAA, borrows at close to double that.

The truth is investors are well ahead of the curve when it comes to debt and equity investments. While the ratings agencies base their assumptions on the past, investors are making assumptions about the future. For this reason, the ratings are always playing catch-up with the market, which makes their ratings look outdated and stating the obvious.

The agencies are also suffering massive credibility issues after being exposed during the global financial crisis as being captured by the financial system in terms of the AAA credit ratings they granted to trillions of dollars of complex derivatives. These derivatives were really junk and, like Warren Buffett predicted in 2003, eventually blew up the financial system.

Even before that, questions should have been raised as to how they got it so wrong on companies such as Enron or Worldcom, which were ascribed as investment grade days before they went belly up.

In the wake of the GFC, many Europeans have lobbied to have them banned, while others want regulators to strangle them with regulation. More recently, China's central bank governor, Zhou Xiaochuan, warned Chinese companies to do more of their own due diligence rather than rely on the credit assessments of the big three credit ratings agencies. He referred to the AAA rating of subprime mortgage products as "modern financial magic".

Despite all the flak, and the massive erosion of confidence in their assumptions, they have managed to hang on, partly because governments and the media continue to give them the same credence afforded them pre-2006. For instance, when Moody's reaffirmed Australia's credit rating at AAA late last year, Treasurer Wayne Swan made headlines saying it was a resounding endorsement of Australia's sturdy public finances and strong economic

fundamentals. "At a time when other developed economies have had their ratings cut, or put on review for potential downgrade, Australia stands tall in the world with its gold-plated AAA status safe and secure," he said.

But it seems 2012 could be the year they pay the piper. In Australia they are now liable for their ratings and if they give consent to having a rating put in a prospectus, they are exposed if they get it wrong.

In the US they recently lost two US judgments, which could open the floodgates to more legal action. Their defence, that they should be protected by the First Amendment free speech, was tossed out. In one court case, the ratings agencies argued that the US Constitution protected them from claims that they issued inflated ratings on more than \$US5 billion of securities issued in 2006 and 2007, and backed by loans from former Thornburg Mortgage and other lenders. In a recent judgment, it was found that the ratings were shared with too small a group of investors to deserve the broad protection sought.

During the good times it was convenient for millions of investors to not do their own thinking and simply rely on the rating given to the investment. This took great trust on the part of investors and brought great wealth to the agencies and it could never have happened without the US Securities Exchange Commission imbuing the agencies with the full faith and credit of the US government. This was the beginning of their rise to power and mystique. But what the SEC giveth, it took away in 2006, and along with it their power. Between the Europeans wanting to outlaw them and everyone else starting to ignore them - the survival after the GFC is a testament to their determination to stay alive. The new focus should be what's next.



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